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ECONOMIC REFORM PROGRAMME

OF

NORTH MACEDONIA
(2022-2024)

COMMISSION ASSESSMENT

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

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1. EXECUTIVE SUMMARY

The economy rebounded in 2021 and growth is expected to gradually accelerate in the mid-term. 2021 saw a solid recovery from the COVID-19-induced recession, supported by external demand and private consumption, while inflationary pressures increased during the year. The programme's baseline scenario is optimistic, with growth expected to average 5.2% between 2022 and 2024, benefiting from a global recovery from the pandemic and a planned increase in public investment to historically high levels. In a context of high uncertainty, the growth outlook for 2022 is, as elsewhere, subject to a series of downside risks due to the impact of Russia's war against Ukraine, the future course of the COVID-19 pandemic, global and domestic inflationary pressures, e.g. from strong wage growth, and potentially tightening financial conditions. Large implementation risks connected to private and public investment could also weigh on the growth outlook. War-related risks could in particular translate into further rises in energy and food prices and less favourable external trade developments due to a deteriorated growth outlook in the main EU trading partners.

Public finances improved in 2021, and the ERP aims to stabilise debt in the medium term, by curbing current expenditure. Tax revenue recovered in 2021, and the fiscal deficit narrowed significantly, to 5.4% of projected GDP, also on account of under-implementation of the very ambitious capital expenditure budget. This came in spite of a rise in subsidies, transfers, and government consumption, mainly resulting from crisis needs. Between 2022 and 2024, the ERP expects fiscal consolidation to continue, and the general government deficit to drop to 2.9% of GDP by 2024, mainly due to savings in current expenditure, as crisis-related support measures are slowly phased out. The deficit is expected to decrease, while remaining above its pre-crisis level. Public debt, which rose sharply in 2020 due to pandemic-related financing needs, is projected to rise further in 2022, and to decline thereafter, but to stay above 60% of GDP during the programme's horizon. The declared objective is to restructure the budget, i.e. improve the composition of public finances, by significantly raising the share of capital expenditure. These plans largely depend on the unwinding of pandemic-related fiscal support, and on strong GDP growth. However, they are not sufficiently underpinned by concrete consolidation measures on the revenue or expenditure side. Hence, the envisaged consolidation path seems unrealistic, despite a likely overestimation of capital expenditure, considering that government activity in addressing shortcomings in the management of public investment is protracted.

The main challenges facing North Macedonia are the following:

- **Downside risks to the economic recovery call for a cautious phasing out of fiscal support while rebuilding fiscal space in the medium term.** The economy started to recover in 2021 from the downturn induced by the COVID-19 crisis. Due to high uncertainty about potential further pandemic effects and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. At the same time, once the recovery is on solid grounds, the country needs to return to more prudent fiscal positions and to stabilise debt levels in the medium term. This should be supported by strengthening fiscal governance. Once adopted by the parliament, the provisions of the new Organic Budget Law (OBL) should be swiftly implemented, particularly its fiscal rules, and an independent fiscal council be set up.
- **The implementation of budgeted capital expenditure remains weak largely because of shortcomings in the management of public investment.** It is important to address these shortcomings to ensure a rigorous and transparent project selection and efficient preparation and implementation, given the government's plans to significantly raise capital

investment. Measures should be based on the approved action plan. Adopting the new legal framework for public-private partnerships could provide additional financing sources for public infrastructure projects. The country's revenue-to-GDP ratio is, by comparison, very low. Revenue collection suffers from substantial - primarily structural - weaknesses, including a comparatively narrow tax base, and shortcomings in technical and human capacities. These need to be addressed, so as to facilitate the move towards a reduction in the primary balance.

- **Competitiveness of domestic companies, investment and global value chain integration is undermined by a challenging business environment.** This includes a large informal economy, a lack of skills, innovation and technology adoption, low productivity and the need to modernise and digitalise public administration. COVID-19 had significant negative effects on the economy of North Macedonia and exacerbated these structural challenges, causing companies to reduce their investment in development of human and physical capital. At the same time, the crisis has revealed vulnerabilities in global value chains, which also affected the companies of North Macedonia. Improving the competitiveness of local companies and benefiting from the post-COVID-19 restructuring of global value chains will require improvements in human and physical capital and the business environment, including better enforcement of business regulation and corporate governance, a more focused investment attraction strategy, less complex state-aid rules, as well as better services including trade and transport logistics. Greater investment in research and innovation, as well as further regional integration, could further support competitiveness.
- **The Russian aggression against Ukraine clearly demonstrates the urgent need to accelerate the clean energy transition as a way to reduce vulnerability to external shocks and increase energy security.** At this stage, the economy of North Macedonia is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistently high dependency on highly polluting lignite coal, and inefficient energy consumption. A sustainable post-COVID recovery will have to address longer-term transition to green growth, particularly in the context of geo-political shocks and bearing in mind the upcoming carbon border adjustment mechanism. Energy supply is unreliable and efforts on energy diversification need to be improved. The government has annual targets on raising the share of renewables in energy consumption, but, at this stage, renewable energy still only accounts for a relatively small share of power generation and hydropower is the most exploited renewable source of energy. Energy efficiency has the potential to significantly reduce the impact of energy costs on the competitiveness of the economy by reducing the need for energy overall, but measures to improve energy efficiency are hardly progressing. While energy transition and the sustainability of the energy system are priorities in the recently adopted government program, demonstrating the government's commitment to the green transition, implementation will be a challenge and needs to be accompanied by enhanced institutional capacity.
- **The education system does not adequately equip young people with the key competences – skills and knowledge – that they need to actively participate in the labour market.** While North Macedonia has made good progress on the number of people with higher education, insufficient quality of education and business structures weigh on the persistently high unemployment level and a still-significant share of young people not in employment, education or training (NEET). The education strategy and the related action plan prioritise equipping young people with high-quality competences to prepare them for the labour market, but State financial support is insufficient and inter-sector coordination

still needs to be improved. Students and families receive limited career guidance when making important choices and curricula are not always in line with labour market needs.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 12 July 2021 has been partially implemented. Notably, on formalising the informal economy, the government adopted a new 2021-2022 Action Plan along with a report on the implementation of the previous Action Plan (2018-2020). By preparing a decision to appoint the Deputy Prime Minister, steps were taken to coordinate the 2018-2022 strategy for formalising the informal economy. Efforts were made to improve the national e-services portal (www.uslugi.gov.mk) which provides electronic services to citizens. The country shows a continued commitment to streamlining para-fiscal charges. North Macedonia focused the development of a new financing formula on primary and secondary education and is planning to review the financing of the vocational education and training (VET) system. A national council was established to develop a new financial model for higher education. Staff received training in an effort to improve the Centres of Social Work. On active labour market policies, North Macedonia provides more targeted solutions to low-skilled and vulnerable unemployed individuals. Structural reform measures planned in last year's ERP (2021-2023) were only partially implemented.

The key challenges identified in the ERP match those identified by the European Commission. The planned structural reform measures nearly entirely focus on addressing the identified key challenges, following a fairly coherent but not always strategic vision for the country's economic development, consistent with other national plans and strategies. The impact assessment of the structural reform measures could be further improved to allow prioritisation based on measures' economic, social and environmental impact. The shared European growth model based on the green and digital transition will also have to be strengthened in the ERP process for North Macedonia, even more so in the current geo-political context. While North Macedonia continued to successfully implement the Digital Agenda for the Western Balkans and the Regional Roaming Agreement, further efforts are needed, particularly to increase access to broadband, e-government and digital skills.

2. ECONOMIC OUTLOOK AND RISKS

In 2021, the economy started to recover from the pandemic-induced downturn. After a major economic recession in 2020, real output increased in 2021 by an estimated 4% y-o-y, mainly driven by exports and private consumption. Strong real wage growth, stable inflows from remittances as well as substantial government support measures, with a budget totalling about 5.4% of cumulative GDP in 2020 and 2021, bolstered household's disposable incomes and thus supported the economic recovery. Investment was markedly above the level of the previous year. Both, exports, benefiting from the recovery of foreign demand, and imports, driven by firming domestic demand, surged. Mainly on account of wage subsidies and liquidity support, the labour market proved resilient, with employment increasing further.

The programme expects increased growth dynamics largely driven by domestic demand. A large rise in public investment, further increases in disposable incomes stemming from solid employment growth and further strengthening transfer inflows from abroad, flanked by continued government support measures are projected to be the key determinants for investment and household consumption. On the external environment, a gradual stabilisation of global supply chains is expected, which should have boost exports. However, due to strong domestic demand and a high import content of exports, import growth is also projected to be rather high, leading to an overall small negative contribution of net exports to economic growth. Overall, the ERP expects real GDP growth to accelerate from 4.6% in 2022 to 5.7% in 2024, resulting in average real growth of 5.2% over these 3 years. This is about one percentage point higher than in the previous programme and much above the historical pace of expansion in the pre-COVID-19 years, mainly reflecting stronger projected investment and private consumption. On average, investment is expected to increase by 8.9% a year during the programme period, while private consumption is expected to increase by 3.9% on average. As a result of strong growth, the ERP forecasts that the pre-crisis level of production will be reached during 2022, while the projected output gap remains very negative, but would close in 2023. The labour market is set to benefit from the strong economic recovery, as well as from additional policies to boost job creation through active labour market measures and business support. The high investment spending is projected to have a positive effect on capital formation and thus also on labour productivity.

The programme's projections are rather optimistic. The macro-scenario significantly exceeds the forecasts of the Commission and international financial institutions. The macroeconomic outlook continues to be affected by relatively high uncertainty in the recovery phase from the COVID-19 pandemic and new risks stemming from Russia's invasion of Ukraine. In particular, the recent strong increase in energy prices and persistent supply bottlenecks in the labour market might have more permanent effects on the country's general price dynamics. This could impede disposable income and the expected acceleration in private consumption. Propelled by government subsidies and rises in both the minimum wage and public sector pay, real wage increases have recently far exceeded productivity developments, harming external competitiveness of North Macedonia.¹ The GDP projection relies significantly on the large projected scaling up of public investment, which is very optimistic, also in view of added fiscal pressures arising from the energy crisis. On the upside, the global recovery as well as a more vigorous return of investors to the country, could benefit the country's manufacturing industry given its proximity to the EU market. In particular, progress

¹ As of the last quarter of 2020, there has been a renewed, slight increase in overall productivity and the rise in unit labour cost has slowed down somewhat.

on the country's EU accession could represent a major boost to consumer and investment confidence and thus support the country's economic catch-up.

The programme presents two alternative macroeconomic scenarios based on identified risks to the baseline projection. The programme contains two lower growth scenarios, looking at external and domestic risks, respectively. The materialisation of unfavourable external risks would result in a lower average annual output growth of 4%, while domestic risks scenario would lead to output growth of 4.6%. Both of these scenarios still seem rather benign.

Table 1:

North Macedonia - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP								
Real GDP (% change)	-4.5	-6.1	4.0	4.1	3.9	4.6	3.7	5.2	n.a.	5.7
<i>Contributions:</i>										
- Final domestic demand	-3.5	-7.6	5.0	5.8	4.7	5.3	4.1	5.8	n.a.	6.2
- Change in inventories	-2.3	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	1.3	1.5	-1.0	-1.7	-0.8	-0.7	-0.3	-0.6	n.a.	-0.5
Employment (% change)	-0.3	-0.3	1.1	0.8	2.6	3.1	2.5	3.5	n.a.	3.8
Unemployment rate (%)	16.4	16.4	15.7	15.8	15.1	14.4	14.6	12.9	n.a.	11.4
GDP deflator (% change)	0.9	0.9	1.9	5.7	1.4	2.4	1.0	2.0	n.a.	2.0
CPI inflation (%)	1.2	1.2	3.3	3.2	2.1	2.4	1.8	2.0	n.a.	2.0
Current account balance (% of GDP)	-3.4	-3.4	-3.6	-3.8	-2.6	-3.8	-2.2	-2.4	n.a.	-1.6
General government balance (% of GDP)	-8.2	-8.3	-6.1	-6.4	-4.9	-4.3	-4.3	-3.4	n.a.	-2.9
Government gross debt (% of GDP)	51.2	51.9	54.5	51.9	56.3	53.3	58.1	53.0	n.a.	51.7

Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

The ERP expects import-driven inflationary pressures to subside in the coming years. Inflation picked up in 2021, driven by higher prices for food, energy and transport, mainly due to increasing global prices, and reaching 4.9% y-o-y in December 2021. As a result, annual average inflation rose to 3.2% in 2021, compared to 1.2% the year before. Core inflation was less buoyant, but nevertheless rose to 4.2% in November. The programme projects annual average consumer price inflation to level out from 3.2% in 2021 to its long-term average of about 2% in 2024. This is based on a projected slowdown in the growth of energy prices and decreasing price pressures for primary goods as a result of the gradual unblocking of supply chain bottlenecks. The programme acknowledges significant risks related to the currently high volatility of energy prices and the possibility of renewed supply chain disruptions in case of a COVID-19 resurgence. The programme's baseline inflation forecast is on the optimistic side. As a small, open economy with a de-facto currency peg, the country's price level is largely determined by international price developments. But higher than assumed inflationary pressures could also result from domestic demand, given the expectation that the output gap will close in 2023 and turn significantly positive in 2024, and given the continued upward trend in nominal wages in 2021. The latter was boosted by the government's decision to hike the minimum wage by 18.5% beginning in March 2022, while public sector wages and pensions will also be increased markedly this year.² The Central

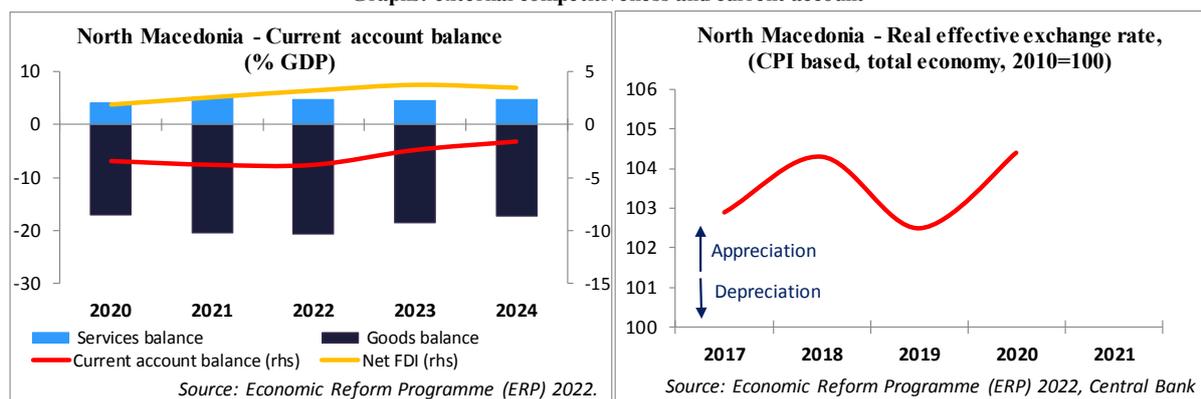
² The government recently changed the methodology for the indexation of pensions to a 50% CPI- and 50% wage-based formula, which is likely to push up the pensions bill. It also granted a temporary supplement for pensioners for April, May and June 2022 in the amount of 1000 MKD.

Bank maintained its accommodative monetary stance by lowering the policy rate to 1.25%, in March 2021.

The projected fall in the current account deficit is optimistic and partly relies on expected improvements in the country's trade structure. The merchandise trade deficit widened in 2021 (-3.3 pps. to 20.3% of projected GDP), as imports surged, driven by higher prices for energy. At the same time, private transfers increased by 3.9 pps. y-o-y to 17.3% of projected GDP. Overall, the current account deficit widened from 3.4% of GDP in 2020 to an estimated 3.5% of GDP in 2021. The programme expects it to narrow as of 2023, to reach 1.4% of GDP in 2024. The merchandise trade deficit is expected to rise slightly in 2022 (+0.5 pps. to 20.8% of projected GDP), given sustained high imports of energy, and then to gradually decrease to 17.2% of GDP in 2024, thanks to stronger external demand and the expected further transformation of the country's trade structure towards higher value-added products. According to the programme, private transfers, as a share of GDP, would gradually decline to 15.2% in 2024, i.e. below the average of the 5 years pre-COVID (16.7%). This projection might have benefited from some more information regarding its assumptions. The diversification of exports towards higher value-added products has not progressed much in the past few years and remains a challenge in the short term. The primary income deficit is expected to deteriorate slightly, towards 4.4% of GDP by 2024, reflecting foreign investors' earnings projections. Given the planned sizeable increase in investment as a share of GDP, from 33.8% in 2021 to 35.9% in 2024, the projected improvement in the current account balance would necessitate a significant rise in domestic savings, which is however not further discussed in the programme.

Inflows from foreign direct investment are projected to more than cover the current account deficit and bolster foreign reserves. In 2021, foreign direct investment (FDI) inflows rose to around 3.7% of projected GDP, up from 1.5% of GDP in 2020, fully covering the current account deficit. The programme expects a further increase in the role of FDI for financing the current account, reflecting a recovery of the global economy from the COVID-19 pandemic but also taking into account planned government measures to increase the country's attractiveness to FDI. FDI inflows are expected to increase from 2.6% of GDP in 2021 to some 3.5% on average during the programme period, which is in line with the -year average before the pandemic. External vulnerabilities remain contained. Gross external debt is projected to have inched up somewhat in 2021 (+3 pps. y-o-y to 81.3% of estimated GDP). Taking into account mid-term public debt refinancing needs, it is projected to rise somewhat higher in 2022 and then to decline. A high share, about 70%, of external debt continues to be long-term. Additionally, at some 37% of total external debt, intercompany loans and trade credit represent a less risky and more flexible category of debt, as the programme notes. The country's net international investment position had deteriorated in the third quarter, compared to one year earlier, mainly on account of increased public borrowing abroad. Foreign reserves increased markedly in 2021, covering about 4.8 months of prospective imports at end-December, as funds from the second tranche of the EU's macro financial assistance (MFA) as well as IMF Special Drawing Rights flowed in, and the central bank intervened in the markets, resulting in net purchases. The programme expects foreign reserves to rise further. It presents stress-test results on shocks to GDP (stronger sensitivity of debt dynamics), the primary deficit and interest rates (less sensitive).

Graphs: external competitiveness and current account



The financial sector remained stable during 2021. The sector's key indicators, such as capital adequacy ratios, liquidity, and profitability recovered from the COVID-19 shock. Borrower relief measures, in the form of loan moratoria for households, ended in 2020, for corporates in 2021. So far, while the number of restructured loans increased in the first half of 2021, there has been no marked impact on the non-performing loan (NPL) ratio. This may, however, remain a risk for the future, when government support to households and corporates is phased out. Private sector credit rose by some 5-6% in 2021, supported by credit lines from the European Investment Bank, as well as the temporary relief for banks on reserve requirements for loans to vulnerable companies. The currency denomination of domestic credit moved further towards denar-denominated loans, partly thanks to government measures to bolster the use of the country's domestic currency. Banks continue to dominate the financial sector of North Macedonia, accounting for some 82% of sector assets. Banking sector concentration remains moderate and was almost unchanged compared with previous years, with some 57% of assets held by the three biggest banks in 2021. Ten out of the sector's 13 banks are predominantly under foreign ownership, accounting for some 75% of the sector's assets. The banking system remains well-capitalised, but there is a need to preserve capital in view of the likely future rise in NPLs, following regulatory normalization. The Financial Stability Law, attributing the key macroprudential role to the central bank, is currently awaiting adoption in the parliament. Important legislation on financial stability, such as the Bank Resolution Law and the Law on Deposit Insurance, is still in the drafting phase.

Table 2:

North Macedonia - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	7 513	8 187	8 945	9 490	9 779***
Foreign ownership of banking system (%)	70.1	71.4	72.8	75.0	
Credit growth (aop)*	2.4	6.6	7.2	6.4	5.8
Deposit growth (aop)	5.7	8.6	9.6	7.8	8.3
Loan-to-deposit ratio (eop)	93.4	91.5	88.4	87.1	86.9
Financial soundness indicators (eop)					
- non-performing loans**	6.3	5.2	4.8	3.4	3.2
- net capital to risk-weighted assets	14.2	15.0	14.8	15.3	15.8
- liquid assets to total assets	29.8	30.6	31.9	32.5	32.4
- return on equity	13.5	16.0	11.7	11.3	12.9
- forex loans to total loans (%)	42.5	41.4	42.3	42.3	41.2

* corrected for the write-offs

** including the impact of write-offs.

*** Q3

Sources: National Central Bank, IMF, Macrobond.

3. PUBLIC FINANCE

Public finances improved in 2021 on the back of stronger than expected revenue, and in spite of large expenditure increases. On 28 July, the parliament endorsed a budget revision for 2021. It raised the planned central government fiscal deficit from initially 4.9% to 6.5% of GDP, since higher total spending (by 8.6%) was only partly offset by stronger revenue (by 4.7%), compared to the original budget. The increase in expenditure mainly reflected the continuation of anti-crisis support³ and a 24% increase in public investment, compared to the initial plan. Allocations for subsidies and transfers rose by almost 65%. According to preliminary data on actual budget execution, central government revenue increased by 15.3% compared to the 2020 outcome. Tax income rose by 17.6%, with the biggest increase accounted for by VAT receipts (+24.1%). Income from social contributions, which benefited from government measures subsidising employer contributions, rose by 6.1%. Total expenditure was higher by 5.7% y-o-y, with the rise in current expenditure of 2.9%. The fiscal deficit eventually turned out lower than budgeted in the revised plan, at 5.4% of projected GDP. This was partly due to under-execution of capital expenditure, which reached only 79% of the revised budget, or 3.2% of projected GDP. Still, compared to the 2020 outcome, capex implementation was higher by 45.2%.⁴ The budget deficit was financed by domestic and foreign borrowing and grants, including a EUR 700 million Eurobond placed in March 2021, and the second tranche of macro financial assistance from the EU, worth EUR 80 million.

Government anti-crisis measures supported households and companies. According to the government, the fiscal impact of discretionary measures in 2021 amounted to 2.5% of projected GDP (the projection in the previous ERP was 2.9% of GDP in 2021, probably assuming higher implementation rates of the first four packages of measures). Wage subsidies continued to be the fiscally most important measure also in 2021. The eligibility criteria for wage subsidies, as well as for deferral for personal income and profit tax payments focus on firms that were generally solvent before the crisis and that suffered a revenue drop of at least 30% compared to the previous year. Special assistance was granted to economic sectors that were hit especially hard by the crisis, such as hospitality and tourism, athletes and artists. Support measures not directly reflected in the budget include liquidity support via interest-free credit lines of the Development Bank of North Macedonia (guarantees constituting contingent liabilities for the government).

³ This includes implementation of parts of the four sets of anti-crisis measures providing fiscal and liquidity support to households and companies adopted in 2020, totalling EUR 1.1 bn in allocations, with an implementation rate of some 82% (end-February 2021), and the budget for two further sets adopted in 2021.

⁴ However, payment arrears increased in 2021 by 0.6 pps. to 3.3% of GDP on account of overdue payments in the health sector, state enterprises, and local governments.

Table 3:

North Macedonia - Composition of the budgetary adjustment (% of GDP)

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	30.5	33.7	33.6	33.3	33.7	0.0
- Taxes and social security contributions	27.6	28.4	28.9	29.0	29.7	1.2
- Other (residual)	2.9	5.3	4.7	4.3	4.0	-1.2
Expenditure	38.9	40.0	37.9	36.7	36.6	-3.5
- Primary expenditure	37.6	38.7	36.6	35.5	35.5	-3.3
<i>of which:</i>						
Gross fixed capital formation	3.2	5.2	6.1	6.1	6.6	1.4
Consumption	10.7	11.6	10.8	10.3	9.9	-1.7
Transfers & subsidies	23.7	21.9	19.7	19.1	18.9	-3.0
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.2	1.3	1.3	1.3	1.1	-0.2
Budget balance	-8.3	-6.4	-4.3	-3.4	-2.9	3.5
- Cyclically adjusted	-6.2	-4.8	-3.6	-3.5	-3.7	1.1
Primary balance	-7.1	-5.0	-3.0	-2.2	-1.7	3.3
- Cyclically adjusted	-5.0	-3.5	-2.3	-2.2	-2.6	0.9
Gross debt level	51.9	51.9	53.3	53.0	51.7	-0.2

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The programme's fiscal scenario projects gradual consolidation based on lowering current spending. Over the ERP period, the general government deficit is projected to narrow to 2.9% of GDP in 2024, which constitutes an effective adjustment of 2.5 pps. compared to the estimated 2021 deficit outcome (or 3.5 pps. compared to the 2021 deficit target). The 2024 deficit would still remain larger than the pre-crisis 2019 deficit of 2.2%. Consolidation in 2022 and 2023 will be entirely based on a reduction in the expenditure ratio (-3.4 pps. between 2021 and 2024 to 36.6% of GDP), which is set to be slightly frontloaded in 2022. Notably, current expenditure would be reined in through a drop in social transfers (-2 pps. of GDP between 2021 and 2024) and in subsidies (primarily frontloaded consolidation by -1.3 pps. y-o-y in 2022). Government consumption would decline by 1.7 pps. of GDP between 2021 and 2024. In contrast, capital expenditure is projected to rise further, by 1.4 pps. in 2024, from the historically high level achieved in 2021. The revenue ratio, which is estimated to have risen, in 2021, to above its pre-crisis 2019 level, would remain broadly stable over the programme's horizon. Yet, its relatively low level, by regional comparison, reflects the country's narrow tax base and persistent problems with revenue collection. These two issues prevent a better balanced fiscal consolidation and a swifter achievement of a balanced primary budget. The ERP's projection for the cyclically-adjusted primary budget deficit points to a significant tightening in 2022, a neutral stance in 2023 (when the output gap is expected to close), and some fiscal impulse from discretionary measures in 2024 (0.4 pps. of potential GDP). Given the programme's assumption that the economy operates above potential in 2024, the renewed deterioration in the cyclically-adjusted primary balance, indicating discretionary support to demand, seems incongruous. The fiscal targets for 2022 and 2023 are similar to the previous ERP, but the fiscal tightening in 2022 is projected to be significantly larger, given that the previous programme assumed a smaller deterioration in the cyclically-adjusted primary balance in 2021 than projected by the current ERP.

The 2022 budget continues to back the economic recovery, while shifting expenditure from crisis support to public investment. The 2022 budget marks a balanced approach between the withdrawal of temporary, pandemic-related payments to companies and households; cuts in current spending; and a rise in capital expenditure. The general government fiscal deficit is projected to drop to 4.3% of GDP, down from an estimated deficit of 5.4% of GDP in 2021. It is based on a (rather too optimistic) projection of 4.6% real GDP growth and 2.4% inflation. The programme expects total revenue for the general government to amount to some 33.6% of projected GDP, marginally below last year's level. Tax income is projected to be higher by 10% compared to the 2021 outcome. Total expenditure would amount to 37.9%, which is 2.1 pps. below the estimated level of 2021, mainly due to a projected drop in subsidies and transfers (for which the programme does not provide an explanation other than the overall phasing out of crisis-related support), and in government consumption. The general government's capital expenditure would rise by 24.5% y-o-y (+0.9 pps. in terms of GDP) – a steep jump from 2021 and prone to serious implementation risks. Social transfers would increase by some 2% y-o-y (-2.2 pps. of GDP), compared to the 2021 outcome. The budget appropriately includes an envelope of non-earmarked funding, amounting to 0.6% of projected GDP, which could be used for stepping-up emergency support, allowing the government to respond swiftly in case of need.

Capital expenditure is projected to rise markedly in the medium-term. The government aims to successively raise the share of capital expenditure in total expenditure from 8% in 2020 to 18% in 2024. In terms of GDP, capital expenditure is expected to rise from 3.2% in 2021 to 6.6% in 2024. This seems overly ambitious, given the government's track record of under-implementing the capital expenditure budget, but also given the deficient framework governing the management of public investment, and the possibilities of private sector cofunding, which the government explicitly targets through its recently adopted Growth Acceleration Plan. The Plan aims for EUR 4 bn of public investment to leverage private financing for an additional EUR 8 bn (equivalent to 68% of estimated 2021 GDP) from a variety of sources, including the budget, IPA funds, and commercial loans in the 2022-2026 period. To help attract private financing, the government plans to issue new, innovative types of bonds targeted at infrastructure and green projects (development bonds, green bonds, and project-specific bonds). While the government declares its intention to redesign the structure of public expenditure in favour of capital investments, the structure of current expenditure would remain focused on social transfers over the programme's horizon (some 52% of total current expenditure), including pension payments. The share of subsidies (the bulk of it being agricultural subsidies followed by subsidies to public and private enterprises) is projected to drop from 15.4% in 2020 to 12.1% in 2024; the share of spending on goods and services would rise from 6.8% to 9%; and the share of wages and allowances would increase slightly from 13% in 2020 to 13.2% in 2024 – while the programme expects significant savings in current expenditure from lower government consumption.

The programme does not plan for specific budgetary measures that would underpin the expected consolidation, making the outlook overly ambitious. While the medium-term fiscal plans appropriately balance the needs to phase out crisis-related emergency support and to advance structural reforms and fiscal consolidation, information on concrete measures and their implementation is scarce. In support of the fiscal projections, the programme lists a number of policies aimed at reining in current expenditure; improving the implementation of capital expenditure; and enhancing revenue collection, without elaborating on or quantifying concrete measures. Overall, the ERP would have benefited from more detail on the operationalisation of these objectives, such as presented in the recent Fiscal Sustainability and Economic Growth Support Plan. In particular, the intended measures to achieve the envisaged

savings in public consumption and in subsidies to the corporate and to the agricultural sector could have been outlined. On the revenue side, more precise, and quantified, roadmaps for the streamlining of tax relief and deductions in income taxation as well as of VAT preferential rates would have informed the assessment of the government's fiscal projections. Moreover, in addition to ongoing expenditures to uphold the energy sector and maintain subsidised electricity prices for households, authorities adopted a package of measures to protect households from rising food and energy prices and to help firms maintain liquidity in the amount of EUR 400mn in March 2022, which is likely to require an adjustment of the fiscal consolidation path.

Raising capital spending remains a challenge given protracted shortcomings in public investment management. Apart from permanent savings in current expenditure, redesigning public expenditure in favour of growth-enhancing investment requires significant improvements in the management of public investment. The implementation of wider-ranging measures to improve the planning, allocation and execution of investment projects, based on the 2020 Public Investment Management Assessment (PIMA) by the IMF has seen limited progress so far. The government is in the process of setting up a dedicated unit in the Ministry of Finance, so as to ensure centralised oversight of public sector investment. Measures to ensure the productivity-enhancing character of projects, so as to support the sustainability of the economic recovery, are lagging. This concerns, among other things, the planned adoption of a new methodology for the appraisal, selection and prioritisation of projects, which, in turn, partly hinges on the adoption of the new Organic Budget Law.

The projected improvement in the primary balance is not sufficient to lower debt from its 2021 level. In 2021, general government debt remained at the same level as one year earlier, at 51.9% of estimated GDP, after having jumped by 11.4 pps. in 2020, reflecting financing needs arising from the COVID-19 crisis and the fall in GDP. The ERP forecasts that the general government debt ratio will be at the same level in 2024 as 3 years earlier, close to 52% of GDP. After rising further in 2022, the debt-reducing impact of economic growth and inflation would prevail over the debt-enhancing impact of the primary deficit, leading to a decline in the ratio. The public debt level, which includes the debt of public enterprises, stood at 60.9% of government-estimated GDP at the end of 2021, almost the same level as one year earlier. The government expects the public debt level to rise further in 2022 and 2023, reaching 63.3% of GDP (*different figure for 2023 in the Fiscal Sustainability and Growth Support Plan: 65.2%*), before stabilising in 2024, and then starting to drop due to declining fiscal deficits and accelerated economic growth. The debt level is projected to exceed the 60% threshold provided for in the draft fiscal rules (that are currently up for adoption by the parliament in the context of the draft Organic Budget Law) until the end of 2024. Although the dynamics of general government debt are driving the overall rise in public debt, the government expects guaranteed public debt (accounting for 9% at end-2021) to peak in 2023, as loans are released to finance public-investment works carried out by state-owned enterprises. It would then stabilise and drop to 6.3% of GDP in 2026, consistent with last year's expectation.

Box: Debt dynamics

North Macedonia

Composition of changes in the debt ratio (% of GDP)

	2020	2021	2022	2023	2024
Gross debt ratio [1]	51.9	51.9	53.3	53.0	51.7
Change in the ratio	11.4	0.0	1.4	-0.3	-1.3
<i>Contributions [2]:</i>					
1. Primary balance	7.1	5.0	3.0	2.2	1.7
2. "Snowball" effect	3.5	-3.3	-2.1	-2.3	-2.7
<i>Of which:</i>					
Interest expenditure	1.2	1.3	1.3	1.3	1.1
Growth effect	2.6	-1.9	-2.2	-2.6	-2.8
Inflation effect	-0.4	-2.7	-1.2	-1.0	-1.0
3. Stock-flow adjustment	0.9	-1.7	0.5	-0.2	-0.4

[1] End of period.

[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.

Source: Economic Reform Programme (ERP) 2022, ECFIN calculations.

General government gross debt is projected at close to 52% of GDP by 2024, the same level as in 2020 and 2021. Overall, economic growth and inflation will not lead to a reduction in the debt ratio over the programme's horizon due to a continued negative primary balance. After rising by 1.4 pps. y-o-y in 2022, mainly due to a still sizeable, albeit declining primary deficit; interest payments; and a positive stock-flow adjustment (replenishing government deposits at central bank with excess inflows), the debt ratio is projected to decline as of 2023, when the programme projects that the debt-reducing snowball effect will supersede the debt-driving impact of the primary deficit, which is expected to gradually decline further.

The structure of government debt carries moderate risks. Largely on account of continued heavy borrowing abroad in 2021, to meet pandemic-related financing needs, the share of foreign currency debt increased in this period (to 76% at the end of Q3-2021). More than 90% of this debt is denominated in euro, which is significantly above the minimum threshold established by the government (85%). Risks stemming from exchange rate depreciation are mitigated by the de facto currency peg to the euro. The risk to the debt portfolio from interest rate developments has declined somewhat, as the share of fixed rate debt in total debt has risen by 2.4 pps. from end-2020 to 79.5% at the end of the third quarter of 2021. The programme considers these risks by testing the sensitivity of public debt to interest and exchange rate risk. In the medium-term, the government should be in a position to refinance more of the maturing external debt via new domestic issuance, given the recent extension of the maturities of domestic issues, mitigating potential pressure on the exchange rate.

The financing of fiscal deficits and debt repayments is projected to average some 8% of GDP per year between 2022 and 2024. Apart from financing the still elevated budget deficit in 2021, the government needed to roll over a Eurobond worth EUR 500 million, which it had refinanced through new debt issued in March (EUR 700 million). The government estimates that financing requirements in 2022 will be significantly lower than in 2021 (by 11%), amounting to some 5.8% of projected GDP, and including the expected fiscal deficit (4.3% of GDP), foreign debt repayments totalling 0.8%, and domestic debt repayments of 0.7%. They would be funded through domestic (3.3% of projected GDP) and foreign borrowing, including a Eurobond. Financing needs would peak in 2023, mainly on account of a maturing Eurobond, at 9.3%, and drop again in 2024, to 6.3%. Overall, around EUR 1 490 million in foreign and domestic government debt is due for repayment in this period.⁵ However, these figures do not

⁵ In 2023, the 2016 Eurobond (EUR 450 million) matures, followed by the 2018 Eurobond (EUR 500 million) in 2025.

include potential calls on contingent liabilities the government has assumed by guaranteeing the debt of public enterprises.

Box: Sensitivity analysis

The programme includes a sensitivity analysis of the fiscal deficit based on three parameters. The first parameter is GDP growth. If average annual real GDP growth is lower than projected, by 1.4 pps. in 2022-2026, the budget deficit would increase by an average of 0.8 pps. per year. The second parameter is capital expenditure. Lower capital expenditure (about 70% realisation) would imply a reduction in GDP growth by 0.8 pps. per year and an increase in the deficit by 0.4 pps. on average annually. The third parameter is tax collection. If tax collection drops by 5% per year, this would imply a budget deficit of 4% on average in 2022-2026 (compared to 3.1% in the baseline scenario, and to 4.2% in the same risk scenario in last year's programme for 2021-2023). The programme also assesses the potential impact on debt-servicing costs of external government debt arising from higher interest rates (+1 pp. compared to the baseline) and a 10%-appreciation against the euro and other currencies.

The government's fiscal consolidation plan is subject to significant implementation risks. On the revenue side, progress in increasing public revenue by streamlining tax deductions is weak. The government could strengthen its commitment to fiscal consolidation by making fiscal policy initiatives more consistent, and by pursuing its declared intention to improve revenue collection in a more determined manner. Revenue projections might also prove optimistic if economic growth turns out lower than forecast. Some recently adopted or announced policy initiatives aimed at supporting the recovery and employment, and involving further fiscal expansion, do not comply with the requirements of being targeted and/or temporary, such as government subsidies covering the rise in employers' social contributions resulting from the 18% increase in the minimum wage effective as of April 2022; an additional, ad hoc rise in pensions, on top of the two statutory increases, in 2022; and the planned increase in public sector wages. The government intends to reduce expenditure for goods and services, in line with the planned phasing out of pandemic-related support measures, as well as expenditure for wages and allowances. It plans to generate savings from better targeting of subsidies and transfers. However, it does not specify the source of the savings, which seem to rely mainly on the unwinding of temporary support measures rather than on systemic reforms. The allocation of subsidies at company level generally remains generally opaque in terms of the sums received by beneficiaries and the criteria for allocating support. Introducing a state aid registry would make this process more transparent, and contribute to a more targeted, efficient, and growth-enhancing use of funds. Moreover, potential savings in the biggest category of subsidies, in agriculture, accounting on average for 1.1% of GDP in the period 2015 to 2020, have not been considered in the consolidation plans. Also, the pension system may require more resources than anticipated - the statutory indexation of pensions is high (+2.9% y-o-y in January, with an additional increase planned for July). Pension expenditure as a share of total current expenditure already accounts for 27% of the 2022 budget. Between 2015 and 2021, budget transfers to the Pension and Disability Fund have increased by 35%, while the Fund's pension expenditure rose by 37.4%. The government is also discussing to raise public sector wages in some key segments in 2022.

The energy crisis requires the government to find additional financing. More recently, uncertainties about the fiscal and economic cost of high energy prices have heightened risks for the fiscal scenario. For 2022, the government projects some EUR 800 million in additional costs, of which some EUR 230 million (some 2% of estimated 2021 GDP) would be direct fiscal cost, resulting mainly from subsidies to electricity producers, revenue shortfalls (estimated at some EUR 32 million) from the temporary reduction of VAT on electricity, and

transfers to households to cover the rise in energy prices. The government hopes to raise some of the needed funding from unspent budget allocations for pandemic-related measures. To cover the remaining financing needs, it is pondering a supplementary budget for early summer.

Plans to leverage private capital through public-private partnerships would require a strong legal framework. The drafting of a new law on improving the implementation of public-private partnerships, including better management of fiscal risks has been finalised, but not yet been submitted to parliament. The draft law is envisaged to address a number of shortcomings in the current legal framework governing PPPs and concessions, such as a lack of detailed administrative guidelines on selecting, implementing and managing PPP projects; and limited central oversight, as each contracting authority sets its own contract formats and terms and conditions. Currently, fiscal risks, such as contingent liabilities arising from PPPs financed by municipalities, are not systematically reported to the central government.

There was little progress in further improving the fiscal framework. The new draft Organic Budget Law (OBL), which introduces fiscal (deficit and debt) rules and provides for an independent fiscal council, and for a proper medium-term budget framework was submitted to the parliament in December 2021 and is awaiting adoption. The government started drafting secondary legislation, but implementation of the rules might take time. Clauses allowing deviations from the fiscal rules have been widely discussed, and need to be carefully drawn up so as not to endanger debt sustainability. The fiscal rules in the new draft OBL would apply to the general government whose definition is planned to be based on ESA 2010 requirements.

4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter sets out the Commission's independent analysis of the economy of North Macedonia and identifies the main structural challenges the country faces. Addressing the immediate impact of the COVID-19 pandemic as well as new risks stemming from Russia's invasion of Ukraine has been a priority for the government. However, medium- to longer-term prospects for both economic growth and resilience to external shocks will depend on the ability of North Macedonia to implement structural reforms. Each of the main challenges faced by the country influences overall competitiveness in its own way. However, because these challenges are very often mutually reinforcing, it will be essential to address them to boost productivity and inclusive growth in the medium-to-long term. The three most significant challenges the Commission identified - and essentially shared by North Macedonia - are:

- (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatch levels,
- (ii) improving the competitiveness of domestic companies, including integration into global value chains (GVCs) and reducing informal economy
- (iii) energy sector modernisation and transition to clean energy.

Education outcomes are not sufficiently linked with the needs of the labour market which prolongs the transition from school-to-work, feeding the informal economy, out-migration and poverty. Key factors that undermine the country's competitiveness, investment and GVC integration include a challenging business environment, a lack of skills, innovation and technology adoption, low productivity, a distortive effect of subsidies on competition and the need to modernise and digitalise public administration. Although tackling the immediate

challenges of the COVID-19 crisis has been an immediate priority, reform measures to foster the competitiveness of domestic companies need to be strengthened further. A sustainable post COVID recovery suggests to address longer term transition to green growth, in particular in the context of geo-political shocks exacerbating the energy crisis. Such a green transition entails significantly improving energy efficiency in buildings; promoting the distribution of less polluting energy production sources, including, as an intermediate step in the decarbonisation process, the diversification of gas supply sources and routes; and investing in renewable energy sources.

North Macedonia also needs to continue to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. The Commission is closely following issues to do with the strengthening the rule of law and the fighting of corruption in its enlargement package, including the Report on North Macedonia.

Key challenge #1: Improving the quality and relevance of the education system to increase employment and mitigate skills mismatches

The labour market of North Macedonia has shown a relatively high resilience to the COVID-19 pandemic, albeit progress in the employment rate has been put to a halt. Improvements in the labour market of the past two decades were halted by the pandemic, but the latest figures show some recovery. In the third quarter of 2021, the employment rate (20-64) increased slightly by 1.4 pps. to 59.8% and the activity rate by 1 pp. to 70.8%, compared to the third quarter of 2020. This is corroborated by the slightly shrinking unemployment rate (15-74), which in the same period fell from 16.5% to 15.5%, but is still well above the EU-27 average (6.9%). The impact of the COVID-19 pandemic, as demonstrated by the main socio-economic indicators, has so far been partially mitigated by the package of measures adopted by the government. However, long-lasting negative effects of the pandemic are still possible due to limited fiscal space. Data show that the pandemic primarily hit low-skilled workers, especially people working in agriculture, transport and manufacturing, while employment continued to increase among those with tertiary education. The ERP acknowledges the deficiencies of the labour market under the key challenge ‘Strengthen human capital for inclusive development’. However, the proposed measures only address some aspects.

Some fundamental structural weaknesses of the labour market remain. Women and young people are particularly exposed to unemployment and inactivity, as are people with disabilities and the low-skilled, particularly Roma. The population is also ageing. Many of the unemployed in North Macedonia, 75.4% in 2020, are long-term unemployed. This is more than double than the share in the EU-27 (35.8%) and higher than in the other countries in the region. The quality of available jobs remains an important issue fuelling the emigration of higher educated people (‘brain-drain’): 27.6% of employed young people works in a field that does not correspond to their level of education (World Bank, 2020). The regional disparities are strong, as the employment gap between the southeast (the best-performing region) and the northeast (the worst-performing region) remains high. With the support of the ILO, the Government developed a national employment strategy to promote more and better jobs for all. The strategy was adopted in November 2021 and aims to address the structural challenges affecting employment growth but also to mitigate the consequences of the COVID-19 pandemic.

Young people in particular continue to face difficulties in entering the labour market. 45% of young people stay unemployed for 4 years or longer after finishing school, while only 7.3% are unemployed for less than 1 year (Labour Force Survey, 2019). The employment rate

of recent graduates (20-34) is only 54%, which is one of the lowest compared to the EU and other countries in the region. The countrywide implementation of the Youth Guarantee in all 30 employment centres in 2019 led to a significant reduction in youth unemployment (aged 15-24) from 45.4% in 2018 to 35.6% in 2019 and in the share of young people not in employment, education or training (NEET) aged 15-29 from 29.8% to 24.5% between 2018 and 2019. However, the rates remain high in 2020: unemployment has stagnated at 35.7% and the NEET rate has increased to 26.2% - both substantially above the EU-27 averages of 16.8% and 13.7%, respectively. The COVID-19 pandemic has interrupted a five-year declining trend of NEETs. The report evaluating the effectiveness of the Youth Guarantee in the country has still not been released. Importantly, looking at the larger group of people aged 20-34, the broad gender gap (27.6% of male NEETs compared to 37.1% of women) indicates the social conventions or pressures which place higher importance on women's roles within the family (OECD, 2020). Further success of the Youth Guarantee scheme significantly hinges on the improvement of the employment service capacity as well as that of other providers of key services such as social protection and education.

Spending on active labour market policies is relatively high, compared to the region, but lower than the EU average. In 2020, spending reached 0.27% of GDP (EU-27 average: 0.39% of GDP in 2019). Despite the countrywide implementation of the Youth Guarantee, there has been no comprehensive impact assessment of the effectiveness of active labour market policies for many years. Active labour market policies have a limited scope and cover less than 25% of the poor. However, in 2020, 66.8% of young unemployed aged 15-29 were involved in some type of active labour market programme. Better targeting the most vulnerable categories could include a combination of additional benefits and specific activation and skills development or the establishment of mobile units to reach and work with vulnerable groups, considering also the experience gained from previous outreach support. Despite recent progress the capacity of the public employment service is hindered by: limited human resources; insufficient staff training; limited funding allocation for active labour market policies with increased dependence on EU funding allocation; and limited investment in infrastructure.

Reform measure 2 of the ERP ("*Increasing the flexibility of the labour market*") aims to extend the labour legislation, including active employment programmes, to non-standard form of work. As part of a new law on labour relations, planned to be adopted in 2022, the measure is deemed necessary due to an existing lack of legislation on remote working and working from home. Furthermore, specific active labour market measures will be directed at people in an unfavourable social position, primarily the beneficiaries of guaranteed minimum assistance. The measure aims to help increase the employment rate, decrease unemployment and reduce poverty and social exclusion. However, the measure does not focus on the right things and addresses the key challenges only partly.

The insufficient relevance and quality of education continues to contribute to skills mismatches, leading to persistent unemployment and underuse of young people's potential. The education system contributes to the lengthy school-to-work transition by failing to identify and meet the needs of the labour market. Some of the issues related to the quality of education in North Macedonia already identified in the past are still evident. The skills mismatch continues to be a major impediment to people finding work. In 2019, job mismatches in terms of young tertiary graduates aged 15-34 working in jobs below their education level stood at 35% (ETF, 2019). However, new school and VET curricula focus more on the demands of the labour market. In addition, North Macedonia has put in place an institutionalised process and tools for monitoring/forecasting skills needs to adequately align

VET, higher education, and up- and re-skilling offers to labour market needs. The national qualification framework, which was referenced to the European Qualifications Framework in 2016, was designed to support the modernisation of education and training, with a view to improving the quality of education and its adaptability to labour market needs, and promoting lifelong learning and mobility.

The education system of North Macedonia does not give young people sufficient key competences and skills they need to actively participate in the labour market. International student assessments show substantial weaknesses for students in North Macedonia and reveal disparities in learning outcomes based on the place of living, ethnicity, socio-economic status and gender. This continues to hinder companies' competitiveness and their deeper integration into the global economy. Despite substantial improvements in the Programme for International Student Assessment (PISA) results in 2018, compared to 2015, North Macedonia still ranks low among the other participating countries (68th place out of 78) and compared to its regional peers. TIMSS 2019 survey results show a similar trend, with the country's students ranking in the 45th place in mathematics and 51st place in science among the 58 assessed countries. The gender gap is a particular issue, as boys perform worse than girls. This gender gap is far greater than international averages (North Macedonia has the third largest global gender gap in reading performance). Other significant gaps are linked to students' socio-economic status, educational track, and language of instruction. The OECD has signalled that there is a specific problem in fostering the 'growth mind-set'. PISA data also highlight the need for improvements in the quality of teaching, since half of all students have not achieved basic literacy and numeracy skills by the age of 15.

A reform of the education system was planned in the 2018-2025 education strategy, but it requires greater funding. The education strategy and the related action plan both prioritise providing quality skills to young people to prepare them for the labour market. However, these two documents also state that financial support is insufficient and that inter-sector coordination is lacking. Public spending on education is clearly insufficient. North Macedonia has steadily reduced its spending on education from 4.62% of GDP in 2011 to 3.9% in 2020. This level is currently below the EU-27 average of 5.0% in 2020 and also below peer-country averages. The education system is also undermined by the inefficiency of public spending (World Bank 2019). In addition, discrepancies in student-teacher ratios in schools are significant, impacting the overall quality of education. North Macedonia is planning to draw up a new financing model to redistribute public education funding and to make it more transparent. The new financing model aims to make the funding of primary and secondary education more transparent and to regulate how the funds from the Ministry of Education and Science are redistributed by the municipalities. The current formulas have not changed for many years and do not properly account for school equipment and teacher training needs. The new system will be based on standardised input parameters, including a basic amount per student, a variable component providing funding for costs for some students in primary education, such as those from socially disadvantaged families, and a development component to be introduced in 2023 to provide additional funds depending on the schools' achievements.

Major reforms are being made in VET, but the quality of teaching is still an obstacle to participate in the labour market. Approximately 56% of upper secondary students in North Macedonia follow a vocational pathway (42 641 students in 2019/2020) – a proportion comparable to the rest of the Western Balkans and higher than the EU-27 average (43%). In 2019, 79% of the country's VET graduates subsequently enrolled in tertiary education, compared to 53% of students from general schools (World Bank, 2019). The low transition of students from general upper secondary education to higher education means that almost half

of those who leave secondary school have not acquired a specialisation to participate in the labour market. The three-year and four-year VET curricula were revised in 2019. The development of the three regional VET centres (Tetovo, Kumanovo, Ohrid) is hampered by slow parliamentary adoption of the necessary legislation. The lack of technical skills among vocational-school graduates is considered a major bottleneck by companies in North Macedonia. This is because the teaching and learning methods in VET schools are largely theoretical, offer limited practical training, and suffer from a lack of teaching and learning materials (OECD, 2019).

Reform Measure 1 of the ERP (*“Further development of the qualification system”*), rolled over from the last year, addresses the key bottleneck of the education system and builds on the activities implemented in 2021, such as the adoption of the new curricula or establishment of a National Council for Higher Education and Scientific Research. The measure reflects the key policy reforms presented in the Employment and Social Reform Programme (ESRP) adopted by the government. To implement this measure, the modernisation of three regional VET centres is key, and such centres of excellence need to be further developed throughout the country. The modernisation of the reform of VET led to an increased share of students enrolled in VET and participating in work-based learning. The measure presents indicators and a budget in the fields of employment, education and social policy. Although both the ESRP and the inclusion of the measure in the ERP signals that education is among the government's top priorities, the measure's expected impact on competitiveness could be further strengthened.

Adults' participation in learning is low. The percentage of adults participating in learning was 2.6% in 2020, significantly below the EU-27 average of 9.2%. Further development of qualifications, arrangements for validation of non-formal and informal learning and up-skilling/re-skilling programmes throughout the country are key to integrate medium-skilled and low-skilled people into the labour market. Promoting lifelong learning and the strengthening of non-formal education should help to improve workers' technical and managerial skills. This can support fast productivity growth in companies and industry.

The continuing gender gap undermines the overall economic potential of North Macedonia. The gender employment gap (the percentage-point difference in the employment rate of men and women aged 20-64) stood at 19.9 pps. in 2020, relative to the gender gap in EU-27 of 11.3 pp. The low activity of females (20-64) is characterised by a high inactivity among low-educated women (79% in 2020). This is partly due to women's traditionally lower presence in the labour market, disincentives for women to work, caring and household duties and women's lack of confidence in their skills and labour market prospects (OECD 2021) and the burden of childcare and family care. Women are much more likely to be low paid. Estimates of earnings indicate a significant gender pay gap and the potential for discrimination in the labour market against women. Women in North Macedonia also have a working life that is on average 10.6 years shorter than that of men (2020).

Emigration and population ageing further contribute to weaken the skilled workforce of North Macedonia. Emigration of workers is a serious impediment to business. The shortage of jobs – and secure, well-paid jobs in particular – is the biggest challenge that makes it especially difficult to prevent young people from leaving the country, leading to a substantial risk of brain-drain. According to projections, the share of the population aged 65 and above will double from 12.5% in 2015 to 25.4% in 2050, placing significant strain on the social protection system. This trend will gradually reduce the share of the working-age population (those aged 15-64) from 70.6% in 2015 to 60.4% in 2050 (ILO, Decent Work Programme,

2019). About 59% of businesses struggle to find workers with appropriate skills (OECD 2020). Available analysis recommends that all labour market policies are mutually consistent and contribute to keep workers in the country, including by regularly analysing and monitoring emerging skills gaps at national, regional and local levels and recognising skills acquired outside the formal system or abroad (ETF 2021).

Key challenge #2: Improving the competitiveness of domestic companies, including integration in global value chains and reducing informal economy

The COVID-19 pandemic exacerbated structural challenges, leading to significant negative effects on the country's economy with the war in Ukraine increasing economic uncertainty and slowing down the recovery from the pandemic. As regards the COVID-19 crisis, domestic economic activity plunged in the wake of containment measures, and external trade suffered from lockdowns and recessions in trading-partner economies, and through the temporary breakdown of automotive supply chains. The COVID-19 pandemic has put a significant additional burden on companies, causing them to cut their investment in human and physical capital. It has negatively affected profitability and turnover in 90% of companies and caused a drop in their productivity (International Labour Organisation, 2020). According to the COVID-19 follow-up Enterprise Survey, 70% of firms experienced decrease in liquidity, while around 40% of them needed to close down temporarily their businesses. Although tackling the immediate challenges of the COVID-19 crisis has been an urgent priority since 2020, reform measures to foster the competitiveness of domestic companies need to be strengthened further. More recently and following the Russian aggression against Ukraine, rising geopolitical tensions, pressure on energy, commodity and food prices, combined with supply-chain disruptions (including in the automotive sector) negatively affect sustainable growth and competitiveness. Adverse effects of the rising energy prices on the private sector include loss of contracts with electricity providers and an unpredictable rise in electricity and gas costs.

Key factors that undermine the country's competitiveness, investment and GVC integration include a challenging business environment, a lack of skills, innovation and technology adoption and low productivity. The country's businesses suffer from unsophisticated technology, limited capacities of production and innovation, inconsistent quality of goods and services, low investment in human and physical capital, frequent changes to the regulatory framework, low productivity and competition from a large informal sector. While since the last OECD Competitiveness Outlook, North Macedonia progressed in various policy areas, its policies to increase competitiveness need to be effectively and continuously implemented as well as stepped up to have a more sustainable impact. The future success of the economy mainly hinges on the success of a broad range of structural economic reforms, especially ones aiming to further improve the business environment (e.g. measures to combat the informal economy, simplification of the legal framework for doing business and the establishment of a fully functional state registry), enhanced support to innovation and technological development and promotion of human capital (i.e. skills development). Such reform efforts could also help attract foreign investment to sectors with high value added.

The regulatory framework's lack of transparency and predictability continues to negatively affect the business environment and the competitiveness of domestic companies, in particular SMEs. Moreover, implementation remains a challenge, also due to frequent election cycles. Contract enforcement is lengthier and costlier than in peer countries

(OECD, 2021). A new bankruptcy law, intended to facilitate market exit by reducing the cost and time⁶ of procedures, is still awaiting adoption. To effectively support a sustainable economic recovery and faster growth, the government also needs to improve the management of public investment. Decisive steps are needed to rationalise parafiscal charges at central and local levels. *Measure 12 of the ERP, “Streamline the use of parafiscal charges”, rolled over from 2021 and linked to the policy guidance.* The measure envisages the assessment of 377 previously identified parafiscal charges, aiming at further elimination, remodelling or optimisation and digitalisation. The methodology for further rationalisation of para-fiscal charges for SMEs will be established only after the 377 charges are screened and optimised. The measure should also seek to clarify the rationale for these charges and their impact on competitiveness.

To enhance the business environment will require further efforts on increasing the efficiency and transparency of public administration, in particular its modernisation and digitalisation. Especially in this challenging period, businesses need a fair, predictable and functional regulatory framework, with an effective and increasingly digital public administration (ILO, 2020). Public administration reform is an important precursor of growth and the pandemic has amplified the need for an enabling business environment, with low administrative burden and improved access to public services, allowing businesses to cope with the new challenges of the pandemic. While the national e-portal for services is being upgraded with more than 130 services, uptake is still low (*see also measure 11 in Section 6*).

The business environment also continues to be impeded by the substantial informal economy whose challenges have not been addressed decisively. Unfair competition, especially from the informal sector, is cited as a major challenge for businesses in North Macedonia (OECD, 2021). In the latest Enterprise Survey⁷, more than 50% of surveyed firms noted that they competed against informal or unregistered firms, and 40% of all firms identified this as a major constraint. According to IMF estimates, the informal sector of North Macedonia could account for as much as 37.6% of GDP. It takes various forms, notably unregistered labour, partially undeclared wages and other irregularities in the enforcement of the Labour Relations Act. Other practices common to the informal economy include not issuing tax receipts or invoices, or underreporting turnover. Undeclared work exacerbates the negative impact of the COVID-19 crisis on the economy. Backed up by high-level political commitment of all relevant institutions, the strategy and the action plan formalising the informal economy will have to be more vigorously implemented, assessed and reviewed, with specific attention paid to the business environment component. Measure 16, rolled over from the previous year and linked to the policy guidance, aims at *introducing mechanisms for formalising informal work in sectors with high incidents of undeclared activities*. However, there is scope for more effectively addressing the motives for engaging in informal business activities identified in the country’s 2018-2022 strategy. The measure focuses on employment policies and does not address other important aspects, such as taxation, including social security contributions sufficiently. Awareness raising activities are missing. Activities are delayed and the adoption of a new strategy is expected only in 2023. The proposed activities could be presented more clearly. The impact of COVID-19 on the labour market and undeclared work is not taken into account. The impact of the measure on competitiveness is not quantified and the impact on employment and gender is not sufficiently considered.

⁶ An e-auction system applied for the liquidation process has already helped to reduce the time

⁷ As agreed between the participating institutions World Bank, the EBRD and the EIB

As the lack of skills undermines economic growth and the development of a knowledge society, increasing investment in human resources is vital. Reform of the education system is sluggish and the large skills mismatch persists. While North Macedonia has made substantial progress on the number of people with higher educational attainment, curricula do not equip graduates with the necessary skills to match labour demand. Therefore, structural deficiencies of the labour market persist, restraining potential growth. Among the most important ones are low participation rates, especially for women and weak human capital development, leading to underutilised labour resources amid demographic decline. Many young people are not active in the labour market. Around 80% of unemployed are long-term unemployed, largely reflecting the skills mismatch. Both domestic and FDI companies face rising emigration and (qualified) labour force shortages.

Domestic companies' low and slow-growing productivity continues to hinder their competitiveness. The deterioration in labour productivity and price competitiveness in 2020 largely reflects the economic impact of the pandemic and the government's job-retention measures. The continued rise in wages, bolstered by crisis-induced government wage subsidies, remain a challenge for external competitiveness, given the adverse developments in labour productivity over recent years. A large share of the workforce is still employed in low-productivity and low-wage sectors (OECD, 2021). The recent increase in the minimum wage (not linked with increased productivity) entails risks of not being sustainable over time.

Productivity could be further improved by more investment in research and innovation. At 0.4% of GDP, the economy's expenditure on research and innovation has not increased over recent years, and remains significantly below the EU average. The country is an emerging innovator, according to the EU innovation scoreboard. An increased budget (but also non-financial incentives and measures for collaboration between researchers and businesses) in this area would support the country's economic recovery, also given the relevance of innovation to the Economic and Investment Plan for the Western Balkans. Even though government funding for innovation increased in 2020, private firms are reserved about adopting new technologies. The Fund for Innovation and Technological Development invests in small and medium sized enterprises (SMEs) to improve the innovative capabilities of companies and to support the adoption of new technologies that boost private sector competitiveness. Finalisation of the smart specialisation strategy delayed by the COVID-19 crisis, should consolidate the country's economic policy priorities and support the further development of sector-level strategies in the relevant fields such as education and skills, industry, research and innovation, as well as attracting FDI. Measures for closer cooperation between academia and the private sector are being implemented (*see also measure 17* in Section 6) and subsidies are being provided to companies to intensify their research and innovation capacities. The Economic and Investment plan aims to boost competitiveness of SMEs through investments in start-ups and the scaling up of innovative companies. The combination of grants and guarantees should reinforce open, innovative, business friendly ecosystems in the region based on a "triple helix" approach.

Instead of tackling the country's underlying structural challenges and business environment issues, the government's flagship policy to attract foreign direct investment (FDI) and improve domestic firms' competitiveness relies on providing various forms of state aid to businesses. In the 2019 Global Competitiveness Index, the country ranks 112 (out of 141 countries) in 'Distortive effect of taxes and subsidies on competition'. In a post pandemic environment, the extended use of State-aid schemes to support domestic companies must be based on close, continuous assessment of the business environment issues and clear policy objectives. The current model of state-aid is highly complex, untargeted and involves

too many providers. The system is characterized by a short-term perspective and would benefit from more outcome focused approach. In spite of some progress, a fully operational State aid registry and a more effective State aid notification system are yet to be developed. Measure 15 of the ERP aims at the *establishment of Management Information System on State aid* and is linked to the 2021 policy guidance. The measure will build a network of institutions dealing with State aid. It has the potential to enhance transparency for the general public and to create a level playing field for companies. The envisaged State aid registry will have to contain the legal basis (i.e. which State aid rules) based on which the respective aid is approved by the Commission for Protection of Competition. The expected impact on competitiveness is not explained in quantitative terms.

The COVID-19 crisis has shown the vulnerability of global value chains (GVCs) which represented 80% of global trade before the crisis (IMF, 2019). The dependency of the automotive sector on GVCs and the ongoing supply issues have the potential to create bottlenecks in the automotive production and to hold back GDP growth. North Macedonia's links to global value chains are still predominantly concentrated in services and low- to medium-value manufacturing (IMF, 2019). Following the outbreak of COVID-19, 45% of the country's businesses reported a decline in demand for products and services, 38% reported weaker confidence in supply chain partners, and 35% reported disruptions in the sourcing of raw materials (ILO, 2020).

Prioritising and strengthening of targeted public policies to address the underlying structural obstacles to domestic companies' competitiveness could help to attract FDI and integrate more enterprises into global value chains. Despite positive developments in diversification (FDI is concentrated in a few sectors benefiting from economies of scale on a global level), supplier linkages between domestic enterprises (SMEs) and the FDI sector remain relatively weak as foreign investors rely on imports for most of their inputs other than low-cost local labour. Such weak linkages between the FDI sector and the rest of the economy mitigate the structural transformation of the economy, economic growth and job creation (OECD 2021). The limited growth impact reflects the largely low value added activities in the country's manufacturing plants, including labour-intensive assembly and cabling. The focus should be on attracting FDI that can source more content locally. The modest growth and weak integration of enterprises into GVCs also reflect enterprises' limited capacity to innovate and adopt new technology.

Although the high-end segments of regional and global supply chains hold potential for North Macedonia, firms do not invest sufficiently in innovation or meet quality standards necessary for attracting FDI and enhanced GVC integration. This is a critical barrier to GVC integration for many industries, including the automotive sector (OECD 2021). Most domestic companies lack the capacities and skilled workforce to innovate and adopt technologies and they cannot meet the quality standards required by the automotive or other relevant industries and value chains. This stems from difficulties in accessing finance as well as human capital and skills given the shortcomings in the quality and relevance of the education system (OECD 2021).

Further developing certain service sectors such as logistics, transportation, and information and communication technologies could be an opportunity for domestic companies. Because of their size, MSMEs could become ideal providers of the types of services GVCs are increasingly asking for. According to multinationals operating in the country, 30% of the companies surveyed held the view that services needed by these multinationals do not meet the required quality standards (Finance Think, 2019). This forces

foreign companies to use alternatives outside the country. Most of these services are highly human-capital intense and require the mastery of digital tools.

While there is little evidence so far of much FDI nearshoring taking place, North Macedonia could still benefit from a realignment of global production networks in the post-pandemic phase. In that sense, the COVID-19 crisis may also offer opportunities for domestic companies to integrate sustainably into global value chains to further diversify their export structure and mitigate future shocks. Following the war in Ukraine, supply chain reshuffling may take place, especially in the automotive sector. To benefit from potential nearshoring opportunities, the country can embrace proactive policies to enhance its investment competitiveness and promote itself to potential investors based on currently successful sectors and those with identified potential. The global shift toward electrical vehicles and digitalisation holds potential to integrate into automotive, electronics and IT–Business Process Outsourcing value chains by targeting FDI in these emerging sectors (World Bank, WIIW, 2021).

The Economic and Investment Plan for the Western Balkans will help increase the competitiveness of the economy of North Macedonia backed by a green and digital transition. A substantial investment package, which is at the heart of the Economic and Investment plan, will direct a large majority of support towards key productive investments and infrastructure. A crucial element of the EIP - building a common regional market - has the potential to further enable competitiveness and growth. Implementing the plan will help the country integrate into regional and European value chains and attract FDI in tradable sectors, notably by increasing the size of its market.

Overall, North Macedonia presents 10 measures related to this key challenge in its ERP. The ones that are more closely linked to the European Commission’s assessment of this key challenge, are analysed in this section, the rest in Section 6.

Key challenge #3: Energy sector modernisation and transition to clean energy

The economy of North Macedonia is highly dependent on energy imports and characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on highly-polluting lignite coal, as well as inefficient energy consumption. The country has no gas or oil and has limited quantities of coal. Approximately ~68.7% of electricity is domestically produced and 31.3% is imported. Domestic electricity production relies heavily on lignite (41.95%) followed by hydro (16.86%) gas (10.81%), wind (1.48%), biogas (0.78%) and solar (0.33%). The country’s 2040 energy development strategy provides guidance on the direction of the energy sector up to 2040, but an action plan for its implementation is still pending. The government formally initiated an energy transition process and the country was the first Contracting Party to commit to a coal phase-out (by 2027) as a member of the Powering Past Coal Alliance. Still, the transition to low-carbon growth has been slow (OECD 2021). Challenges have been exacerbated by the Russian invasion into Ukraine. Energy prices have significantly gone up, risking higher inflation for a longer period and impacting on demand and competitiveness. The adoption of a 5-year programme for implementing the energy development strategy and an integrated national energy and climate plan will be a positive step for the Green Agenda for the Western Balkans, notably its aim to remove bottlenecks in key network infrastructures, accelerate the shift to a low-carbon economy and promote the clean energy transition and a European integrated energy market.

Energy supply is unreliable in North Macedonia and efforts on energy diversification needs to be improved. The country still faces challenges related to electricity supply. In spite of some improvements, the economy relies heavily on highly polluting coal for electricity generation and electricity and distribution networks are outdated and inefficient. Domestic lignite has a low caloric value and estimated reserves are limited to 15-20 years. Hydro capacities (particularly valuable in ensuring the fast supply of energy to compensate for surges in demand) depend on hydrological conditions, which have not been favourable in the past several years. Taken together, these factors have led to an increase in the import of electricity in recent years to 37% of the gross domestic consumption in January-September 2021, up from 32% in 2020. When considering security of supply on the basis of a diversified energy mix and sources of supply, the country's natural gas supply framework has some way to go (OECD, 2021). Distribution of natural gas, as an intermediate step in the decarbonisation process, is advancing, with efforts made to increase the transmission network. However, the country relies exclusively on Russian gas through a single connection, exacerbating the energy crisis in the current geo-political context. The diversification of gas supply sources and routes is progressing slowly. The government is taking measures to ensure the necessary funding for the construction of an interconnection line e.g. with Greece (a second interconnector towards Greece is currently in an advanced stage of planning), thereby supporting diversification of natural gas sources and facilitating access to transit pipelines⁸. The construction of a new 400kV electricity transmission interconnector line with Albania is under way. Despite recent efforts, the production of renewable energy lacks diversification. No new wind capacities have been built since 2014 (ECS, 2021). Implementing the Economic and Investment Plan for the Western Balkans, strengthening connectivity and going towards greener and more digital economies, will assist in diversifying energy supply and in reducing dependencies from Russian oil and gas imports. This includes developing gas interconnector to Serbia, Kosovo* and Greece. End March 2021, in an effort to push down prices for consumers, EU leaders agreed that member states will work together on voluntary common purchase of gas, LNG and hydrogen. The common purchases platform will also be open to Western Balkan countries.

Concerns related to energy supplies and the risk of significant price hikes prompted the government to declare a 30-day energy crisis in November 2021 which was subsequently extended to June 2022. Rising energy import costs continue to have an impact on North Macedonia, its policies, competitiveness and public finances. Russia and Ukraine are major commodities producers, and disruptions have caused global prices to surge, especially for oil and natural gas. The Energy Regulatory Commission increased the regulated electricity price for households and small consumers by 9.48% starting from 1 January 2022. At the same time, the country's own energy reserves, hydro and lignite are at a worrying low level due to unfavourable hydrology but also poor resource planning in the State owned enterprise ESM. To mitigate the energy crisis, exacerbated by the Russian aggression against Ukraine, the government undertook various measures, starting with a range of initiatives in the energy sector designed to secure supplies, shield consumers from significant price hikes (e.g. subsidizing heating prices and temporary taking over of the private heating company (BEG) in January 2022 until the end of the heating season) and ensure confidence in the state-owned

⁸ The project will Provide a diversified gas supply in North Macedonia from TAP pipeline and LNG terminals in Greece, aiming to improve competitiveness and reduce gas prices (currently only Russian gas from TBP), and to increase possibility of supply by 2.8 bcm (existing 0.8 bcm)

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

electricity generation entity ESM. More recently, Parliament had agreed a package of 26 measures⁹ worth EUR 400 million, of which EUR 90 million in tax holidays and EUR 310 million for direct payments from the State budget. If the efforts to increase domestic production fail to materialise, ESM (production) will have to reduce delivery volume and buy the remaining demand at market prices. This would lead to an extraordinary high price for the end consumer, while the need for additional electricity import volumes using current international transmission lines may cause capacity problems for existing infrastructure. Inflation expectations¹⁰ have already increased significantly and could feed into wage- and price-setting processes. As requested by IFIs, a more targeted approach to vulnerable household to offset the impact price increases is needed in the short term.

While planned investments in new coalmines and extension of the work of the thermal power plant (TPP) Bitola can provide some short-term mitigation, they may jeopardise the strategic goals of de-carbonisation and decommissioning the two TPP's by the end of 2028. The energy crisis will therefore likely have additional negative environmental effects both due to the direct effects of increased burning of lignite and oil. The government has yet to propose medium to long-term sustainable solutions. 'Just transition' activities have yet to be pursued in a determined manner while progress in activating the development of renewable energy in an efficient and transparent manner – in particular solar – is still lagging behind. To mitigate the negative social and economic impacts of the closure of coal-fired power plants and related coal mines in the affected regions, it is important to urgently work out a plan to address associated labour and regional development issues (EBRD, 2021).

North Macedonia aims to increase the share of renewable energy sources (RES) to 35-45% of gross final energy consumption by 2040. The amended national renewable energy action plan is in line with the revised binding target of 23% of energy coming from RES by 2020 and 24% by 2025. The Energy Law is fully aligned with the Renewables Energy Directive. The government pursues annual targets to raise the share of renewables in energy consumption. While at this stage, renewable energy still only accounts for a small share of power generation, important wind park and solar power plant investments are foreseen in the framework of the Economic and Investment Plan, including installation of solar power plants on the site of the exhausted coalmine in Oslomej and adjacent to the coal-fired thermal power plant in Bitola. Hydropower is the most RES in the country and several of the already-built and planned plants are in protected areas. The overall target of 23% of renewable energy in gross final energy consumption by 2020 is far from being achieved (19.22% in 2020) because of the insignificant share of renewable energy in the transport sector, not reaching even 0,5% in 2020 (ECS, 2021). Feed-in-tariffs and premiums are used to support the deployment of renewables. In 2020, contracts were signed for installing capacity 62 MW-capacity solar power plants, using premiums granted via auctions. The government should reconsider the decision to keep the feed-in-tariffs for small hydro power plants, which either do not require support or have a negative environmental impact. Thresholds for administratively set feed-in tariffs are not aligned with the Guidelines on State Aid for Environmental Protection and Energy (ECS, 2021). The capacity cap per type of renewable energy technology has to be removed to achieve the 2025 renewable energy target. Provisions on sustainability of biofuels are still not aligned. Electricity prosumers can refer to the rulebook on renewables but its implementation is lacking due to administrative obstacles. *Measure 5, rolled over from last*

⁹ For instance, a reduced VAT rate for electricity that was supposed to gradually return to 18% (planned increase from 5 to 10% in July 2022) is now postponed until December 2022

¹⁰ Inflation already accelerated to 4.9% in December 2021.

year, aims to promote renewable energy sources. It is very relevant as it will help diversify energy generation and contribute to energy supply security, with expected positive effects for the economy, by lowering the electricity costs and creating green jobs. However, the activity looks narrow in its scope as it focuses primarily on biofuels. Some activities foreseen in the previous ERP and the follow-up of the assessments performed in 2021 are no longer included, i.e. measures to improve the heating and cooling sector or on the electrification of the public transport. Schemes supporting the deployment of renewables may have to be reconsidered, in particular schemes on small hydropower. They should ensure that the incentives do not favour RES that do not require support or have a negative environmental impact. The proposed result indicators do not reflect the specific activities, i.e. use of biofuels. The impact assessment needs improvement.

Energy efficiency can boost the competitiveness of the economy through cost savings, but measures in this area are stalled. The economy is characterised by high-energy intensity with low efficiency in energy production and consumption. A Law on energy efficiency transposes the energy efficiency and the energy performance directives. Despite these improvements, implementation is lacking. Energy intensity in North Macedonia needs to be reduced and legislation on energy efficiency must be enforced. The adoption of implementing legislation remains a challenge, due to limited human and technical capacity at the Energy Department of the Ministry of Economy and the Energy Agency. Financing to promote energy efficiency is limited, and the envisaged Energy Efficiency Fund remains to be set up (activities for its establishment and operationalisation have started). There is a particular need to improve energy efficiency in buildings. To that end, a buildings renovation (and street lighting) programme with a budget of EUR 25 million is currently under way. As a member of the Energy Community and following the adoption of the Clean Energy package by the Energy Community Ministerial Council in November 2021, there is a need for timely alignment with and implementation of the Energy Efficiency Directive (2018/2002/EU). *Measure 6, rolled over from last year, aims to improve energy efficiency.* A refurbished and improved building stock will help pave the way for a decarbonised and clean energy system, as the building sector is one of the biggest energy consumers and is responsible for a high proportion of greenhouse gas emissions and air pollution. However, the lack of capacity within the public institution (Ministry of Economy and Energy Agency) for collecting and sharing information, monitoring progress and promoting energy efficiency, remains an obstacle. Insufficient information on the current energy and resource profile of buildings and the potential benefits of renovation, are among the biggest barriers to taking decisions on energy efficiency measures. The impact assessment part needs improvement.

The country's long term energy strategy, extending to 2040, considers the need for expansion in infrastructure. There also appears to be extensive international donor community involvement in investment projects (OECD, 2021). The Growth Acceleration Plan envisages offsetting up an Energy Efficiency Fund within the Development Bank of Northern Macedonia, to invest in energy efficiency and renewable energy in public buildings. Financing is also planned under the Hybrid Green and Digital Economy MSME Fund and as the Hybrid Strategic Green Investment Fund for projects undertaken by large companies. The new government has pledged medium-term investment in RES, a gas interconnection with Greece, the completion of the gasification of the country and energy efficiency. However, the same government program foresees the opening of the Zhivojno coalmine to provide domestic quantities of coal to enable stable production of electricity in the TPP Bitola for an additional 10 years. The Transposition and swift implementation of the acquis on guidelines for trans-European energy infrastructure (through a revised law on strategic investments) should

facilitate the realisation of PECEI (projects of energy community interest) and PMI (projects of mutual interest) infrastructure projects.

Energy transition and the sustainability of the energy system are priorities in the recently-adopted government programme. A sustainable post-COVID recovery, combined with the ongoing geo-political shock exacerbating the energy crisis, should involve a longer term transition to green growth in a determined manner. This includes: improving energy efficiency in buildings; promoting the distribution of less polluting energy production sources, such as natural gas, as an intermediate step in the decarbonisation process; investing in RES; and advancing on regional interconnectivity. Pursuing a business-as-usual growth model post-COVID-19 carries the risk of locking in growth on an unsustainable (brown as opposed to green) trajectory (World Bank, 2021). The process of gradually phasing out coal has to be strategic as well as carefully planned and has to be accompanied by heavy investment, including in human capital and in the restructuring of the work force. So far, the share of carbon-intensive exports in total exports in 2019 is still over 40 % (World Bank, 2021). Appropriate pricing for carbon would not only provide incentives to focus on green recovery but would also offset the adverse effect of the EU Carbon Border Adjustment Mechanism on the competitiveness of Western Balkan exports (World Bank, 2021). In line with the EIP, the Commission will support the development of renewable and less-polluting energy sources.

Digital technologies can boost the effectiveness of green transition policies. This includes innovative production and manufacturing processes and their digitisation, new business models, sustainable-by-design advanced materials and technologies enabling the switch to decarbonisation, including green digital technologies.

Overall, the country needs to continue its effort to improve the competitiveness of the energy industry. In addition to short-term measures aimed at mitigating the economic impact of the war in Ukraine, efforts are required to diversify energy supply, increase the share of renewable energy resources and to swiftly proceed with measures to improve energy efficiency. Specific attention should be given to sustainable growth given the country's potential for sustainable energy and efficient energy use. Affordable energy security can be achieved through a combination of imported natural gas, affordable local renewable energy, and energy storage technologies. In line with the Green Agenda and through the Economic and Investment Plan, the support in the field of energy will be reinforced. Strong emphasis will be put on energy market integration, decarbonisation and clean energy, just transition, increased digitalisation of the system and smart grids, energy efficiency, including modernisation of district heating, and energy security. Greening growth drivers can be an important incentive for much-needed innovation and productivity-driven growth. Despite challenges, for example in applying the EU Carbon Border Adjustment Mechanism, the green transition is also an opportunity to discover new products and new markets (World Bank, 2021).

North Macedonia presents five measures related to this key challenge in its ERP. Some of them, more closely linked to the European Commission's assessment of this key challenge, are analysed in this section, the rest in section 6.

Box: Monitoring performance in light of the European Pillar of Social Rights¹¹

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights concerning equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

Relative to the EU-27 average, North Macedonia faces challenges for a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights.

NORTH MACEDONIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., no change
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., no change
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., no change
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., no change
	Disability employment gap	Worse than EU avg., improving
	Housing cost overburden	Similar to EU avg., improving
	Children aged less than 3 years in formal childcare	Worse than EU avg., trend N/A
	Self-reported unmet need for medical care	Worse than EU avg., no change

North Macedonia steadily improved employment and unemployment rates, though they lag behind best performers in the region, and the labour market has shown relative resilience during the COVID-19 pandemic. A new legislative framework and targeted measures aiming to bring more people into the labour market is a step in the right direction, but spending on for this active labour market policy (0.27% of GDP) remains too low in scope and volume to substantially improve the situation. Despite the favourable trends in employment observed before the COVID-19 pandemic, the unemployment rate remains high and has several distinctive structural characteristics, including long-term unemployment, inequality, and large regional disparities. Women and youth are particularly exposed to the risk of unemployment and inactivity. Despite significant improvements due to the implementation of the Youth Guarantee, the youth unemployment rate (15-24) was 35.7% in 2020, while the rate of NEETs (15-29) in 2020 was 26.2%. The high rate of inactivity in the labour market is particularly characteristic for women. In 2020, 41.8% of the women aged 20-64 were out of the labour market.

The education system of North Macedonia does not equip young people with the necessary key skills and

knowledge. The low quality of the education system contributes to the lengthy school-to-work transition and the skills mismatch continues to be a major impediment to people finding work. In 2019, 35% of people with tertiary education worked below their level of qualification. However, new school and VET curricula focus more on the demands of the labour market.

The reform of the social protection system aims to better target those in need. Social assistance has very little effect on reducing poverty, both due to very low social benefits and ineffective targeting. The groups most at risk of poverty remain young people, those without education and ethnic communities such as the Roma. North Macedonia plans to continue its measures to strengthen the system for social inclusion of vulnerable groups, including by improving social services in local communities across the country.

North Macedonia has a well-developed statistical system. The State Statistical Office is the primary producer and coordinator of the country's statistical system. Since 2004, the Labour Force Survey (LFS) has been carried out every quarter, providing quarterly and annual statistics. The Survey on Income and Living Conditions (SILC) has been carried out every year since 2010.

¹¹ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance (PG) for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (43.1%) ¹²	
2021 policy guidance	Summary assessment
<p>PG 1:</p> <p>Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, foresee in the 2022 budget and the medium-term fiscal plan a gradual return to the pre-crisis primary deficit to GDP ratio.</p> <p>Also with a view to improving the realisation of capital expenditure, reinforce the management of public investment, in line with measures outlined</p>	<p>There was partial implementation of PG1:</p> <p>1) Substantial implementation. In order to mitigate the economic shock triggered by COVID-19 pandemic, the Government responded by adopting six sets of temporary economic measures aimed at protecting the liquidity of companies, preserving jobs and ensuring social protection for the unemployed and the vulnerable households. The international community agrees that the overall measures were successful in mitigating the major negative effects on the population and businesses. The State Budget for 2022 includes a programme of above EUR 88 million to cover the measures to deal with the consequences of the health pandemic and to overcome the economic consequences of the coronavirus. Ex-post assessment is needed to better appreciate the overall impact of the measures. In 2021, despite the protracted pandemic effects, the domestic economy started recovering, but in the fourth quarter slowed down somewhat, due to the impact of the omicron variant, the supply side restrictions and the energy crisis. For these reasons, the budget of 2022 needs to still focus on economic resilience. However, fiscal consolidation still remains an important policy objective of the government; the medium-term fiscal policy aims to gradually reduce the budget deficit as percentage share of GDP. Yet, the consolidation path relies on overoptimistic economic and revenue growth and it is not underpinned by concrete measures apart from the phasing out of temporary crisis support.)</p> <p>2) Limited implementation. The Government approved the Public Investment Management (PIM) action plan in 2020, covering the period 2021-2024. The capacity of the</p>

¹² For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

<p>in the related Action Plan.</p> <p>Improve revenue collection and broaden the tax base in line with the Tax System Reform Strategy, including by drafting annual action plans to streamline tax exemptions.</p>	<p>Ministry of Finance is limited and roles and responsibilities in the PIM cycle have to be further clarified. The plan envisages the establishment of a PIM department in MoF. Nevertheless, this department has not been created yet and implementation of the PIM action plan is behind schedule. The new methodology for capital spending which rewards good spenders on a quarterly basis, taking away planned capex from underperformers is operational. Persistent challenges in the capital investment policy are as follows:</p> <ul style="list-style-type: none"> - A number of policy documents not consistent with each other; no umbrella document to frame the national public investment priorities; multiple pipelines of projects, depending on the donor funding and the responsible institutions; - selection, planning, preparation, implementation and monitoring methodology for capital investments is not transparent, inclusive or based on solid criteria. - The EU proposed methodology that is implemented by the National Investment Committee was not mainstreamed to all investments. - A number of contracts were signed last year without a link to the adopted infrastructure pipelines and in a way that questions the current dominant methodology. - Very few of the co-existing pipelines include the maintenance of the existing and the new infrastructure, putting at stake the sustainability of the EU financing, (particularly of those under IPA I) - There is overlapping responsibilities and no real centre of weight at the Government to ensure monitoring over the implementation even in the case of major projects (Corridor 8 railway). - There is no central oversight. <p>3) Limited implementation. In order to improve revenue collection and optimise the tax base for most taxes, the MoF prepared a tax base analysis. There are certain deviations compared to the EU directives, which would be targeted and followed by future legal changes. MoF prepared a report on tax deductions, which are calculated as a percentage of GDP. Annual action plans to streamline tax exemptions would help to tackle the issue. Furthermore, an analysis with comparison of the list of goods and services subject to reduced VAT rate in line with the national legislation was conducted; minor deviations were noted, related to the goods and services for strategic products (e.g. agricultural mechanisation) and other products (e.g. medical services, computers). Activities to create a business intelligence unit continue as part of the twinning project "Improving Revenue Collection" and are planned in the draft PFM Reform Programme 2022-2025.</p>
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<p>PG 2:</p> <p>Adopt the new PPP law and ensure its efficient implementation, including the development and functioning of the PPP registry.</p> <p>Take the necessary legislative steps for the establishment of the Fiscal Council.</p> <p>Improve transparency and evaluation of firm-level subsidies by setting up a state aid registry.</p>	<p>There was limited implementation of PG2:</p> <p>1) Limited implementation. The Government has developed a draft PPP law, but it has not been submitted to the Parliament for final adoption.</p> <p>2) Limited implementation. The establishment of the Fiscal Council is foreseen in the draft Organic Budget Law that was submitted to the Parliament for final adoption in December 2021. The second reading of the OBL took place in December 2021 but it has not been adopted yet by the Parliament.</p> <p>3) Limited implementation. The State aid registry is still not set up. The draft law on state aid is still in the parliament and has gone through a process of consultations with relevant institutions</p>
<p>PG 3</p> <p>Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning.</p> <p>Further reduce institutional and legal obstacles to swift and effective NPL resolution, including by facilitating out-of-court settlement and modernising the insolvency regime.[Ruzica]</p> <p>Safeguard the National Bank’s independence in its key statutory tasks, including in staffing issues, in line with the law on the national bank, and to this end exclude the National Bank from the scope of the new law on administrative servants.</p>	<p>There was partial implementation of PG3:</p> <p>1) Substantial implementation. The European Commission decided to consider the supervisory and regulatory framework applicable to credit institutions in North Macedonia as equivalent to that applied in the EU. Key legislations and regulations improved, and progress was made in bringing the financial stability law to parliament. Nevertheless, the law on the national bank still needs to be amended to clearly establish the National Bank as the competent resolution authority. There are also some delays in aligning the banking law with the EU law on deposit insurance. Provisioning seems broadly adequate, despite a slight decrease in the coverage ratio.</p> <p>2) Partial implementation. The quality of financial reporting and corporate governance was further improved through a new Code of Corporate Governance of companies. A draft Law on Insolvency was provided for public consultation in 2021 and another on valuation was drafted. But the progress could be accelerated.</p> <p>3) No implementation. The National Bank has not been excluded from the scope of the new draft law on administrative servants, therefore, despite some efforts, there are still concerns about adequately safeguarding the National Bank’s independence, including in staffing issues</p>
<p>PG 4</p> <p>Improve transparency in the adoption and implementation of legislation, particularly by ensuring a timely formal consultation of businesses and social partners on new legislation affecting their operations.</p>	<p>There was partial implementation of PG 4</p> <p>1) Partial implementation. Public consultations through the dedicated national electronic consultation system allow for inclusive participation of all stakeholders, however the electronic system is not used to its full potential. The main tool for consultation remains the online platform ENER (National Electronic Register of Regulations). However, the practice for the adoption of laws under a short legislative procedure and the use of the “EU flag” procedure (a fast track procedure aimed at aligning legislation with the EU acquis) continued. Great care should be taken in the use of fast track procedures, which need to be limited to ensure effective scrutiny and consultation of legislation. The quality control and the follow-up to the public consultation process needs to improve.</p>

<p>Use the list of mapped parafiscal charges to clarify the public services provided through the proceeds of individual charges and identify those that need to be eliminated, remodelled or streamlined.</p> <p>Continue the digitalisation of public services for businesses and citizens.</p>	<p>2) Limited implementation. Consistent with reform measure 12, the country shows commitment to streamlining parafiscal charges. However, activities have only just started to reducing the number of parafiscal fees. To streamline the wide range of parafiscal charges imposed on businesses, the government published, on a designated web page, a list of 377 parafiscal charges at central and local level along with their value. Technical assistance is being put in place with the aim of evaluating, annulling, optimising and rationalising these charges. First results are expected by end of 2022 (with support of IPA).</p> <p>3) Partial implementation. Consistent with reform measure 11, the national e-services portal www.uslugi.gov.mk provides electronic services to citizens. The government instructed line ministries to digitalise the internal processes and the services they provide to business and companies. However, insufficient resources (human and technical) are allocated for this purpose and the adoption of the National ICT strategy is delayed. An EU funded e-governance project, should contribute to digitalisation of more than 135 services.</p>
<p>PG 5</p> <p>Ensure high-level political commitment by all institutions relevant for the coordination and implementation of the Strategy and the Action Plan for formalisation of the informal economy.</p> <p>Assess the implementation of the 2018-2020 Action Plan and identify gaps, in particular related to tax policy and administration.</p> <p>Develop and implement the new 2021-2022 Action Plan.</p>	<p>There was partial implementation of PG 5</p> <p>1) Limited implementation. The decision to appoint the Deputy Prime Minister office to coordinate the implementation of the strategy was prepared, but not yet adopted by the government.</p> <p>2) Full implementation. The government adopted the report in October 2021. Some progress was made on the action plan, but the COVID-19 pandemic impeded its implementation, including the formalisation of undeclared workers as supported by an EU funded project. When reviewing implementation, additional activities were added to all four strategic goals of the action plan. The report was also reviewed by the Economic and Social Council.</p> <p>3) Partial implementation. The new 2021-2022 action plan was adopted in October 2021, but implementation in 2021 was limited. Several activities from the previous action plan are continuing under the new action plan, in particular those which were added as part of the above-mentioned review process</p>
<p>PG 6</p> <p>Develop a new formula for the financing of the VET system and of higher education with a focus on the functioning of the Regional VET Centres.</p>	<p>There was partial implementation of PG 6</p> <p>1) Partial implementation. North Macedonia developed a new formula for financing primary and secondary education. The formula establishes clear standards on the basis of which funds are distributed from the Ministry of Education and Science to the municipalities, and from the municipalities to the schools. Its gradual implementation is envisaged to start as of 2022. The measure also comprises a review on the financing of regional VET centres that is done through the central government budget and seeks to review practical education in VET schools in order to reduce costs for schools due to increasing co-financing by companies. The National council for higher education and scientific research was set up. It adopted guidelines for methodology, standards and accreditation procedure in the higher educational institutions and will develop the new</p>

<p>Strengthen access to active labour market policies, particularly for low-skilled unemployed and people in vulnerable situations.</p> <p>Increase the capacity of and cooperation between the employment agencies and centres for social work to provide integrated services and measures for improvement of inclusion in the labour market.</p>	<p>financial model.</p> <p>2) Partial implementation. The Operational Plan for Active Labour Market Employment and Services Programs and Measures provided low-skilled and vulnerable unemployed people with more targeted solutions and contributed to a general improvement in active labour market policies. In July 2021, additional funds were ensured for salary subsidies for low-qualified people; and in November for self-employment, salary subsidies and general employment. The Employment Service Agency launched psychosocial support and mentoring services to Guaranteed Minimum Assistance (GMA) users. More attention is also being paid to sustainable employment. However, COVID-19 has hindered further steps and the overall financing is still below the needs.</p> <p>3) Partial implementation. Efforts were made to improve case management in the Centres of Social Work, including by training staff. As of June 2021, the electronic exchange of information between employment agencies and centres for social work was set up. Individual activation plans were prepared for GMA users. However, capacity is still insufficient and the pandemic has slowed the cooperation between the Centres of Social Work and Employment Centres.</p>
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ANNEX A: ASSESSMENT OF THE OTHER AREA/SECTOR AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2020-2022 ERP

Public financial management (PFM)

North Macedonia, like most WB6 countries has considerable room for PFM improvement. The Organic Budget Law introduces fiscal rules, a Fiscal Council, multiannual expenditure framework and programme-based budgeting and its adoption is a pre-conditions for many PFM reforms going forward. Moreover, the public internal financial control law establishing strengthened managerial accountability and internal audit functions, is still awaiting adoption. An action plan for the implementation of the Public Investment Management Assessment (PIMA) recommendations is in place, but to overcome fragmentation in public investment, a co-ordination structure has to be set up involving all key institutions in order to ensure efficient implementation. New draft legislation on PPPs also provides for new tools and processes to ensure better management of fiscal risks arising from PPP. However, considerable delays are expected on the development and establishment of the PPP and concessions registers which would facilitate the implementation of the laws. It will be important to ensure consistency of the ERP with other plans, including the 2021-2027 intervention investment plan and the 2022-2026 growth acceleration plan. North Macedonia is moderately prepared in the area of financial control. The implementation of the public internal financial control (PIFC) policy paper and action plan has been delayed due to the COVID-19 crisis and limited capacities of key stakeholders. The functioning of the financial inspection is not sufficient. The independence of the State Audit Office is not yet guaranteed by the Constitution. The parliamentary oversight of public funds management is not efficient yet. The analysis could have mentioned the role PFM plays – e.g. through spending reviews – in creating fiscal space for new policy priorities and in informing the medium-term fiscal consolidation plan.

Measure 20: PRO digital transformation by setting up ITIS

This new measure is very relevant as it addresses the long-standing issue of the Public Revenue Office's (PRO) obsolete and fragmented IT system, which impedes its administrative and operational capacities. The measure has the potential to address EU and IMF (e.g. Tax Administration Diagnostic Assessment Tool assessment) recommendations to improve the PRO's business processes, implement a new integrated IT tax system, develop compliance risk management and further extend e-services. To this end, the measure is relevant and well explained, including a description of the key functionalities of the system. The potential risks are well identified and will need to be addressed in order to minimise their impact when implementing the measure (i.e. insufficient institutional ownership and very weak human resource capacities, especially in the IT sector). There are some concerns that the reversal of an earlier decision to procure a COTS tax administration software in favour of a modular system may lead to suboptimal results (IMF, 2021). The IT system is one of the key pre-conditions for improving revenue collection and it features in the 2020-2023 Tax System Reform Strategy and the newly drafted 2022-2025 public financial management strategy. The measure's expected impact on competitiveness could be further improved.

Green transition

This reform area is very closely linked to key challenge 3 and is analysed above in Section 4. Complementary to this analysis and as part of a sustainable post-COVID-19 recovery, the country also needs to unlock the potential of the circular economy, with recycling and reuse as the rule and a significant reduction in the use of natural resources.

Measure 7: Building wastewater collection and treatment infrastructure in line with EU requirements

Measure 7 is new and although it is relevant, it focuses almost exclusively on (donor-funded) capital investments and does not address the necessary structural reforms, including implementation of the full cost recovery and polluter-pays principles enshrined in the Water Law of 2008. Moreover, there is little reference to the required strengthening of administrative capacity and interinstitutional coordination. The activities planned for 2022, 2023, 2024 are not realistic. The measure related to EU funding needs to respect the procurement and disbursement plans for the respective projects. The impact analysis is poor. Circular economy is mentioned as a project objective, but the text does not mention any benefits for the country's competitiveness.

Measure 8: Establishing an Integrated and financially self-sustainable waste management system

The measure, supported by EU funding, is new and relevant. Waste management regions were identified in the country's 2021-2031 Waste management plan and the planned steps to set up a regional waste management system are consistent with Commission recommendations. However, important elements of the implementation and sustainability of the investment are missing. For instance, a reference to a cost covering waste tariff policy, which is considered key to ensuring proper quality services and a sustainable waste treatment system, is missing. Another key milestone is to set up the Regional Waste Management Company, but regrettably this is not explicitly in the list of planned activities. The impact analysis is very poor. Circular economy is mentioned as a project objective, but no mention is made of the benefits for the country's competitiveness.

Business environment and reduction of the informal economy

This area is analysed above in Section 4 as a crucial element of key challenge 2. Structural weaknesses in the business environment continue to be an obstacle for domestic companies even though North Macedonia is ranked 17 out of 190 economies in the latest World Bank *Doing Business 2020* report. It remains to be mentioned that the ERP refers to the growth acceleration plan (GAP) adopted in autumn 2021 which aims to boost the competitiveness of the private sector and investments in physical and human capital over 5 years. The GAP aims to finance the post-COVID economic recovery and to support fast and sustainable growth, while maintaining fiscal stability by mobilising capital from the private sector, in addition to the funds allocated from the budget and borrowing. One of the ERP measures is to create a hybrid fund for green and digital start-ups and innovative SMEs, as mentioned in the GAP.

Measure 13: Hybrid investment fund for start-ups and innovative micro, small and medium enterprises

This new measure is very relevant. So far, commercial loans from local commercial banks are the predominant source of funding. This measure has the potential to effectively address the lack of diversification of sources of funding, especially the micro and small businesses, which is a major constraint of the business environment. The idea of a hybrid fund is included in the GAP. Contrary to general State aid applied so far, such a public-private venture capital fund can be seen a more progressive market-oriented step forward towards sustainable access to finance for SMEs. Still, the description of the measure should further explain the synergies with other funding options mentioned in the GAP, such as the hybrid green strategic

investment fund. The government could further explain the measure's impact has on competitiveness.

Measure 14: Financial support for Roma entrepreneurs

This new measure is very relevant, also from a social point of view, as it targets a very disadvantaged group of the country's society. The measure is supported through EU funds. One challenge is that the implementing agency - the Roma Entrepreneurship Development Initiative - still needs to be registered in the Central Donor Assistance Database before work can begin. The impact analysis of the social outcome includes some quantification, while the impact on competitiveness should be further explained.

Research, development and innovation (R&D&I)

The strategic vision for support of innovation is unclear, as the strategy for research and innovation ended on 31 December 2020. While implementation was monitored on an annual basis, no assessment of the impact of the 7-year strategy was undertaken. Gross domestic expenditure on R&D relative to GDP remains low at 0.37% of GDP, significantly below the EU average. An increased budget in this area would support the country's economic recovery, also given the relevance of innovation to the Economic and Investment Plan for the Western Balkans. Measures for closer cooperation between academia and the private sector are being implemented and subsidies are being provided to companies to intensify their research and innovation capacities. Participation by the private sector in overall research spending remains low at 0.1% of GDP. The government's support for R&D&I is being provided mainly through State-aid schemes implemented by the Fund for Innovation and Technology Development (FITD). The FITD's investments in SMEs aim to improve their innovative capabilities, and to support the adoption of new technologies that contribute to private sector competitiveness. The impact of this funding should be further assessed. The country's performance in the Horizon 2020 framework programme has improved compared to the previous year but it still remains slightly low at 11.7%, compared to an average success rate of 12.1%. The finalisation of the smart-specialisation strategy, supported by the Joint Research Centre, is delayed by the COVID-19 crisis.

Measure 17: Enhancing cooperation between the academy and the industry

This measure is rolled over from last year as there were no significant developments. The comments from last year's assessment are still valid. It includes two sub-measures: (i) further development of the science technology park (STP) and (ii) grants to increase cooperation between academia and industry. The STP is planned to be a complex organisation offering professional business support and innovation services to increase both innovation, and networking possibilities at national level. The facility was formally set up at the State university in Skopje, and some funding was secured for its initial operation. However, the government has not yet explained the STP's specific fields of operation and specialisation. A balanced public-private structure for ownership and management, with initial public funding, is a preferred model for operating a life-science park. However, it is not clear whether potential private investors have been found. This measure could benefit from activities going beyond the setting up of the STP, for example encouraging industry to provide advice to universities on areas of research that would be beneficial for certain sectors of the economy. Increased possibilities for private-sector funding of research and innovation would also be beneficial. There are no detailed plans for the activities under this measure. The government has also not quantified the measure's expected impact on competitiveness, while the measure's impact on employment and gender has been insufficiently considered.

Digital transformation

While North Macedonia continued to successfully implement the Digital Agenda for the Western Balkans and the Regional Roaming Agreement, further efforts are needed to unlock the potential of the country's digital transformation. The digitalisation of the economy has proven to be particularly relevant during the COVID-19 pandemic. A strategy for development of digital skills was prepared, as part of the broader ICT strategy and action plan. As the strategy is still under preparation, it is not yet certain that it will address the digitalisation of SMEs effectively (OECD, 2021). The national e-portal for services is being upgraded with more than 130 services. This is in principle an encouraging development given the importance of digitalising the public administration and increasing online services for citizens and businesses due to COVID-19. However, a large number of these services are not directly available through the portal, which only publishes information and links to the relevant portals. For the e-services that are available, usage and satisfaction levels remain low (OECD, 2021). Greater efforts by and improved coordination between institutions are still needed to modernise and digitalise the public administration, including the planned establishment of an Agency for Digitalisation and Registers. Successful e-services include the e-Tax System that has simplified tax reporting, and mobile applications like e-VAT that enables VAT returns for individual taxpayers. On e-commerce, the National Bank reported a five-fold increase in internet transactions by citizens in 2020 compared to 2019. Yet, e-commerce in the country is progressing at a slow pace. Further digitalisation is still hampered by the relatively high cost of digital services and by the low level of digital skills in the population. The use of electronic signatures for services to citizens and companies modestly increased. Overall, there is a particular need to increase access to broadband, expand available e-government services and develop digital skills.

Building on the 2018 Digital Agenda for the Western Balkans, the economic and investment plan offers an opportunity to accelerate the digitalisation of governments, public services and businesses, in a manner consistent with the EU's values and legal framework.

Measure 11: Broadening the scope of digital services provided on the national e-service portal

This measure is also rolled over from 2021 and the portal has been in place for several years. As it increases the efficiency of the administration and improves service delivery to citizens and businesses, it is important for improving the overall business environment and the ease of doing business. A large-scale, EU-funded project to upgrade the e-services portal with 139 new services for companies and businesses started in August 2020. The project identified most of the services that are to be included in this project, as well as the registers that need to be digitalised to allow for e-service delivery. Most of the new services should be functional in 2022. Currently 127 services are provided by administrative bodies that are accessible in the online portal, but only 50 provide for fully electronic interactions. The ERP explains the measure's purpose, timeline, impacts, and potential implementation risks clearly. These risks stem from the inefficient coordination and communication between State institutions, lack of IT human resources and lack of commitment at operational level. These risks should be clearly monitored and actions taken to mitigate them. The indicators used to measure implementation are appropriate, but the measure national strategic investments and country's policy guidance of the country on digital transformation could be better explained. A strategic approach on digital skills and access to broadband is lacking.

Economic integration performance

2020 was a very challenging year due to the COVID pandemic. North Macedonia had one of the highest trade levels in the region in 2019, but in 2020, pandemic-related export bans, restrictions on the movement of people, and closures of shops and services, led to a significant decline in imports and exports. Trade, tourism and transport, which are substantial drivers of growth in the economy, were the most affected, contracting by almost 12.3% (OECD, 2021). As one of the economies in the region with a greater level of integration into GVCs, it felt the immediate effects more severely (OECD, 2020). In particular, it suffered from the disruption to supply chains from the manufacturing slowdown in the People's Republic of China and reduced demand in the United States and especially the EU. Producers of machinery and equipment, and mechanical appliances were most affected (OECD, 2021). Although the EU remains the country's main trading partner, total bilateral trade declined by 12.9% in 2020, due to the COVID-19 pandemic, which was slightly worse than trade patterns elsewhere in the region. Total volume of trade in goods in 2020 was worth EUR 8.7 billion (2021: EUR 10.8 billion). In 2020, the EU accounted for 58% (2021: 61%) of North Macedonia's total trade in goods (74% of total exports (2021: 79%) and 46% (2021: also 46%) of total imports). After the EU, the UK and Serbia are the most significant trade partners of North Macedonia (representing 13% and 5% of total trade respectively in 2021). The main traded products are machinery and appliances, chemicals, and mineral products. In terms of foreign direct investment (FDI), the EU is also the country's main economic partner: EU companies are by far the leading investors, accounting for about 64 % of FDI stock in North Macedonia in 2020, against 2.2% for Chinese companies and 0.5% for Russian companies. North Macedonia has an open economy and is highly integrated into international trade. The economy posts a high degree of trade openness with a trade to GDP ratio of 124% of GDP in 2020. This is slightly lower than in the preceding year, as trade volumes declined by significantly more than GDP. Exporting companies, notably SMEs, still face key obstacles to trade. These impediments are due to non-tariff barriers, including technical standards, but also administrative obstacles for trade in services (OECD, 2021). The insufficient quality of logistics is an impediment to further increases in exports. The economic and investment plan and deepening the regional integration of the common regional market both have the potential to further increase trade and enable competitiveness and growth.

Measure 18: Strengthening the market rules in North Macedonia

The measure is rolled over from 2021. Strengthened market surveillance began in January 2021 supported by EU funding. The measure continues to be relevant for country's planned internal market reforms and its further inclusion in the European single market, as indicated by the economic and investment plan. It is expected to improve the country's position by harmonising legislation with that of the EU in the area of free movement of goods, free movement of services, and market surveillance. The measure's expected impact on competitiveness and environment, which is only described in general terms rather than with a clear focus on quantitative targets, could be better explained.

Energy market reforms

An analysis of this area is partly included in the analysis of key challenge 3 in Section 5.1, namely energy sector modernisation and transition to clean energy. The electricity and gas markets are open for competition. The electricity transmission and distribution network operators are unbundled in accordance with the EU *acquis*. However, the gas transmission system operator is not yet unbundled in line with the Third Energy Package. Legislation is not yet aligned with the EU Regulation on wholesale energy market integrity and transparency.

Regional market integration of North Macedonia requires significant improvement as the country has not implemented any market coupling with any of its neighbours, largely reflecting the lack of a day-ahead market. The market coupling project with Bulgaria hinges on the creation of a day-ahead market in North Macedonia (ECS, 2021).

In line with the economic and investment plan, the Commission will support the development of renewable energy sources and less-polluting energy sources that will secure energy supply in line with the commitments of the Green Agenda for the Western Balkans.

Measure 9: Increasing the competitiveness of the electricity market

This measure is rolled over from the previous year. Given the energy crisis, it is very relevant. It aims to set up a more liquid and organised electricity market to allow more competition in energy supply for the benefit of customers. Additional efforts are needed to finally set up the day ahead market and couple with Bulgaria after years of delay. The activity looks ambitious as it plans to finish the process in 2022, though the roadmap is not yet finalised. The impact assessment part is not quantified

Transport market reforms

The transport market remains concentrated on road transport, with limited investment in other means of transportation and with no consistent, intelligent system to manage and control transport traffic. Road maintenance is handled by State companies, operating with old equipment. In 2020, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average of around 5%. The country's integrated road transport system reduces travel time by 17% and road fatalities by 16.6%, benefiting trade flows and the economy (ERP, 2022). The World Economic Forum's *2019 Global Competitiveness Report* ranks the country 84th out of 138 economies for transport infrastructure. Relatively low-quality transport infrastructure, as well as weak trade and transport logistics still present barriers for foreign companies aiming to invest in the country. These issues also cause difficulties for domestic companies. The flagship policy of the economic and investment Plan will be to further develop the Trans-European Transport Railway Corridor VIII, directly linking North Macedonia, Albania and Bulgaria¹³. This corridor will give the country's companies an alternative export option via Albanian and Bulgarian ports. North Macedonia would also benefit from opening up of its rail-transport market – at least for domestic and regional firms. At 32%, the fatality rate in traffic accidents is high and above the EU average. However, the national system for continuous road crash data collection is still to be set up and the action plans on road safety inspection and audit need to be followed up and implemented.

Measure 10: Implementation of an Intelligent Transport System (ITS) along Corridor X

This measure, linked also to the digital economy policy, is rolled over from the previous year. The ITS should be put in place along Road Corridor X from Tabanovce to Gevgelija, which is a strategic objective of the 2018-2030 national transport strategy. In parallel, a National ITS strategy should be finalised by mid-2022 which may be overoptimistic. The measure aims to

¹³ On 23 February, the WBIF endorsed a related flagship project: Construction of the final stretch of the rail corridor between Kumanovo in North Macedonia and Bulgaria will get underway with a €412 million investment. Electrification systems will also be installed on the entire railway line. This project will create over 200 new jobs, slash travel time, decrease pollution, and facilitate trade across the region and with the EU.

improve the safety of road transport and ease traffic flow along Corridor X. Nevertheless, it remains unclear how the measures will influence travel time along the corridor, given that the main bottlenecks are at border crossings and toll stations, the numbers of which have significantly increased in recent years. The measure's full potential impact on competitiveness and growth cannot be fully determined, given the insufficient analysis in the ERP and the lack of any estimate for savings (in cost and time).

Agriculture, industry and services

Agriculture, forestry, and fisheries accounts for 10.3%¹⁴ of gross value added and 12% of the country's employment (2020 data) making it the third largest sector in terms of employment. The agricultural sector is characterised by an unfavourable farming structure (large number of very small semi-subsistence farms) with mixed agricultural production on small and scattered land plots. Efficiency and productivity of the sector is low and, following the war in Ukraine, the lack of fertilizers has the potential to further significantly agricultural productivity. Data released by the State Statistical Office show an increase in food prices by 9.6% compared to February 2021 and the government has introduced various forms of mitigating measures, including subsidies. One of the major problems in the country's agricultural sector is the ageing of the labour force. About 15% of agricultural workers are young (15-24 years-old). Low incomes and unfavourable working conditions, as well as deteriorating living conditions in rural areas, discourage young people from starting a career in agriculture (FAO, 2021). The sector receives the largest portion of state aid, and subsidies to the sector have been increasing while production has been going down. To reform the agricultural sector to align it the EU common agricultural policy (CAP), involves the "decoupling" of farm subsidies, i.e. a shift to payments that are not linked to area and production levels of specific commodities, livestock numbers, and input use (FAO, 2020). There needs to be a stronger link between agricultural policies and other sectoral policies such as those on trade, education and SMEs. On the positive side, there is a good level of preparation in the area of food safety, veterinary and phytosanitary policy and absorption of EU funds under the Instrument for Pre-accession Assistance for rural development (IPARD II) has been improving. Opportunities of the sector include good access and distribution links to European markets and potential for structural improvement (land consolidation, producer groups, cooperatives). Several actions could be taken to increase productivity through innovation and the application of modern technologies. These actions include: (i) investing in the skills and know-how of agricultural workers; (ii) strengthening the agriculture advisory services; and (iii) connecting agriculture with research, education, and tourism.

Measure 19: Modernization of the post-harvest management of agricultural products from North Macedonia

This is a new measure. It is relevant as it is in line with the national priorities set out in the 2021-2028 national strategy for agriculture and rural development. The measure is ambitious enough to impact on the income of the involved farmers, agriculture co-operatives and producer organisations. The activities planned under this measure are based on the analysis and recommendations provided earlier by an EU- funded project that helped establish of the Common Market Organisation in North Macedonia. The description of the measure is adequate and its implementation is ensured through a World Bank loan (World Bank Agriculture Modernization Project). Still, the lack of favourable legal framework for the

¹⁴ Eurostat estimate

setting up and operation of agricultural co-operatives might have a serious negative impact on the project. To mitigate the identified risks, swift clarification is needed on whether the locations for the purchase centres in Resen and Strumica and for the trading platform in Skopje have been identified and whether construction licences have been issued. Activities should include comprehensive details on the preparations for the construction. It should also be clarified whether construction activities will be continue in 2024. Complementary costs and related activities funded by IPA in 2023 and 2024 should be clarified in the activity table. The impact assessment is incomplete, as there is no quantification. The impact of the war in Ukraine on this new measure will have to be assessed.

The main obstacles to competitiveness in the country's industry include: (i) low productivity and the slow growth rate of productivity; (ii) limited modernisation of production processes and obsolete technologies caused by insufficient public and private spending on research and innovation; (iii) insufficient development of clusters of businesses; and (iv) a significant skills gap. The industrial sector (excl. construction) contributed 19% of the economy's gross value added and 23.9% of jobs in 2020. The structure of the industry is continuously improving with the industry's share of higher-value-added manufactured goods (machinery and equipment, chemical products) rising at the expense of basic goods (iron, steel and clothing). Low levels of skill among workers also hinder productivity: the average manufacturing and services worker is on average only 25% as productive as their counterpart elsewhere in Europe and central Asia (World Bank, 2018). No measure has been included for this area in the ERP.

North Macedonia has a sizeable and diverse service sector. The services sector accounts for 64.2% of gross value added and 57.1% of employment in 2020. The further development of companies in the services sector is hampered by weak entrepreneurial skills and a significant skills gap among employees, particularly in soft skills. Despite the increase in exports of services, they represent only around 25% of the value of the country's export basket, indicating the low competitiveness of companies in this sector. Tourism and transport continue to account for the largest chunk of the country's services exports (close to 40% of services exports) Close to 36% of service exports are made up of exports in: (i) telecommunications services; (ii) computer, and other information services; and (iii) other business services. There is room for these categories of service exports to grow further. Services provided by manufacturing companies (23% of services exports) have significant potential for growth because their development is closely related to the inflow of export-oriented FDI. No measure has been included for this area in the ERP.

Education and skills

This area and the relevant reform measure 1 are analysed above in Section 4 under key challenge #1.

Employment and the labour market

This area and the relevant reform measure 2 are analysed above in Section 4 under key challenge #1.

Social dialogue

Bipartite social dialogue in the private sector and the commitment of social partners to reinforce collective agreements remain weak. Only few enterprises have collective agreements at company or branch level. The tripartite Economic and Social Council (ESC) is actively involved in the elaboration of relevant legislation before its adoption, but participation is limited to proposal that fall under the competence of the Ministry of Labour

and Social Policy. The visibility and impact of the ESC are low. On funding, the ESC depends on the budget of the Ministry of Labour and Social Policy for financing its activities and the secretariat. At the local level, despite some progress in raising awareness on the benefits of social dialogue, the utilisation of the Local Economic and Social Councils as an effective tool for formulation and implementation of local employment policies is still very limited. The 2021-2027 National Employment Strategy aims to strengthen the role of central and local-level social dialogue institutions, including by collective bargaining - the primary instrument for the setting of wages and other conditions of work by 2027.

Social protection and inclusion

The number of people at risk of poverty after social transfer rate slightly decreased by 0.3 pps to 21.9% in 2020. However, research estimations show that child poverty has increased during the pandemic. Social transfers, particularly pensions, are key for keeping individuals above the poverty line. Since 2020, the pension contribution rate has slightly increased from 18% to 18.8%. In the same period, the maximum allowed fee from pension contributions collected by private pension companies decreased from 2.25% to 2%. The government adopted the 2021-2027 national strategy for social entrepreneurship that aims to set up a favourable legal framework for social enterprises. However, the pandemic has hampered the update of other national social protection strategies. Although the Law on Social Protection strengthens their competencies, municipalities still do not sufficiently recognise their role in designing and adopting their own programmes in the field of social protection. Improving coordination between Public Employment Service (PES) and other services like social work centres, associations, social service providers, health sector, municipalities which have legal obligations to provide additional forms of social protection support, is another prerequisite for the success of the social reforms package. The social impact of the COVID-19 pandemic has been mitigated by enabling the access to Guaranteed Minimum Assistance (GMA) for individuals who lost their jobs during the pandemic.

Measure 3: Enhancing the system for social inclusion of vulnerable groups

Reform measure 3 aims to better target cash transfers and increase their effectiveness by connecting them to labour market activation and social inclusion. This measure is considered crucial for tackling poverty in the country and is rolled over from the previous year with some amendments. The new Law on Social Protection was adopted in 2019 with accompanying bylaws providing the comprehensive legislative framework for social protection in North Macedonia. The capacity of the bodies that are responsible for implementing, monitoring and enforcing the new Law has to be increased. The measure includes developing a new law to provide financial and technical support to social enterprises that focus on improving the employment prospects of vulnerable people, including people with disabilities. The measure also aims for a greater inclusion of people with disabilities in the open labour market and seeks to further deepen the cooperation between PES and Centres for Social Work to provide support and labour activation to employable GMA beneficiaries.

Healthcare

The country's healthcare system covers 90% of the population but its adequacy remains insufficient. The share of public expenditure was 4.2% of GDP in 2017, far below the EU-27 average of 7.8% in the same period. However, according to data of the Ministry of Finance the share reached 8.5% in 2020 due to the COVID-19 pandemic. Social security contributions accounted for 52.4% of total health budget in 2020. The contribution rate for the actively employed is 7.3% of their gross wage. The unemployed and those not covered by insurance from any other source pay 5.40% on 50% of the average national wage. Health insurance for

injury at work and occupational diseases is paid by the employer (0.5% of the gross salary). The health insurance system provides a broad network of primary healthcare at the municipal level and an extensive network of secondary healthcare institutions. Categories lacking coverage include in particular farmers, people without identification documents and people in irregular jobs and with irregular incomes, most of which are Roma (UNICEF, 2016). Healthcare causes a significant financial burden on households: Up to 20% of the average total costs of medical treatment is paid out-of-pocket by the patient. However, robust statistical data on what out-of-pocket payments are used for is missing. In addition, distance or transportation problems and long waiting lists are among the most relevant unmet needs. EU Statistics on Income and Living Conditions (EU-SILC) data show that 20.5% of people in the country have difficulty using the healthcare service. This figure is close to the official number of people at risk of poverty suggesting that most who have difficulty in accessing healthcare may also be at risk of poverty. The Moj Termin eHealth system that was introduced in 2013 helped to significantly reduce waiting times and should be extended to primary care doctors. The National Health Strategy 2020 identifies strategic goals and is complemented by a strategy and action plan (2019-2023) to improve primary healthcare. However, low public expenditure on health and the major shortage of health professionals remain among the biggest challenges.

Measure 4: Strengthening the quality of the Primary Healthcare

This measure was introduced in last year's ERP. Its main goal is to improve the quality of primary healthcare (PHC) by reforming the PHC payment model to ensure disease prevention, standard-setting, and reducing reliance on a higher level of healthcare, including by increasing the number of specialised general practitioners. The development of a platform is expected to facilitate appointments and ensure the traceability of health data.

ANNEX B: OVERVIEW OF THE MAIN INDICATORS PER AREA/SECTOR OF THE ECONOMY

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average 2020 or most recent year
Energy						
Energy imports dependency (%)	58.8%	56.2%	58.4%	58.1%	63.3%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand euro	289.97	292.98	267.13	285.87	271.97	110.18
Share of renewable energy sources in final energy consumption (%)	18.04%	19.64%	18.18%	17.49%	19.22%	22.09%
Transport						
Railway Network Density (metres of line per km ² of land area)	26.85%	26.85 ^w	26.85 ^w	26.9 ^w	26.9 ^w	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	190	194	200	205	206.7	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	10.6%	9.1%	9.8%	9.3% (p)	10.3 (e)	1.8%
Share of employment (Agriculture, Forestry and Fishing)	16.6%	16.2%	15.7%	13.9%	12.0	4.3%
Utilised agricultural area (% of total land area)	49.8%	49.8%	49.7%	49.7%	50.0	40.6%
Industry						
Share of gross value added (except construction)	19.7%	20.5%	21.5%	20.7%	19%	19.5%
Contribution to employment (% of total employment)	23.1%	23.3%	23.9%	24.1%	23.9%	18.2%
Services						
Share of gross value added	61.7%	62.9%	62.5%	63.6%	64.2%	73.1%
Contribution to employment (% of total employment)	53.1%	53.2%	52.9%	55.0%	57.1	71,0%

Business environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	63	60	84	82	N/A	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 37.6%	N/A	N/A	N/A	N/A	N/A
Research, development and innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.44%	0.35%	0.36%	0.37%	N/A	2,32%
R&D expenditure – EUR per inhabitant	20.30€	17.20€	18.8€	19.9€	N/A	694.6€
Digital economy						
Percentage of households who have internet access at home	75%	74%	79%	82%	79%	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	72%	75%	79%	81%	81%	88%
Trade						
Export of goods and services (as % of GDP)	50.7%	55.1%	60.4%	62.3% (p)	58.1% (e)	46.7%
Import of goods and services (as % of GDP)	65.5%	69.0%	72.8%	76.5% (p)	70.9 (e)	42.9%
Trade balance (as % of GDP)	-18.5%	-18.1%	-16.8%	-18.2%	- 16.9%	N/A
Education and skills						
Early leavers from education and training (% of population aged 18-24)	9.9%	8.5%	7.1%	7.1%	5,7%	9,9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	31.3%	31.1%	29.8%	24.5%	26.2%	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	9.1%	10.3%	8.8%	13.0%	N/A	32.3
Individuals who have basic or above basic overall digital skills (% of population 16-74)	34%	32%	N/A	32%	N/A	N/A

Employment and labour market						
Employment Rate (% of population aged 20-64)	53.3%	54.8%	56.1%	59.2%	59.1%	71.7%
Unemployment rate (% of labour force aged 15-74)	23.7%	22.4%	20.8%	17.3%	16.4%	7.2%
Long term unemployment rate (% of labour force aged 15-74)	19.1%	17.4%	15.5%	12.4%	12.4%	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	21.2 pps.	21.9 pps.	21.4 pps.	21.3 pps.	19.9 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	28.4 pps.	29.4 pps.	27.1 pps.	28.6 pps.	N/A	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	N/A
Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	39.2%	37.0%	35.3%	34.2%	N/A	21.9%
Impact of social transfers (other than pensions) on poverty reduction	14.80%	14.29%	14.79%	15.00%	N/A	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	6.63	6.38	6.16	5.56	N/A	5.24
Housing cost overburden (% of population)	12.5%	11.7%	10.2%	9.9%	N/A	10.0%

Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.9%	2.5%	2.3%	2.5%	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	35.32% ^z	42.43% ^z	42.11% ^z	40.38% ^z	N/A	15.57% ⁽²⁰¹⁸⁾

w: data supplied by and under the responsibility of the national statistical authority and published on an 'as is' basis and without any assurance as regards their quality and adherence to EU statistical methodology'

e: estimate (Eurostat)

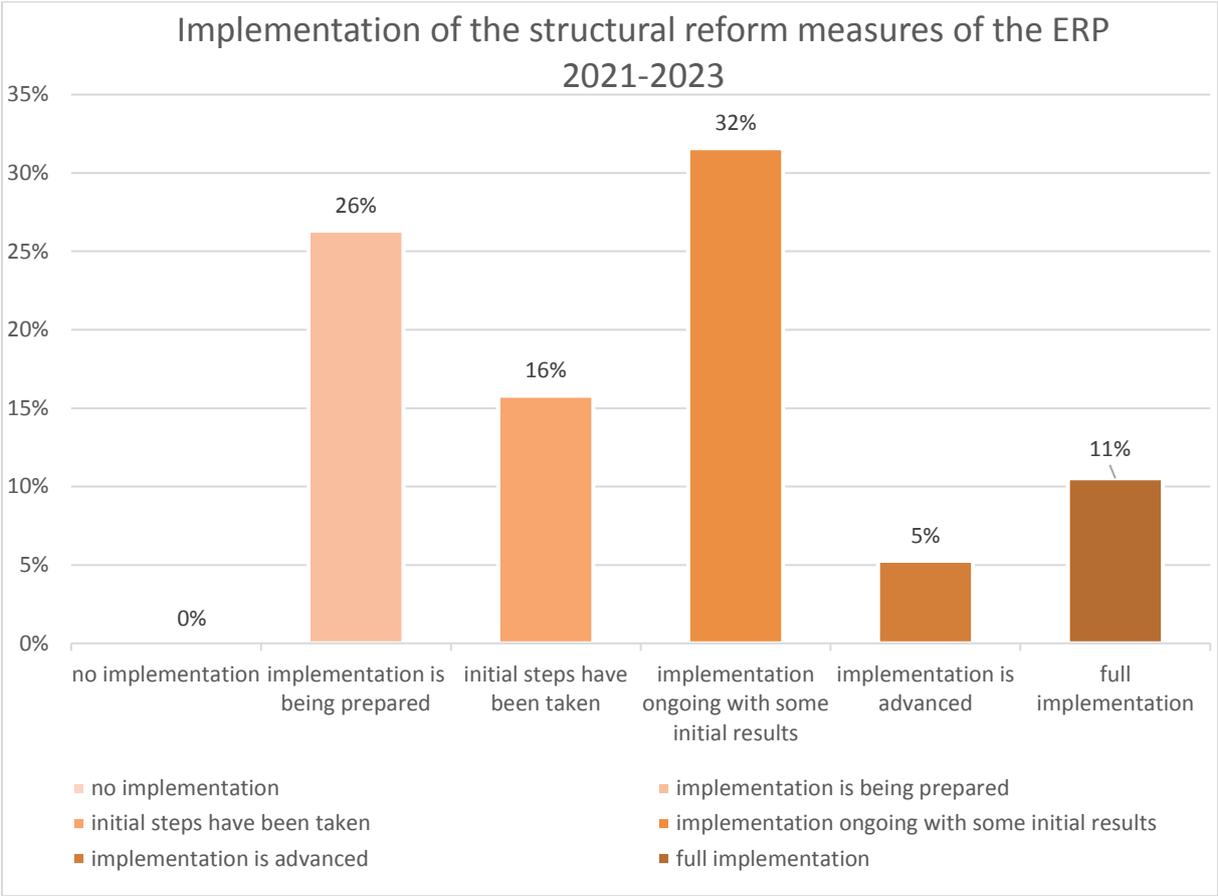
p: provisional (Eurostat)

z: data from World Health Organisation

Source of data in Annex B: EUROSTAT, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2021-2023 ERP

While continuing to tackle the impact of COVID-19 pandemic, in 2021, a robust economic recovery set in and the structural reform momentum has been broadly maintained. Progress was made in implementing the measures from last year’s ERP (average score: 2.6 out of 5). Activity reports provide a mostly accurate description of the level of implementation. The scoring is somewhat imprecise for the measures related to agricultural development and social sector. Implementation is stronger for some measures, such as measures 2 on promotion of renewable energy sources 9 on e-market place for low-value procurement and 15 on trade facilitation. In contrast, implementation is weaker for other measures, such as measure 4 related to the implementation of an intelligent transport system along corridor X and measure 20 on strengthening primary healthcare where implementation is very limited.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2022-2024 ERP on 31 January 2022. None of its components are missing.

Inter-ministerial coordination

The Ministry of Finance of North Macedonia coordinated the preparation of the ERP and an inter-ministerial working group comprised of several ministries, agencies and other offices were involved in this work. The submitted ERP contains the annex with the list of institutions and individuals involved in the ERP preparation. Upon completion, the government formally endorsed the ERP on 28 January. The coordination process worked well and the attendance to technical meetings was good.

Stakeholder consultation

The draft of the 2022-2024 ERP's structural reforms was posted on the Ministry of Finance's website from 10 to 24 December. Interested parties were also invited to send written contributions. Comments and suggestions received in writing are attached as an annex to the ERP.

Macroeconomic framework

The macroeconomic framework is coherent and consistent, while somewhat optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower growth in trade partner countries; and (ii) assuming lower investment. It does not include a low-growth scenario combining both domestic and external risks. The ERP's sensitivity analysis would have benefited from a more comprehensive impact assessment, including on employment, deficit and debt. The external sector outlook is described in detail and an analysis of external debt sustainability is provided in the annex. The latter could have been improved by providing more detail on parameters and on the results of the stress test.

Fiscal framework

The ERP is based on the latest budget projections following the latest budget revision and on the fiscal data available at the end of the third quarter of 2021. In line with the revised economic growth assumptions, the ERP has raised the deficit projections for 2022 and 2023, compared to previous year's program. It includes: (i) information on the expected budgetary impact of new policy measures; (ii) an analysis of the budget balance's sensitivity to lower GDP, lower revenue, and higher expenditure growth; (iii) an analysis of public debt's sensitivity to changes in interest rates and exchange rates; and (iv) a short assessment of the long-term sustainability of public finances based on a number of assumptions, including population ageing. The external debt analysis refers to stress tests for shocks to the primary current account and to economic growth. These stress tests would have benefited from more detail on the impact of individual debt-creating flows and from alternative scenarios.

Structural reforms

The chapter on structural reforms follows the ERP guidance note. Reform areas which have not or only partly been included as key challenges in Section 5.1. should have been analysed more in depth in Section 5.2. More efforts are needed to quantify the impact for each measure and turn the ERP into a more policy relevant document to guide economic reforms consistent

with other national plans and strategies. The description of the implementation risks and mitigation measures continues to improve. The ERP includes 20 measures and exceeds the page limit. Prioritisation of reform measures has focused on addressing the key structural challenges identified. The measure on strengthening the quality of primary healthcare is also prioritised reflecting the needs of COVID-19 pandemic. Tables 9-11 in the annex are properly completed. The implementation reports of the 2021-2023 ERP's policy guidance and Table 11 in annex are well prepared. The scores attributed largely reflect the implementation level. Though not explicitly requested by the guidance note, additional useful information was provided in Annex 2a (links between reform measures and ongoing or planned investments) or summarised in Annex 4 (result indicators of structural reform measures). Contributions received by external stakeholders during the consultation process were annexed to the document.

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