

STABILITY PACT

**SOUTH EAST EUROPE COMPACT FOR REFORM,
INVESTMENT, INTEGRITY AND GROWTH**

**ENTREPRENEURSHIP AND ENTERPRISE DEVELOPMENT
IN THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA**

Country Assessment and Action Plan

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Prepared by
Organisation for Economic Co-operation and Development
and
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in co-operation with
Ministry of Economy, Former Yugoslav Republic of Macedonia

FOREWORD

The South East Europe (SEE) Compact for Reform, Investment, Integrity and Growth ('Investment Compact'), a key component of the Stability Pact, has consistently affirmed that the economic revitalisation of South East Europe is dependent primarily on private sector investment within a market economy framework. Through the Investment Compact process, Stability Pact partners support and promote the structural policy reforms that will improve the climate for private enterprise and increase the level of investment.

Within this broad agenda, entrepreneurship and enterprise development are recognised as important elements in creating dynamic market economies. However, the framework conditions for creating and sustaining businesses remains underdeveloped in many SEE countries. Reforming and improving the various elements constituting an environment conducive to entrepreneurship is a priority for SEE governments.

This Country Assessment and Action Plan (CAAP) report, the first in a series (the second focusing on Romania), was prepared in response to a request by the Government of the Former Yugoslav Republic of Macedonia for Investment Compact support in developing the potential of the small and medium-sized enterprise sector. Designed to assist SEE countries in stimulating entrepreneurship and enterprise development, the series of CAAP reports will draw on the complementary experience and skills of the Organisation for Economic Co-operation and Development (OECD) and the European Bank for Reconstruction and Development (EBRD), two organisations that have been closely involved in European transition countries.

The analysis and recommendations provided in this report have been reviewed and commented on by the Government of FYROM and by the key donor agencies active in the country. There is a consensus that the proposals are sound and, if implemented, would offer wide scope for rapid progress.

Nonetheless, policy action in the SME field cannot be effective without a supportive general context. The current political instability in the Former Yugoslav Republic of Macedonia has been a major setback for economic reform and needs urgent resolution. Implementation of the recommendations contained in this report, as in many other aspects of the transition process, hinge on the establishment of a stable political framework.

The Stability Pact, through initiatives such as the Investment Compact, will continue to contribute to achieving this goal in the Former Yugoslav Republic of Macedonia and in the region as a whole.



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PREFACE

The following report presents the findings and recommendations of the joint OECD – EBRD activity to assess the entrepreneurship and enterprise development environment in the Former Yugoslav Republic of Macedonia (FYROM). This Country Assessment and Action Plan (CAAP) was prepared in response to a request from the FYROM Government.

In the framework of the Regional Flagship Initiative to support small and medium-sized enterprises (SMEs) launched by the Investment Compact for South East Europe, the CAAP was undertaken by the OECD (Directorate of Financial, Fiscal and Enterprise Affairs) and the EBRD (Office of the Chief Economist), in close co-operation with the Ministry of Economy of FYROM. Two missions to Skopje were carried out in September 2000 and April 2001. The OECD and EBRD are grateful to a number of ministries, agencies, private sector firms and NGOs which participated in the project, in particular:

- SME Department of the Ministry of Economy;
- National Enterprise Promotion Agency;
- European Commission Delegation, Skopje;
- World Bank / International Finance Corporation office for Southeast Europe Enterprise Development (SEED), Skopje.

The economy of the former Yugoslav Republic of Macedonia has suffered considerably since the collapse of Yugoslavia in 1991. Although the republic had been underdeveloped in comparison to many other regions in South East Europe, it was further undermined by the sudden cut off of subsidies from the Federal Republic of Yugoslavia, key markets in the other Yugoslav successor states, major transport networks and low-cost supplies of raw materials. This decline continued following the Kosovo conflict, resulting in large numbers of refugees arriving in FYROM and a further loss of markets in the Federal Republic of Yugoslavia for Macedonian goods as a consequence of United Nations (UN) sanctions. The heightened degree of political instability in the region deters domestic and international investors from operating in FYROM. This situation affects the recovery hopes of large enterprises inherited from the previous era, while the public sector continues to shed employment.

Against this background of economic, social and political uncertainty, the development of small and medium-sized enterprises (SMEs) is crucial for the future of FYROM. A dynamic SME sector is needed to ensure economic recovery, and thereby enable economic development and improvement of living standards. Accordingly, appropriate policies and programmes to stimulate the sector are urgently required. This need was recognised by the FYROM Government which, together with the EC, invited the OECD and EBRD to undertake this review as part of the Investment Compact process of reorienting SME policy in line with prevailing opportunities, threats and resources in the country.

The first aim of the CAAP review was to assess the extent of progress in SME development achieved to date by the FYROM Government as well as local agencies and international institutions active in the country. The Government of FYROM was quick to commit itself to supporting the SME sector, and the extent of progress can be assessed against the requirements for successful SME development highlighted in the *OECD-UNIDO Forum on Entrepreneurship and Enterprise Development (FEED) Guidelines* (OECD, 1999), as well as in the *Country Fact Sheets* prepared under the SEE Investment Compact by the OECD and the UK Foreign and Commonwealth Office (OECD, 2000). The CAAP, therefore, builds on over two years of experience in partnership with SEE countries through the Forum for Entrepreneurship and Enterprise Development (SEE FEED) and on the best practice guidelines which were produced to assist entrepreneurship and enterprise development in transition countries. The specific institutional, political, cultural, economic and social background features of FYROM are

factored into the analysis in order to assess where the main problems in the SME development process now lie.

The second aim of the report is to highlight a number of key SME development policy areas where the most rapid and effective progress can be made. This progress can be facilitated through appropriate actions by the government, non-governmental organisations, the private sector, international donor institutions, and through the application of new, and/or the re-allocation of existing, financial resources from both local and international bodies. The recommendations in this report are consistent with the FEED best practice guidelines, and it is hoped that, in conjunction with the activities of the international donor community, they may lead to a range of new measures and policies that will reflect the crucial importance of SME development to the overall economic development and growth of the country. The OECD and EBRD will continue to work with the FYROM Government through the Investment Compact's Regional Flagship Initiative to support small and medium-sized enterprises, including the activities of the SEE FEED programme to monitor progress and assist in the implementation of the recommendations identified in this report.

<p>The opinions expressed in this report are those of the authors in the OECD secretariat and in the EBRD Office of the Chief Economist and do not necessarily reflect the views of the institutions participating in the CAAP Review or of OECD and EBRD Member countries.</p>

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ACRONYMS

BSC	Business Support Centre
CAAP	Country Assessment and Action Plan
CIS	Commonwealth of Independent States
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
EIU	Economist Intelligence Unit
ESA	Enterprise Support Agency
FEED	Forum on Entrepreneurship and Enterprise Development
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
GTZ	Gesellschaft für Technische Zusammenarbeit
FYROM	Former Yugoslav Republic of Macedonia
IFC	International Finance Corporation
IFI	International Financial Institution
KfW	Kreditanstalt für Wiederaufbau
MBDP	Macedonian Bank for Development Promotion
MBRC	Macedonian Business Resource Centre
MFI	Micro-Finance Institution
MSEs	Micro and Small-Sized Enterprises
NBRM	National Bank of the Republic of Macedonia
NEPA	National Enterprise Promotion Agency
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
Phare	Poland Hungary Assistance for Reconstruction of the Economy ¹
RESC	Regional Enterprise Support Centre
SEAF	Small Enterprise Assistance Fund
SEE	South East Europe
SEED	Southeast Europe Enterprise Development
SMEs	Small and Medium-Sized Enterprises
TA	Technical Assistance
UN	United Nations
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
VAT	Value-Added Tax
ZPP	Payment Operations Office

1. Originally the acronym of an EC programme targeting Hungary and Poland, the EC/Phare Programme has become the main channel for the EU's financial and technical co-operation with all of the countries of Central and Eastern Europe.

1. EXECUTIVE SUMMARY

Since independence in 1991, the Former Yugoslav Republic of Macedonia (FYROM) has made significant progress in reforming its political and economic systems. Despite the influence of internal and external destabilising factors, it has managed to set up a macro-economic structure which is demonstrating economic growth.

This report is a direct response to requests from the FYROM Government and the European Commission (EC) for assistance, within the framework of the Investment Compact for South East Europe, in refining the country's policy and strategy for the development of small and medium-sized enterprises (SMEs). Weaknesses in SME policies reduce the potential for growth in the field of enterprise development. Whilst the government acknowledges the significance of entrepreneurship and the development of SMEs as a potential stimulus for job creation and economic growth, numerous policy weaknesses are evident. These issues are worth tackling as a matter of priority. The main recommendations, which are amplified in the main body of the report, are set out below.

1.1 Institutional Capacity-Building

Establishment of an SME Policy Co-ordination Forum

There is little or no co-ordination between ministries and agencies of government with respect to their policies, programmes and proposed future activities which impact upon the enterprise sector. A consultative SME Co-ordination Forum should be created, headed by a senior politician, with the aim of prioritising and co-ordinating SME-oriented policies and initiatives by all relevant ministries and agencies. It should communicate information on its work to the government and to all relevant ministries and institutions. In addition, the Forum should have an advisory role as well as a monitoring and review role, in order to evaluate the effectiveness of enterprise policy. In this regard the OECD/UNIDO guidelines on best practice on entrepreneurship and enterprise development provide a useful framework for wider examination of SME policies.

Capacity-Building for the SME Department of the Ministry of Economy

The existence of new staff and the need to develop complex policies and strategies mean that the SME Department requires capacity-building to perform its role more effectively. This effort should focus on the national SME strategy, working towards the removal of administrative barriers, development of legislation and co-ordination of the SME policy network.

Reform of the Role of the National Enterprise Promotion Agency (NEPA)

The institutional structure for SME support in FYROM is weak and in need of strengthening, in particular the role of NEPA. The following changes are required urgently:

- a) creation of closer ties between NEPA and the Ministry of Economy through regular consultative meetings;
- b) reform of NEPA's existing committees, as these are not operating effectively;
- c) securing NEPA's long-term future by means of a decision on its post-EC/Phare funding and preparation of performance-based contracts with the Ministry of Economy;

- d) reorientation of NEPA away from financial services and towards its core role, namely implementing the SME strategy determined by the Government;
- e) further technical assistance for staff with regard to their monitoring and co-ordination role.

Reform of the Role of the Business Support Centres

The business support centres are the main organisations offering direct support to entrepreneurs, together with private consultancies. Urgent reform is required in three main areas:

- a) A decision needs to be made by the FYROM Government as to whether the business support centres should be given financial support once donor funding has terminated, since they will not attain financial sustainability by the end of 2002. It has always been understood that this would happen, but if the FYROM Government decides not to take over this responsibility, the business support centres should be allowed to compete within the business consultancy market.
- b) In order for NEPA to monitor and co-ordinate the business support centres effectively, it should have non-voting representation on the Managing Board of the Regional Enterprise Support Centres, thus making both more accountable. The same should happen in due course with the network of donor-supported business support centres which are currently not part of the NEPA network.
- c) Accountability and transparency need to be enhanced through performance-related contracts between NEPA and the business support centres. This would have the added benefit of rewarding innovation and success and thereby providing incentives to the network of business support centres.

1.2 Business Environment

Comprehensive Reform Agenda of Legal and Administrative Barriers

Various studies exist on the numerous remaining administrative and legal barriers to enterprise development and inward investment, as well as proposed solutions. This information needs to be assessed and integrated into an action plan, a government-approved set of actions which are prioritised, allocate responsibility and identify deadlines for resolution. These actions would then have to be monitored on a regular basis in order to ensure progress.

Establishment of an SME Advisory Forum

The lack of consultation in the creation of new laws, regulations and taxes affecting the enterprise sector can lead to externalities such as unnecessary compliance costs, non-compliance and unintended consequences. The proposed SME Advisory Forum would have the following tasks: providing independent advice; assessing existing and/or draft regulations/laws/taxes; consulting businesses and citizens; identifying problems and proposing solutions to government.

1.3 Financial Support Capacity-Building

Provision of Long-Term Credit to Micro and Small-Sized Enterprises through a) Local Banks or b) Local Banks and a New Dedicated Micro-Finance Institution

Although the financial system in FYROM has improved markedly in the recent past, credit to enterprises remains scarce and focused primarily on larger firms. Banks maintain that there are few good business opportunities whilst entrepreneurs argue that banks are not sufficiently skilled in assessing SMEs. While most countries in the Stability Pact region enjoy the services of a dedicated micro-finance bank, FYROM does not, mainly because until recently the high minimum capital

requirement for banks relative to the small size of the country made setting up a micro-finance bank a commercially nonviable investment. Recently the Government appears to have been convinced of the usefulness of such an institution and has signalled its willingness to make the necessary amendments to the sector's legislation and regulations to allow International Financial Institutions (IFIs) to set up a new micro-finance bank. The IFIs operating in the region have not yet decided whether they would be able to carry out a micro-finance programme solely through existing banks or whether this would need to be complemented by the setting up of a new micro-finance bank. In the latter case, a derogation from the minimum capital requirement would be required.

Promoting the Development of Mutual Guarantee Schemes

As a way of reducing the serious asymmetric information problem affecting the Macedonian banking system, it is recommended to promote the introduction of local mutual guarantee schemes. These schemes have the benefit of reducing the risk associated with small enterprises by pooling information on these enterprises to a single institution (the local guarantee fund), which provides an alternative to collateral in loan application to banks. Local banks can participate in the fund by having a seat on the board, which enables them to gain important information. The reduction of the asymmetry in information and the presence of a pool of funds that can be used instead of collateral, can facilitate SME access to bank finance by reducing the perceived risk linked to enterprises and easing the collateral requirement for borrowers. It is recommended that support be provided to assist in the development of mutual guarantee funds in FYROM.

The above recommendations represent the policy areas where rapid progress can be made at this juncture in FYROM's development. A more settled political environment is essential in order to allow better concentration on crucial economic policy reforms and advancement, as proposed in this report. The recommendations, if implemented, have the scope to assist FYROM in overcoming important weaknesses which hamper the development of the SME sector and thereby limit the potential for investment, employment generation and economic growth.

2. BACKGROUND AND TRENDS

2.1 General Background

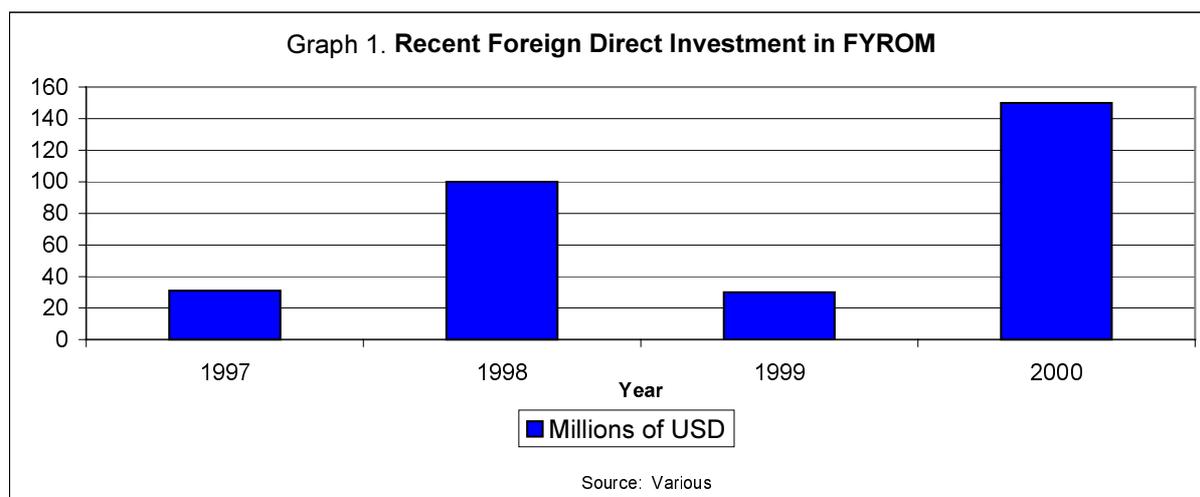
The Former Yugoslav Republic of Macedonia (FYROM) was established in 1991. It is a relatively small country comprising 2.1 million people, the majority of whom define themselves as Macedonians.

The economy of FYROM suffered a severe recession during the first half of the 1990s, in common with almost all transition countries. Since 1995, the economy has been more stable, with steady growth. Real GDP grew by nearly 3% in 1998 and again in 1999, despite the disruption caused by the Kosovo conflict and temporary inflow of a large number of refugees. Growth for 2000 was 5.1%, the highest rate since the start of transition. Following the recent tensions in FYROM, the GDP forecast for 2001 has been revised down from 6% to 2.5%.

The government has successfully maintained stabilisation policies – it has had price stability since 1996 and enjoys low inflation rates (5.8% in 2000), which are projected by the Ministry of Finance to remain around 3.5% annually. The central plank of monetary policy since 1995 has been a *de facto* peg of the currency (denar) with the Deutschmark (with a 15% devaluation in July 1997), and hence with the Euro since January 1999.

Between 1995 and 1998 the current account deficit rose steadily, to nearly 9% of GDP. Although the current account deficit fell to around 4% of GDP in 1999, the lowest figure since 1993, the gap widened again to 7-8% in 2000. Persistent high current account deficits in FYROM reflect the low domestic savings rate, which in turn is a result of a lack of confidence in the banking sector.

The level of Foreign Direct Investment (FDI) in FYROM is shown in Graph 1 below. FDI levels fluctuate in line with one-off privatisation-related direct investments and in per capita terms are amongst the lowest levels in Central and Eastern Europe.



The unemployment rate (around 32%) is among the highest in the region. It is generally acknowledged that many of those who declare themselves to be unemployed are in fact working in the large informal

economy. The unemployment rate reflects high overall labour taxes, institutional rigidities in hiring and firing workers and a fairly generous unemployment benefit system.

Nevertheless, the problems of unemployment and the associated poverty are serious. The per capita GDP is below the Eastern European and CIS average (see Table 1 below). The same applies to adult literacy and education enrolment, although life expectancy (over 73 years) compares favourably with other transition countries in the region (average of 69 years).

Table 1. **Human Development Index (2000)**

	Life expectancy 1998	Adult literacy rate (%) 1998	Education enrolment ratio (%) 1998	GDP per capita (PPP US\$) 1998	Life expectancy index	Education index	GDP index	Human development index (HDI) value 1998
Eastern Europe and the CIS	68.9	98.6	76	6,200	0.73	0.91	0.69	0.777
FYROM	73.2	94.6	69	4,254	0.80	0.86	0.63	0.763
OECD	76.4	97.4	86	20,357	0.86	0.94	0.89	0.893

Source: UNDP (2000)

2.2 Enterprise Environment

Table 2 sets out the categories of enterprises as determined by FYROM law. This definition varies from the recommended EU definition.

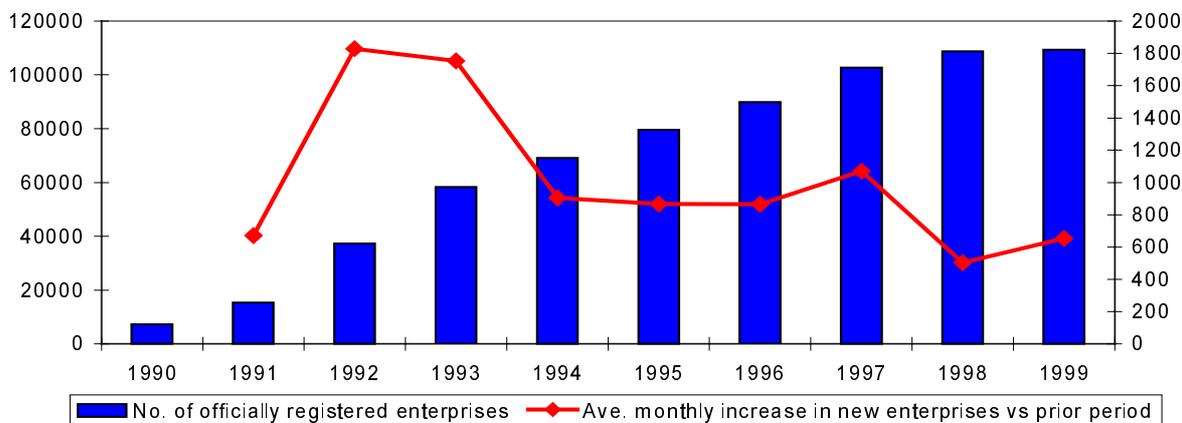
Table 2. **SME Definitions**

Definitions	Micro	Small	Medium
FYROM			
Average number of employees (based on annual working hours)	<10	<50	<250
Annual income (expressed in average number of monthly gross salaries)	N/A	<8.000	<40.000
Annual average assets (expressed in average number of monthly gross salaries)	N/A	<6.000	<30.000
EU			
Maximum number of employees	<10	<50	<250
Maximum total income in million Euro	N/A	7	40
Maximum total assets in million Euro	N/A	5	27
Maximum capital/voting rights held by non-SME enterprises	N/A	25%	25%

Note: The gross average monthly salary is published regularly by the Statistical Office of FYROM.

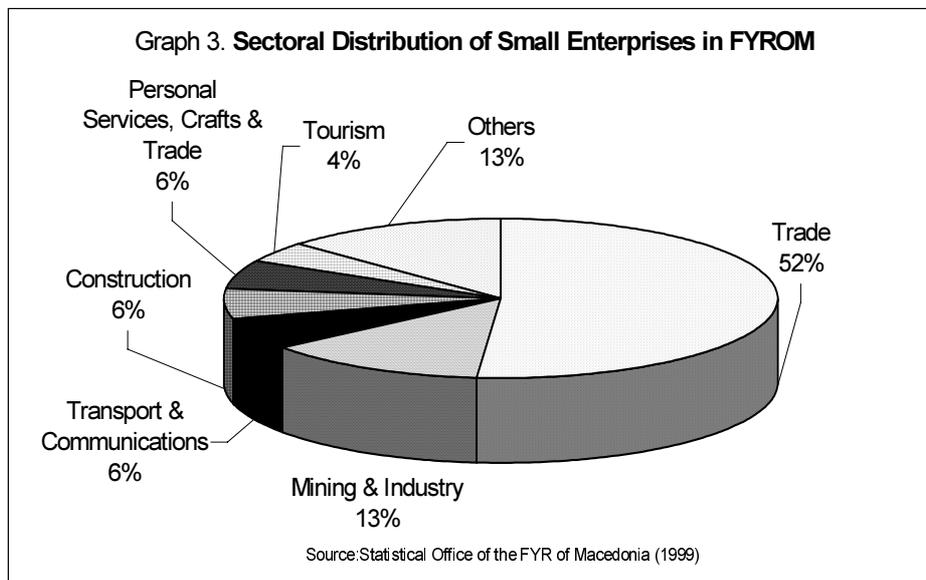
Official statistics show that the overall growth in the number of registered small enterprises has been very rapid over the last ten years, as illustrated in Graph 2 below. It is estimated that these firms can be categorised as being very active, partly active and inactive in fairly equal proportions.

Graph 2. Number of Registered Enterprises since 1990

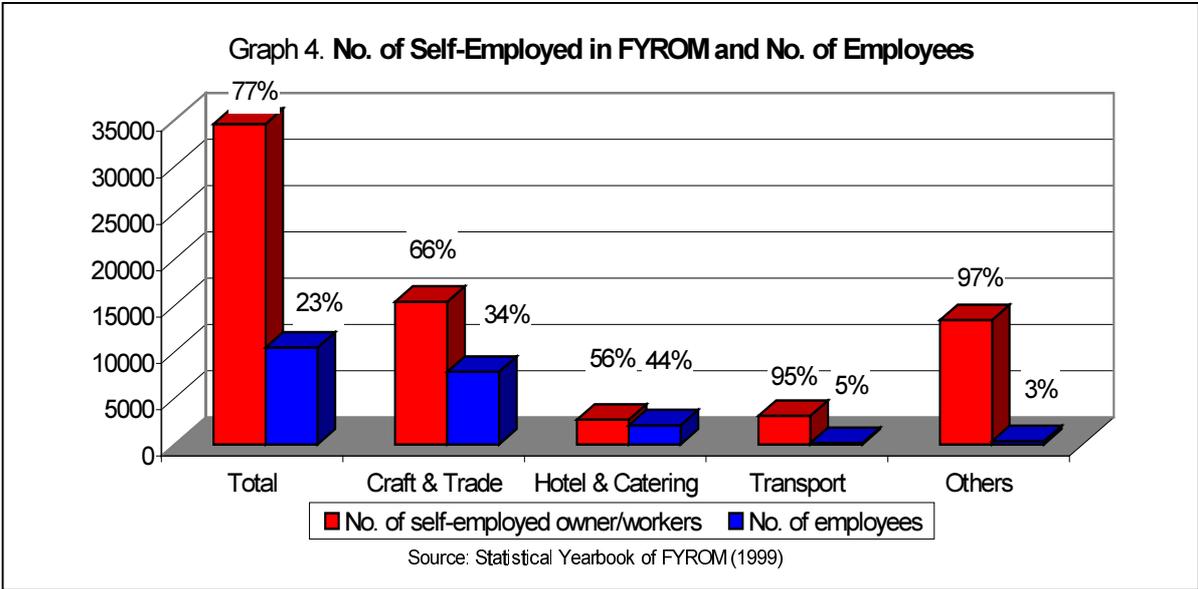


Source: Compiled on the basis of Statistical Yearbooks of the FYR of Macedonia and Soopsteine No. 32, 3.03.1999 Statistical Office of RM

The sectoral distribution of small enterprises reveals a strong bias (52%) in favour of trade (see Graph 3), much of which represents new businesses which are small scale, low risk and low capital-intensity operations such as petty trading.



As with the registered enterprise sector, registered self-employment also grew quite rapidly in the first few years of independence, before levelling off. Graph 4 below illustrates the high proportion of self-employed owners with no employees (77%). The comparatively high tax rates and the relative ease of tax evasion mean that many self-employed owners fail to register their employees.



In terms of the average size of an enterprise in FYROM, there is a preponderance of micro and small enterprises, as illustrated in Table 3 below.

Table 3. Selected Data According to Firm Size Category (1999)

	Employees	Total sales(%)	Net average monthly salary per worker	Net profit (%)
Large (more than 250 employees)	119,515	41%	310 DEM	57%
Medium (50-249)	68,763	59%	248 DEM	43%
Small (10-49)	105,498		209 DEM	
Total	293,776	100%	----	100%

Source: Payment Operations Office (ZPP), Skopje

One of the most notable features of the growth experienced over the last few years has been the strength of the informal sector. Informal sector businesses in FYROM are said to account for up to 50% of economic activity (EIU, 1999; various). Various taxation amnesty plans have been created to coax such businesses into the official economy, but disincentives associated with an overly regulated system means that many informal sector businesses remain unofficial. The recent reductions in personal income tax levels and the introduction of Value-Added Tax (VAT) are reportedly having a positive impact in encouraging official registration of businesses.

2.3 Issues of Concern to Businesses

SMEs in FYROM report a fairly typical range of problems for transition countries. Recent surveys of businesses indicate that although they have potential to expand, they are often constrained by a variety of factors (EC/Phare, Ramboll, 2000b; GTZ-DEG, 2001). The perceived obstacles to the efficient management of business and start-ups include:

- Finance: the overwhelming majority of firms point to finance being a problem. What they require is affordable medium and long-term credit for start-ups, expansion or assets.
- Institutional support: businesses have a wide range of needs which can be met by business advisory centres, regional offices and a variety of other players. Other than access to credit, the main needs relate to assistance with administrative procedures, as well as support with business planning, marketing and exporting.
- Business procedures: there is both a high degree of over-regulation and a lack of transparency in procedures to obtain administrative documents, such as registrations, permits and planning permission. This is considered to be a major hindrance to enterprise development and results in corruption.

The above obstacles represent some of the issues which enterprises identify as being particularly significant, a number of which are addressed in this report.

3. POLICIES AND INSTITUTIONS

3.1 Introduction

Since 1991, the financial resources available to the government have declined. The main resources that the FYROM Government has been able to direct towards enterprise development thus far have been those provided by the international donor community. Notwithstanding the lack of resources to promote the SME sector, the government acknowledges the importance of the activity to the longer run economic development and has welcomed the efforts of the international donor community to establish SME support programmes and has undertaken various measures to strengthen the SME-related institutions.

3.2 Functions and Responsibilities

3.2.1 *SME Department, Ministry of Economy*

The SME Department within the Ministry of Economy is the sole institution responsible for SME policy and strategy in FYROM. Following a process of reform, the new staff are in place. The SME Department has six staff members, consisting of a director, two deputies (respectively responsible for SMEs and handicrafts, the latter being sole traders) and support staff.

Its main areas of responsibility include:

- policy formulation for the SME sector;
- preparation of the national SME strategy;
- preparation of legislation for SMEs;
- co-operation with relevant SME institutions;
- co-operation with the international community.

The SME Department is currently focusing on preparing a new national strategy for SMEs and a draft Act on SME Development Support, the aim of which is to create a favourable institutional, legislative, administrative and financial environment for the establishment and development of SMEs in FYROM.

There has been for some time a recognition that an SME strategy is required for the effective development of the enterprise sector in the country. Various SME strategies have been prepared since 1991, although a mixture of political/ministerial changes and resource constraints have precluded agreement and follow-up. The SME Department recognises the urgent need for strategy addressing the policy fundamentals of SME development. An SME strategy has been in the planning stage since last year and is expected to be ready this year.

The SME Department has recently been presented a proposal for an SME strategy by GTZ/DEG (2001), which is based on a survey and workshops with businesses. The SME Department is reviewing how best to use this detailed recommendation. This work needs to be connected with the EC/Phare programme of SME support. Various SME-related reports have been prepared for the Phare programme and it is anticipated that these will be used in the new technical assistance contract (expected to start in mid-2001) to deliver, among other things, a new SME strategy for FYROM.

In addition, the Ministry of Economy has 34 regional offices which are non-elected organs of the state. These bodies perform an administrative function, which is essentially bureaucratic in nature. The regional offices have an average of three personnel and their role includes:

- collection and analysis of economic data and information;
- registration of businesses;
- transfer of information to the Ministry of Economy.

3.2.2 Other National-Level Organisations

There are a number of national-level organisations with responsibilities which impinge on entrepreneurship and enterprise development issues. These include the following:

- *National Employment Office*: seeks to implement active labour market policies through its regional network of offices. These offices can assist enterprise development through such activities as training programmes for the unemployed and business start-up courses for potential entrepreneurs.
- *National Chamber of Commerce*: has lost much of its former influence following the collapse of the large enterprise sector and is now trying to establish itself as a player in the SME sector. Some of the regional chambers have attracted SME members and are trying to build a portfolio of services to justify their membership fees (mandatory 0.1% of an enterprise's gross salary bill).
- *Privatisation Agency*: was created in 1993 to manage the privatisation process in FYROM and is the body which funds part of the budget for the National Enterprise Promotion Agency, the SME implementing agency (see below).
- *Agency for Development and Investments* and *Agency for Free Trade Zones*: were both created to co-ordinate and promote foreign investments, especially from Chinese Taipei. However, the recent strain in diplomatic ties is likely to affect the flow of assistance and investment coming from this source.

3.2.3 National Enterprise Promotion Agency

With the support of the EU's Phare programme, the National Enterprise Promotion Agency (NEPA) was established at the end of 1997 as the main national promotional body for the SME sector in FYROM. It was officially established in 1999 as a government-owned limited liability company. Budgetary responsibility for NEPA is retained by the Privatisation Agency, although NEPA is linked directly to the Ministry of Economy in that it is required to report regularly to this ministry on its activities, and the Minister of Economy chairs NEPA's Steering Committee.

Based on its Mission Statement and Business Plan, NEPA's role is to promote and support the transition to a market economy in FYROM through the entry, growth and development of vigorous SME enterprises. Its stated role is to:

- stimulate the establishment of sustainable start-up enterprises;
- stimulate the growth of private SMEs in value-added sectors;
- support the development of innovative and export-oriented SMEs;
- improve the basic competencies and business skills of entrepreneurs;
- support the creation of viable jobs in SMEs to reduce unemployment;
- support the transformation of SMEs from the 'informal' to the 'formal' sector;
- encourage the development of a competitive business environment within which entrepreneurship can flourish.

Thus NEPA seeks to promote the SME sector across the broad range of government activities, including working with the international donor community in order to establish new programmes. It sponsors research programmes to investigate the main barriers to business development and the main business opportunities on offer. NEPA manages a micro-credit fund which is provided by Phare and disbursed through local financial intermediaries and, in addition, it is expected to conduct income-generating activities in order to maintain its operation.

As in other transition economies, significant international donor support has been forthcoming in order to establish a countrywide network of local/regional business support centres. NEPA is also charged with monitoring and co-ordinating the network of Regional Enterprise Support Centres (RESCs) funded by the EU's Phare programme.

3.2.4 Business Support Centres

The Regional Enterprise Support Centres (RESCs) are based in Skopje, Veles, Komanovo, Strumica and Bitola. They were established as independent bodies with a Management Board composed of all local stakeholders in the SME development process. The regional offices and municipalities are key stakeholders in the RESCs, often heading up the Management Board. These local/regional RESCs provide a range of services and training packages directly to new and existing SMEs. In the long run, they are meant to act as focal points for a range of SME development activities.

The role of business support centres is typically to provide:

- counselling and advisory services to enterprises;
- assistance to enterprises in preparing business plans (including applications for micro-credit);
- information provision, training and seminars;
- trade and investment services;
- income generation services, such as consultancy.

The RESC network of support services to enterprises is a relatively recent addition to the institutional system in FYROM. By contrast, bilateral donors have long been engaged in funding and providing technical assistance to enterprise support organisations. For example, USAID established the Macedonian Business Resource Centre in Skopje in 1995 and the UK Government's Department for International Development (DFID) has funded and supported three Enterprise Support Agencies (ESAs) in Gostivar, Tetovo and Ohrid since 1998. Added to these business support centres were the Phare-funded RESCs, the Dutch-funded Macedonia Enterprise Development Foundation in Skopje, and the Swiss-funded business support centre in Prilep.

More recently, other gaps in the support services have been filled. For example, the World Bank has supported the development of business incubators in Prilep, Stip, Makedonksa Kemica, Delchevo and Krushevo. These are designed to help create and grow businesses within a specific building or location and form part of the World Bank's programme to ameliorate the adverse employment consequences of large companies undergoing re-structuring and downsizing.

It should be noted that the RESCs, ESAs and other organisations mentioned above represent all that exists to provide businesses with support services in FYROM. There is a fairly good geographical spread and reach, although there is an issue of the sustainability of these business support agencies. Phare funding for NEPA and RESCs will cease in 2002. DFID and Phare are introducing tapered funding which will require these organisations to look for alternative sources of funding or establish a wider range of services from which they can secure an income stream.

3.2.5 Other Players

Apart from the above, key institutional players include:

- Local authorities: elected local governments lack resources and their role is largely confined to participation in business support agencies and in-kind support, such as the provision of business premises.
- Private business support / advisory / training consultancies: having emerged over the last few years, the business consultancy sector is likely to continue expanding in the future and to increasingly compete with the network of business support centres. In the long term, the development of this sector is essential in generating a successful and sustainable market for SME services.

The nature of the current enterprise development institutional structure is illustrated in Figure 1 (page 23).

3.3 Key Issues

The key issue under review is whether the previously described institutional system enables the design, implementation and monitoring of sound SME policies, taking into consideration the special needs of SMEs, and whether these are fully integrated into government policy. There are a number of concerns, as set out below.

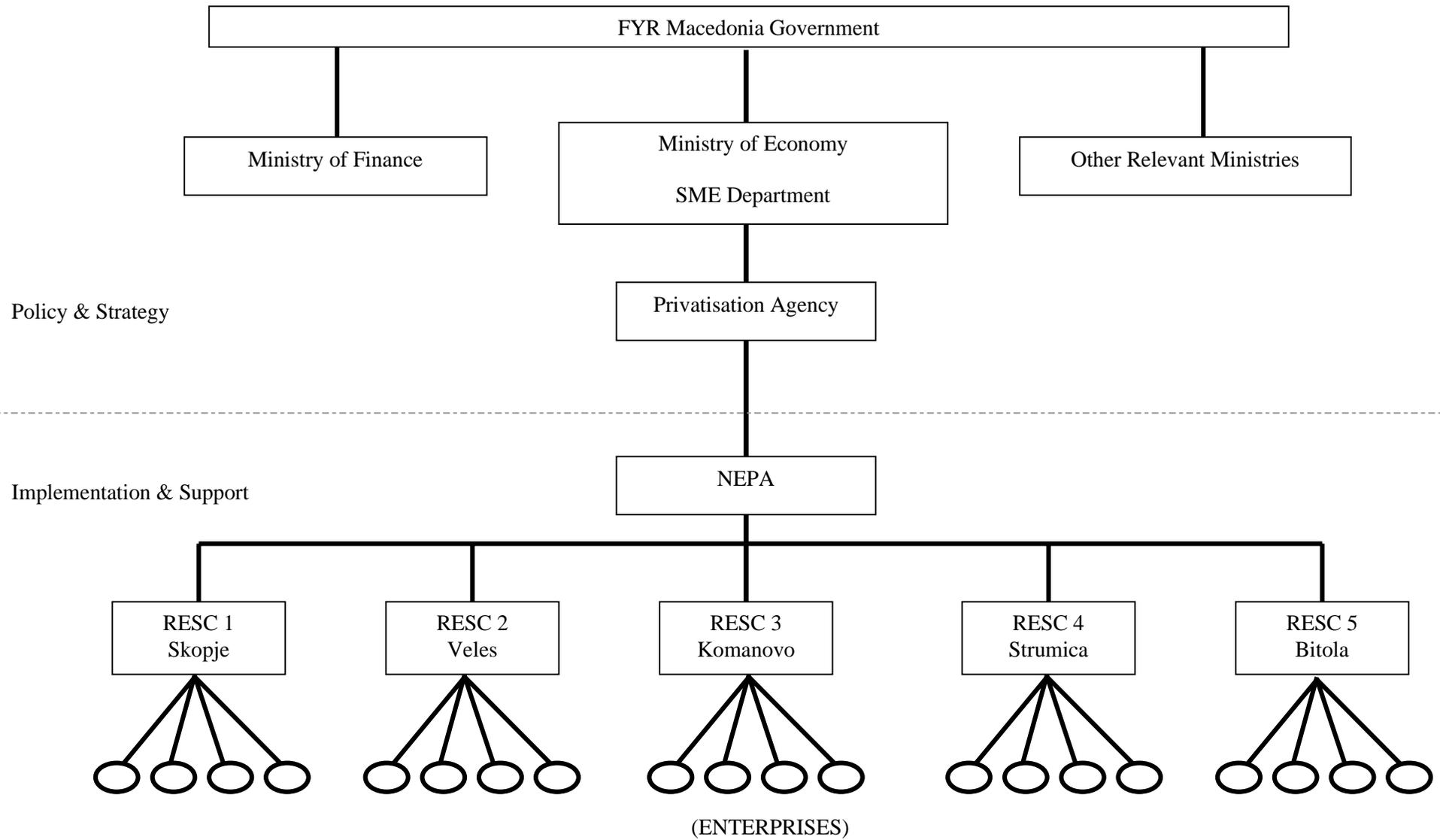
3.3.1 National Policy

There are frequent changes of staff, both at ministerial level (three changes in the last two years) and operational level. The SME Department of the Ministry of Economy has new staff, and although the senior staff are experienced and some have held similar positions before, there is a need for technical assistance (TA) to help them to perform their functions more effectively. In particular, assistance in the development of an agreed SME strategy, as well as in the preparation of appropriate legislation in support of SMEs, would be advantageous. It is anticipated that the latest Phare programme will cover part of this need, together with the activities of other multilateral and bilateral donors.

As previously discussed, a national strategy for SME development remains to be completed. There is potential support from GTZ/DEG, the World Bank/IFC's Southeast Europe Enterprise Development (SEED) programme, and Phare technical assistance. The history of semi-completed SME strategies, including in the current situation, highlights the danger of overlapping programmes and activities. It is important to finalise an SME strategy as soon as possible, so that the ministry can begin to steer the process of implementation within a defined timescale. Previous experience with transition countries suggests that such strategies benefit from the inclusion of clear timescales, responsibilities and actions. The SME Department's progress with implementation can then be measured and assessed against verifiable goals and outcomes.

It remains unclear when this work will be done and, in particular, how it will be subject to consultation and discussion over the next few months. The document would benefit from the involvement of relevant ministries, NEPA, the business support network, as well as other relevant private sector bodies and NGOs.

Figure 1. Current SME Institutional Framework



Allied to the finalisation of an SME strategy, at present, it is not the responsibility of any organisation to co-ordinate the activities of all of the relevant ministries and other key players to ensure that a business-friendly environment exists which will assist the further development of the SME sector in FYROM. A similar committee chaired by the Deputy Prime Minister was discontinued in 1999, which is unfortunate since other countries have implemented such a mechanism in recognition of the necessity for co-ordination of policy, tax and law at national level. Overall, the channels of communication between government, SME bodies, NGOs and the private sector / entrepreneurs remain largely informal or non-existent. It would be useful to establish a formal channel of communication for the SME sector, which draws together the relevant parties on a regular basis. This would represent a positive step forward in working towards more SME/business-friendly government policies, laws and taxes.

3.3.2 Implementation

NEPA has had a difficult start as an institution. It is recognised by the Phare programme that the morale and credibility of NEPA needs to be re-established, something which has not been helped by the delays in the proposed programme of technical assistance. Reconsideration and reform of various aspects of the nature and role of NEPA are required as a matter of priority.

In terms of NEPA's funding, salaries are currently funded by the Privatisation Agency, with the programmes of activity being funded mainly by Phare, but the latter support will end in 2002. Similarly, the Privatisation Agency has almost fulfilled its remit, in that 95% of the companies listed have been privatised. Progress needs to be made in securing core funding, which in turn requires government to determine whether NEPA should continue to perform its role. If so, long-term funding must be forthcoming. NEPA could operate as a separate agency, with its own board. It could have output-based contracts with the Ministry of Economy, which would continue to chair NEPA's board, as well as ensure accountability through regular monitoring and evaluation of its performance. NEPA's future would be dependent on its success in meeting the SME implementation objectives to be set out clearly in negotiation with the Ministry of Economy.

NEPA's reporting line to the Ministry of Economy is currently weak. NEPA's *Steering Committee* is chaired by the Ministry of Economy and consists of representatives of such ministries as Finance, Justice and Social Affairs, Phare and the Privatisation Agency. The original intention of involving the private sector has not materialised in a meaningful way. The Steering Committee's function is mainly to approve the activities of NEPA, its budget and that of the RESC network. This body has failed to convene for some time and its purpose is in need of review.

NEPA currently has two other controlling bodies. The *Management Board* has similar responsibilities as the Steering Committee but consists of government appointees, some of whom appear to have little relevant experience. The appointees receive a monthly fee but do not play a substantive role in NEPA's future, as their appointment is a legal requirement and so functions in a legal sense, but not in practice. The appointee system is in need of review, and criteria and rules need to be defined which attract and retain people with appropriate skills and background.

The role of NEPA's *Controlling Board* is to review the annual financial report and assess NEPA's operational activities. It also has paid appointees who have yet to meet. There is a need for reconsideration and clarification of the roles and rules associated with these bodies, and indeed whether all three are necessary or not.

In acquiring a role in running the Phare micro-credit line, NEPA has gained an income-generating capacity and been drawn into closer contact with entrepreneurs via the RESC network. At the same time, however, it has taken on functions which are not entirely consistent with its role as the implementing agent for SMEs. As a result its image has become blurred, and it is seen as a disbursement institution by

some entrepreneurs. Consideration should be given to whether it is appropriate for NEPA to continue to run this micro-credit fund – for example, one of the local financial institutions may be in a better position to do so – and whether it should focus on its main role, namely to implement the policy and strategy determined by the SME Department. The same argument applies to the draft Law on SME Development Support, which envisages NEPA having a key role in the proposed State Guarantee Fund.

Following on from the micro-credit fund, the requirement for RESCs and ESAs to produce the business plans that are submitted to participating banks for loan approvals has certain advantages for the business support centres. It gives them access to fee-earning work and fosters contacts with enterprises, which may then lead to the delivery of other information, training and consultancy services. However, this represents a market distortion – applicants should be in a position to determine which organisation, if any, is to conduct their business planning in order to be eligible for the micro-credit fund. An alternative would be to open-up the process to competition (including the business consultancy sector) and to award contracts for a limited period, during which performance can be monitored and evaluated.

NEPA is charged with monitoring and co-ordinating the RESC network. In performing their monitoring role, the RESCs submit monthly reports for NEPA approval prior to further funds being released. At present, all RESCs obtain flat-rate funding. An issue which merits further consideration is whether there is a need for a mechanism to assess performance and reward initiative and success in delivering RESC objectives through output-oriented contracts. This would require a revision of the contracting basis between the RESCs and NEPA but could ultimately result in new incentives and co-operation between the two organisations.

NEPA is experiencing difficulties in fulfilling its duty to co-ordinate the activities of the RESC network. There have been major problems in securing resources for the RESCs (other than salaries and some other resources), which have damaged both Phare and NEPA's reputation with the network of RESCs. Until this difficulty is resolved satisfactorily, NEPA's co-ordinating role will be undermined or non-existent. The longer this situation continues, the more the RESC network will have to look for alternative means of sustaining itself. This may increasingly take RESCs on a trajectory which may not be consistent with the original aim of the business support network. Phare anticipates that the funding situation will be resolved in the near future, and indeed it was intended from the beginning that NEPA and RESCs would be state-funded.

Furthermore, the RESCs have formed themselves as foundations, which means that they are independent organisations in a contractual relationship with NEPA. There are sound reasons for NEPA ensuring its presence on all of these foundations in order to effect a co-ordinating function and perform a monitoring role. This involvement could also lead to a more fruitful partnership between NEPA and the RESCs than exists at present. The logical extension would be for the network to be expanded to the ESAs, the Macedonian Business Resource Centre, the Dutch-funded Macedonia Enterprise Development Foundation (Skopje) and the Swiss-funded business support centre in Prilep. This expansion presupposes that NEPA would begin to perform its role more effectively than at present and that the relevant donors would be in agreement.

The business support centres are expected to become the main SME promotional and project implementing bodies in the country. Their longer-term sustainability was premised on revenue generation from the provision of commercial services, but it is increasingly recognised that this is not a likely prospect. The lack of sufficient income generation is leading the business support centres to become, of their own volition, much more commercially oriented. The result is that a range of commercial services is increasingly being offered, such as contract work with the largest enterprises, particularly foreign enterprises.

The long-term nature and thus the funding structure for NEPA and the RESC/ESA network need to be resolved soon. The FYROM Government has to make a choice. At present the business centres have both

a commercial orientation and a public service focus. Some of the services on offer are designed to be charged for, and other institutions are also willing to perform this role. The business support centres also offer a number of core services which have a public service nature. Much of the business information and advice provided is designed to stimulate entrepreneurship and to educate businessmen about basic principles and procedures for establishing and operating a business. They may also include advice about registration, employment and exporting. The FYROM Government must decide whether the latter services should be provided at all, and thus whether they should be subsidised by government. The business support centres will either continue to be (partly) state-supported once donor funding has ended, or they will increasingly become organisations focusing exclusively on their commercial services and competing with others in the marketplace.

Both NEPA and the RESCs / ESAs have already received training through the Phare and DFID programmes. This training needs to continue, at least in the medium term, in order to ensure that these organisations acquire and retain the skills necessary to fulfil their demanding roles. One of the areas with long-term potential would be training on how to work in partnership with others to prepare regional development strategies in anticipation of the EU accession / pre-accession process.

4. REGULATORY ENVIRONMENT

4.1 Introduction

The Government of FYROM recognises the need to promote an energetic private sector and improve the investment climate through market-oriented structural policy reform. The creation of an enabling environment for private sector development is essential, both for encouraging start-ups (especially foreign-owned firms) and expansion of existing businesses. It is generally recognised that much effort is needed to remove the constraints and obstacles to business formation and enterprise development in FYROM.

4.2 Key Issues

One of the most notable bureaucratic problems in FYROM is the registration procedure for start-up enterprises, where anything between 16 and 24 institutions may be involved. Enterprises are helped by the business support centres, some of which have produced fact sheets showing entrepreneurs how to navigate the bureaucracy and become registered in the most efficient manner possible. What is needed, however, is a simple and streamlined registration process. The now defunct Ministry of Development initiated some steps to simplify the registration procedures for SMEs by setting up the Committee for the Simplification of Registration Formalities, whose main proposal was the introduction of a “one-stop shop”. Following some public debate, little progress has been made and the reform of the registration process remains a high policy priority.

However, the problems associated with business registration are just the “tip of the iceberg” as far as legal and administrative barriers to entrepreneurship and enterprise development are concerned. It is widely accepted in FYROM that the numerous remaining obstacles to business activity must be addressed urgently, not least because areas where arbitrary decisions can be made invite corrupt activity. Bribery, corruption and other forms of informal activity are often accepted by entrepreneurs as the only means of facilitating the further development of their businesses. This situation underlines the need for minimizing administrative and legal barriers insofar as possible.

There is no shortage of evidence of the necessity for reducing these barriers. Three reports -- *Removing Legal Obstacles* (EC/Phare, 2000), *Review of the Legal, Institutional and Organisational Environment of Small and Medium-Sized Enterprises* (EC/Phare, 1999) and *Programme of the Republic of Macedonia for Stimulating Investments, with a Special Emphasis on Attracting FDI* (Ministry of Development, 1999) -- together catalogue an extensive range of issues which need to be tackled urgently. The list of these issues will not be repeated in this report, except for a brief review of some of the more serious problems which are encountered by enterprises on a daily basis and which either restrict their activities or impede their future development and competitiveness:

- Registration of SMEs: State agencies and courts have established long, complicated and expensive procedures for setting up, registering and obtaining permits by entrepreneurs who undertake to initiate (or legitimise) their activities. These procedures should be simplified (e.g. one-page forms) and there need not be court involvement in the process.
- Access to land: The reforms which have taken place have not succeeded in generating unrestricted access to land accompanied by sound land market conditions and greater freedom of land management and land tenure for SMEs.

- Planning system: Planning laws are vitally important to business development and to ensuring sustainable growth. The physical planning laws and urban plans in FYROM are out of date and constrain start-ups and expansions unnecessarily.
- Customs formalities: Entrepreneurs seek a customs system with simple procedures which cut down the costs of customs clearance. The system in FYROM consumes both time and money, information about customs formalities is lacking, and in general these formalities hinder enterprise development.
- Court system: Enterprise development necessitates an efficient judicial system which makes, and is able to enforce, expeditious and effective judgements in civil and criminal cases. Reforms are required in order to ensure that there is greater confidence in the courts (e.g. bankruptcy proceedings), that they are not overburdened (e.g. arbitration agreements), that they make judgements quickly and enforce them consistently (e.g. settlement of outstanding payments).
- Security rights: The law on security rights is of primary importance for any commercial relationship and its financing. The enforcement procedure and the registration of securities are not adequate to ensure an investor-friendly climate and represent major impediments to the business environment.
- Labour laws: The current labour laws and regulations are either not applied properly or not respected. In addition, the labour and social security legislation is geared towards large enterprises and needs to be adapted to the needs of SMEs.

The remaining administrative barriers are clearly extensive, although some progress is being made. For example, the payment system obliges firms to have an account in the Payment Operations Office (ZPP) and to perform all payment operations through it. Effectively, the ZPP acts as the clearing house where all payments are processed, but this system involves a number of liquidity, credit, and operational risks to enterprises. The ZPP has been roundly criticised as being costly, inefficient and in need of rapid reform, since the cheque clearing system could operate more effectively through commercial banks. The logic of this argument has now been recognised by the FYROM Government, with the result that the ZPP will be dismantled by the end of 2001. This represents an important step forward in the process of eliminating administrative barriers to enterprise development.

4.3 Consultation on Legislation and Regulations

Informal communication and lobbying remain the main ways open for enterprises to influence government policy. The “one-stop shop” initiative of the former Ministry of Development has been described as a response to the numerous complaints and representations made to the government with regard to the amount of legislation that small enterprises are required to understand and comply with. The handicraft associations are said to be less active in this policy area compared to the taxation system (which directly impacts on members’ pockets). The chambers of commerce (*komora*) have not been particularly active here either. Overall, it is likely that the government is listening more than it has in the past, but the informality and lack of transparency of the lobbying process are real concerns. As discussed in the preceding chapter on “Policies & Institutions”, there appears to be a need for a mechanism which draws together all affected parties on a regular basis in order to vet existing and potential rules, taxes and legislation affecting the enterprise sector.

In conclusion, the environment confronting the enterprise sector is over-regulated. The complexity, rapidity of change and wide scope for local interpretation and discretion hinder enterprise development and represent contributory factors to the persistence of a large grey economy. As discussed, various reports have identified the scope of the problem. What is now required is a comprehensive assessment of

the regulatory environment, the identification and prioritisation of problems, and a programme of action to be carried out urgently in order to simplify the regulatory environment and set specific targets within a defined timetable.

5. TAXATION

5.1 Introduction

Simple and stable tax systems are very important to enterprise development. Simple systems reduce the costs of compliance (of particular importance to the SME sector), and collection (of importance to government). The same logic applies to stable and well-designed tax systems. Enterprises value rules and rates which do not change very often, whereas instability discourages business planning, can jeopardise investments, threatens jobs and adds to the grey economy. FYROM lags behind many of its neighbours in terms of enacting and implementing modern tax rules, although tax policy has recently improved dramatically, resulting in a less onerous and more transparent system.

5.2 Tax System

Progress has been made on the tax system since last year. The recent introduction of VAT and reform of the income tax system have been driven by the Ministry of Finance's desire to move closer to the following tax scenario:

- neutrality in the tax system;
- increase in efficiency of the tax system;
- extension of tax liability and tax base;
- horizontal and vertical equity in taxation;
- compatibility with tax systems in EU countries;
- improvement of the competitive position of enterprises.

The key features of the new tax system are:

- Income tax: The personal income tax bands were previously 23%, 27% and 35%. These have been simplified to 15% and 18% and are low by international standards. Domestic and foreign taxpayers have been given equal treatment. Overall, FYROM has moved some way towards greater compatibility with modern tax systems.
- Corporate tax: The rate of 15% applies to legal entities such as banks, trading companies, joint stock companies and public enterprises.
- Employer contributions: In addition to personal income tax, there are a number of social taxes which are payable by employers (pension fund, health care, unemployment fund and additional health insurance). These contributions amount to a significant additional cost to firms, representing an overhead expense of about 30% (on gross wages).
- Property taxes: Property used for business activities is not subject to taxation.
- VAT was introduced in April 2000 and has been designed to be compatible with the EU's VAT Directive. There are two VAT rates: general (19%), covering most goods and services; and reduced (5%), on such items as food products, books and utilities.

5.3 Taxes and Enterprises

The Company Law allows foreign companies or individuals establishing a new company or purchasing shares in a domestic company to enjoy the same tax status as domestic companies. Enterprises are subject to payment of the following taxes: corporate tax, excise tax, VAT, social benefits, state and local fees, and customs duties.

The smallest entrepreneurs are registered as self-employed and are covered by an imputed tax system. A yearly payment is made to central government and a monthly payment to the municipality in which the business person is registered to trade. Given the size of the self-employed sector in FYROM, the imputed tax system covers a sizeable total of the enterprises officially registered, but different tax rates are levied on different types of small enterprise, creating confusion and possibly opening up to abuse. A number of factors are taken into account when assessing the tax rate a particular activity will be subject to, such as the assumed profitability of the sector and the social importance of the sector in terms of providing a livelihood for those involved.

For registered corporate entities, the system is more complex. Corporate tax is set at 15% of profits (it was 30% until 1997), which compares very favourably with other central and eastern European countries. However, overall labour and social security taxes on small corporate enterprises are higher than in most western European countries (see OECD, 1998) and this remains a concern for enterprises.

5.4 Tax Evasion

There has been some positive development towards a more neutral, transparent and enterprise-oriented tax system. Nevertheless, a culture of extensive tax evasion pervades in FYROM. Estimates vary but it is generally acknowledged that about 50% of economic activity is undertaken in the informal sector, which deprives the government of a substantial amount of revenue from a wide range of activities. Trading and importing activities are particularly hard to register for tax purposes since there is often no need for business premises or other capital assets that might come to the attention of the tax authorities.

The main types of evasion include not recording revenues, employees, businesses and agricultural activities, not to mention criminal and illegal activities. The reasons typically given for such evasion include the fact that taxes are perceived as being too onerous, the overly complicated administration and a relatively recent tradition of enterprises paying taxes. The current situation can only be changed in the long term through a series of actions designed to continue to simplify registration procedures for enterprises, the development of a transparent and stable tax system, and appropriate sanctions for tax evaders.

Some recent initiatives demonstrate that it is possible to make headway:

- The previous government's employment creation scheme involved exempting enterprises from labour taxes on any genuine new employment positions they created on the basis that lowering labour taxes paid by employers would increase labour demand. This scheme was principally taken up in the medium-sized enterprise sector and reportedly created more than 45,000 new jobs within one year. Taking into account displacement and dead-weight effects, it seems probable that the employment creation figure is much lower than this. Probably labour reserves were simply brought out into the open, rather than new jobs being created, but it resulted in some benefits in terms of motivation on the part of now genuinely employed workers.
- The IFIs help to ensure that the fiscal implications of reduced taxes are also appreciated by the government. It was largely on the advice of the IFIs that a strengthened tax service was instituted in order to try to rein in some of the non-taxpaying enterprises and to send a signal to others that tax avoidance would not be tolerated.

- The recent introduction of VAT shows that it is possible to change the situation. Most commentators, including the Ministry of Finance, estimate that in addition to raising revenues and enabling the reduction in other taxes, VAT has also had a positive effect in bringing parts of the grey economy into the open.

Further simplification and reductions, as planned by the Ministry of Finance, will continue to have a positive effect in this area.

5.5 Business Representation

A number of business associations routinely lobby government bodies to reduce the tax burden on their operations, and nearly all of these associations count SMEs among their membership. Local chambers of commerce have also played a lobbying role. Personal connections have been involved in informing the government about the implications of tax, although entrepreneurs are accused of being self-serving in their advice to reduce tax obligations. However, to date no formal, transparent and objective body has been established that can co-ordinate and channel advice on taxation policy to the government and thereby ensure that an unbiased assessment of the full impact of taxation policy on the business sector is reflected in government policy. Part of the work of the Investment Compact for South East Europe is focused on tax policy assistance to review current tax measures relevant to business activities and, together with host country officials, help advance tax policy changes towards promoting private direct investment.

6. FINANCE

6.1 Introduction

The environment affecting the availability of credit and equity can have a significant effect on enterprise development. In particular, the lack of stable, long-term loan and equity finance sources negatively affects the growth potential of both new and fast-growing, innovative SMEs, as well as firms' survival rate, especially during times of economic contraction. The situation in FYROM with respect to access to finance for enterprises has improved dramatically, following a period when public confidence in the financial system was effectively non-existent. The legislation and reforms which have been introduced, together with the entry of foreign banks, are stabilising the situation. However, access to long-term finance for enterprises remains almost exclusively the preserve of IFIs.

6.2 National and International Organisations

FYROM has a two-tier banking system. The National Bank of the Republic of Macedonia (NBRM) determines and implements monetary policy as well as supervising the commercial banks and savings and loan institutions. The Securities Commission monitors the stock exchange, and the Ministry of Finance oversees the insurance industry.

For SMEs, the first organisation of importance is the Macedonian Bank for Development Promotion (MBDP), a state bank which was established in 1998 to support the growth of the small enterprise sector and export businesses. The MBDP's focus is on financing start-ups and development of SMEs through medium and long-term credits and the management and administration of foreign credit and donor programmes. Support is directed principally towards companies which:

- provide higher value-added;
- apply new technologies and innovations;
- have potential for job growth;
- are competitive or potentially competitive;
- are export-oriented or reduce dependence on imports.

By using the German model of the Kreditanstalt für Wiederaufbau (KfW) for its formation, the MBDP ensured that although it is state-owned, it retained operational autonomy. An initial capital of 30 million DEM has translated into a disbursement capacity of over 100 million DEM. Apart from the initial capital, MBDP's credit lines all originate from the international donor community, especially the KfW and Italian Government. The MBDP offers short to medium-term working capital and equipment loans to enterprises working in the export sector and long-term loans for equipment purchase. MBDP's credit lines are on-lent through seven local commercial banks at terms and conditions that are slightly more favourable than the commercial banks' own lending programmes. The full risk is taken by the commercial banks, which thus ensure that the loan is fully viable commercially before passing it back to the MBDP for final approval.

The arrival of the major international donor institutions has represented an important development with regard to the supply of capital for the SME sector in FYROM, especially longer-term credit. There are a number of international credit line operations working in FYROM:

- *EC/Phare Micro-Credit Scheme*: NEPA operates a 9 million EUR fund (6 million EUR provided by Phare and 3 million EUR by seven local banks). The maximum amount of a single loan is 30,000 EUR with a repayment period of 5 years, including a 6-month grace period. The interest rate is 12% per annum.
- *World Bank* operates two credit lines for private sector finance and private farmer finance, and a micro-loan scheme with a 6.5 million EUR fund which is aimed at NGOs. It also has a Private Sector Development Programme providing 23 million EUR for on-lending to local banks (repayment 1-10 years including 3 years' grace period, no minimum).
- *IFC's* Small Enterprise Fund covers 16 countries. The fund covers debt and equity and is worth 50 million EUR for a period of 5-8 years.
- *DEG finances* start-up businesses for German returnees (no minimum, repayment 3-8 years with 6 months to 2 years' grace and an interest rate of 8%). There is also an SME credit line for businesses which are less than three years' old (same terms and conditions). Both funds are apparently undersubscribed and in the process of being restructured.
- *EBRD*: The 1995 credit scheme for SMEs was worth 20 million EUR but is now fully disbursed. It was followed in 1996 by the extension of financing, totalling 7.5 million EUR, to Komercijalna Banka A.D. This financing is to provide on-lending to private sector clients (not directly targeted to SMEs) and to assist the bank in upgrading its operations and improving its information technology systems. There is also a Regional Trade Facilitation Programme in FYROM to underwrite letters of credit for SMEs, which is channelled through local banks. By the end of December 2000, commitments exceeding 22 million EUR had been guaranteed.
- *Chinese Taipei* has a credit line worth 11 million EUR (maximum loan is 450,000 EUR, interest rate Libor + 2,5%, repayment 7 years, including 2 years' grace). There is also an agricultural credit line worth 1 million EUR (maximum loan of 225,000 EUR, repayment period of 5 years, interest rate Libor + 2,5%). Recent diplomatic developments mean that these credit lines may be discontinued.

Although not comprehensive, the above list provides an overview of what is on offer to enterprises. The international donor-financed credit lines are geared mainly toward supporting production-based enterprises and attempt to spread the resources insofar as possible throughout the country. Many commercial banks are involved in the management of international credit lines and it appears that these credits have been used as a substitute for, rather than an addition to, the use of their own resources for the SME sector.

6.3 Commercial Banks and the SME Sector

The banking sector has been significantly reformed since 1991. As in other former Yugoslav republics, the number of banks increased during the 1990s. In the case of FYROM, the increase was from 5 in 1991 to the current 21, a large number for a country of just over 2 million people. Most of the relatively new banks were set up to satisfy the needs of enterprises and groups of enterprises. As a result, most of the existing banks have been burdened by so-called related party-lending – loans extended to enterprises not on the basis of sound commercial banking principles, but because of the interlocking ownership agreements between banks and enterprises. Only a minority of these new banks has a diluted ownership structure and provides banking services following market-based criteria.

The banking sector is highly concentrated in that it is dominated by two banks: Stopanska Bank and Komercijalna Bank. Stopanska alone represented about 70% of the total credit portfolio of the entire banking sector in 1992, but has since been divided up into five independent branches in order to stimulate competition. The concentration of the banking sector is still evident today, as the three largest banks encompass 64% of the total assets of the banking system in 2000. This picture is compounded by the fact

that only six banks and four savings institutions are located outside Skopje. Additional measures to consolidate the banking sector are expected to be taken this year following the increased minimum capital requirements, which came into force in April 2001.

Very recently some favourable developments have followed the entry of foreign banks in the sector. With new foreign shareholders in Stopanska Banka and Tutunska Banka, the share of foreign capital increased from 19% at end 1999 to 41% at end 2000. The immediate consequence was a sudden reduction by 5-7% in lending rates, dropping from the high levels at which they had been in the past few years (20-25%). It should be noted that inflation on an annual basis was 9% at the end of 2000.

Privatisation is well advanced. The state sold its remaining shares in the largest bank, Stopanska Banka, in April 2000 to the National Bank of Greece, EBRD and IFC. At the end of 2000, 84% of banking sector assets were privately owned. However, despite the recent entry of foreign banks and the advanced state of privatisation, corporate governance in banks is not satisfactory. The banking system is affected by extensive related party-lending and large exposures to single debtors. Ineffective banking regulations do not manage to contain net lending to shareholders. Thus the quality of the loan portfolio is very poor: non-performing loans (loans classified as C, D and E) amounted to 37% of total loans in September 2000. The quality problem is very high for seven banks: these had over half of their loans classified at end of September 2000. In the same month, total loan loss provisions covered only 40% of non-performing loans, down from 50% at the end of 1998 and 65% in 1997.

The poor quality of the banks' loan portfolios resulted in very high costs of intermediation, penalising all borrowers. Moreover, the banks have distorted credit allocation by providing credit at preferential rates to bad debtors. This effectively taxed viable enterprises and reduced de facto the number of loan applications.

In addition, the existence of the Payment Operations Office (ZPP) – as in other former Yugoslav republics – has deprived the banks of a way of gathering information about their potential borrowers. All payments were in fact until recently operated through a system of bureaux, separate from the banking sector. The asymmetric information problem, which usually affects the lender/borrower relationship, is extremely severe in FYROM. Although the ZPP is in the process of being dismantled, banks will need time to build up knowledge of the enterprise sector. In the meantime, this problem is another factor explaining the low degree of financial intermediation.

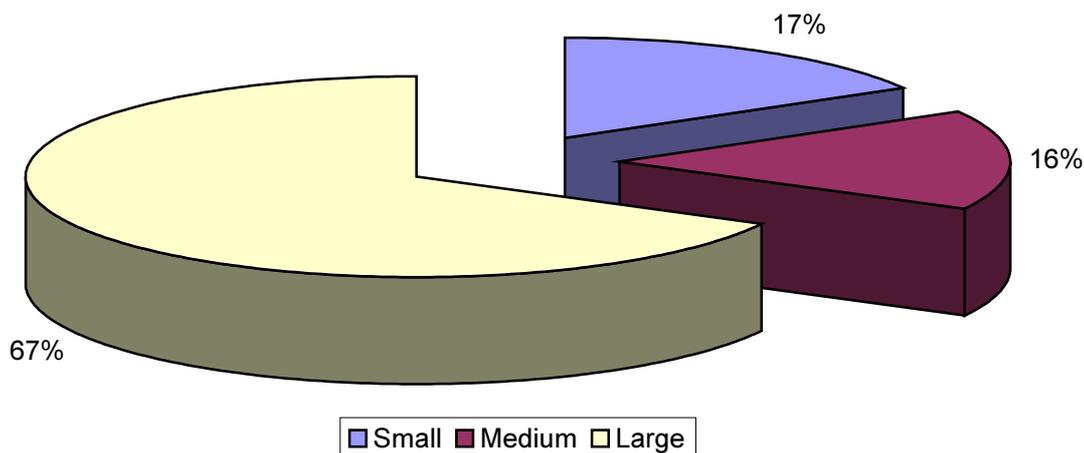
The degree of monetisation of the economy is low even for the region, with the M3 to GDP ratio for 1999 at 22%, as compared to 36% for the southeastern European region and 78% for the Euro region. The comparison in terms of domestic credit to GDP in the same year is even more striking, with a value of 19% as compared to 30% for SEE and 138% for the Euro region. These figures suggest that although the system is over-banked, the degree of financial intermediation is still extremely low. If this is the case for the economy as a whole, it is even worse for the enterprise sector. Domestic credit to the enterprise sector amounted to only 11.3% of GDP in 1999.

Turning to the SME picture, most commercial banks make short-term loans to SMEs. Both Stopanska Bank and Komercijalna Bank provide mainly short-term working capital to their clients. Interest rates to SME clients tend to be high (about 15-20% per annum in 2000) and the collateral requirements remain high at about twice the loan requirement of clients. The credit services on offer remain limited to most small and medium-sized enterprises.

SMEs maintain that banks generally tend to favour their existing clients – some are still locked into cross-ownership with enterprises. This is reflected in the fact that large enterprises (state-owned and privatised) still take the bulk of available credit from the largest commercial banks, which gives rise to the criticism that non-creditworthy firms use up scarce resources which could be used more effectively by others, such as SMEs with potential for growth. Even Komercijalna Bank, one of the most efficient

and well-managed banks in the country, remains wedded to its larger enterprise clients, as Graph 5 indicates.

Graph 5. Credit Portfolio According to Size of Borrower (1999)



Source: Komercijalna Bank, Skopje.

Some other financial services are being developed and sold to individuals, such as insurance and mortgage finance. This new range of small-scale, more profitable and less risky business activities is attractive to banks. These products remain underdeveloped but have the potential to impact on the volume of lending to the SME sector. In addition, many enterprises prepare financial reports that indicate little profitability and thus systematically under-report with respect to corporate tax. This practice will continue to disadvantage such enterprises with regard to accessing capital since the same financial indicators are used to determine whether a loan makes commercial sense for the bank or not.

The commercial banks currently avoid offering long-term credit using their own resources because the environment is considered too risky, the legislative framework remains unpredictable and the internal resource base is thin. The commercial banks recognise that they will have to strengthen their links with the SME sector over the longer term if they are to develop a sustainable client base. They recognize the need to improve their credit evaluation procedures and to develop more affordable loan products.

6.4 Savings and Loan Institutions

There are 16 savings and loan institutions in FYROM. These institutions are legally entitled to lend only to legal persons and individuals, although it is known that small enterprises do use these credit facilities to tide them over difficult periods. Interest rates were generally quite high in 2000, around 2.5% to 3% per month, but the demand for funds was not deterred, indicating that small enterprises and the self-employed are often in need of a source of working capital.

In the late 1990s, the savings and loan institutions acquired a bad reputation when the TAT savings institution collapsed, taking with it about 55 million EUR of savers' money, mainly remittance income. Partly as a consequence, the NBRM closed a further seven savings institutions along with the TAT. The problems surrounding the savings institution events have been a major setback to efforts to create local sources of finance for the self-employed and small enterprises. Indeed, they have been a major setback for the entire banking sector, which is only now beginning to recover.

6.5 Micro-Credit

Partly because of the corporate governance problems experienced in the savings institutions to date, there has been much interest in establishing conventional micro-credit institutions in FYROM, as highlighted below:

- NEPA runs one of the largest micro-credit programmes in the country using funds granted by the EC/Phare SME programme, as previously discussed. They lend up to 30,000 EUR to businesses with a maximum of 20 employees.
- Opportunity International (*Moznosti*) is very active administering funds provided by various donors and providing small loans in agriculture, retail and handicrafts. Loans are made for the purchase of equipment and for working capital up to 18,000 EUR for equipment (3-year loan, 22% p.a. interest) and 13,000 EUR for working capital (1-year loan and 18-24% p.a. interest).
- USAID: A Credit Union (three more are planned) disburses micro-loans to sole traders and family-owned businesses; there is also a Micro-Credit Scheme (6 million EUR, 5-year loan averaging 6,000 EUR).
- Horizonti / Catholic Relief Service lends (250 EUR rising to 1,000 EUR) to groups of women entrepreneurs for trade, services and family businesses.
- KfW's micro-finance programme is to be run through local commercial banks (e.g. Tutunska Banka), with the first loans due to be extended in July 2001.

There are a number of other micro-finance programmes in operation through the local and international NGO sector, such as the International Catholic Migration Committee and the Macedonian Enterprise Development Foundation. Interestingly, organisations such as Moznosti have recently registered as domestic banking institutions in an attempt to obtain deposits, with a view to expanding their range of services.

The interest rates and margins on micro-loans tend to be fairly high as the institutions attempt to become sustainable before donor funding ends. However, this does not seem to deter potential candidates for micro-loans. Demand remains high since many people have little chance of finding an employment opportunity other than self-employment. The clear demand for micro-finance, the absence of commercial banks in this activity, and the prospects of assisting economic development and reducing unemployment are factors leading organisations such as the KfW, EBRD and IFC to explore various options of setting up a micro-credit bank in FYROM similar in nature to other initiatives in Albania, Kosovo and Serbia. This development is discussed further in the Recommendations.

6.6 Venture Capital

The establishment of the Macedonian Stock Exchange in 1995 was one of the earliest and highest profile initiatives undertaken in FYROM. The Securities Commission licenses the Macedonian Stock Exchange members (currently nine) for trading and securities. Although it has been trading since 1996, it has had little impact in terms of facilitating the raising of capital for the business sector thus far.

There are also a number of equity investment programmes in operation that target support to SMEs in FYROM, as set out below:

- The Small Enterprise Assistance Fund (SEAF) has over 15 million EUR for equity investments in SMEs, including participation by various IFIs such as the EBRD. It provides equity in the range of 250,000 to 900,000 EUR, takes a significant minority stake (25%-49%) and exits after 3-7 years.
- The Macedonia Equity Fund has 17 million EUR for capital investment / working capital requirements of SMEs.

- The World Bank / IFC has a regional Small Enterprise Fund worth 45 million EUR in equity.
- EBRD has an equity scheme which invests a minimum of 565,000 EUR in private companies, as well as several regional venture capital funds which also cover FYROM.

Venture capital funds are clearly beginning to operate in FYROM but there is some way to go before the concept becomes established. The regional instability affecting FYROM directly, reluctance to accept equity partners, and the limited supply of good quality business ideas remain significant barriers for the supply of venture capital in the short to medium term. These are only likely to change dramatically once legal, regulatory, tax and cultural barriers have been addressed more fully.

6.7 Savings Mobilisation

Expanding the deposit side of the commercial banks' activities is an important aspect in the ability to extend their SME loan portfolio. The regional risk, problems over frozen deposits inherited from the old system and the difficulties surrounding a number of savings institutions and new private banks have together provided for some time a strong disincentive to save.

The FYROM Government has taken several measures to further reform the banking sector while at the same time strengthen it. The minimum capital requirements have been raised to 11 million EUR for a full foreign operations license and 3.5 million EUR for domestic operations, and this situation is leading to mergers as the smaller banks seek partners in order to continue operating. The new banking law passed in July 2000 brings supervisory standards closer to those of the EU and to those recommended by the Basle Committee (EBRD, 2000). The law also sets out new frameworks for credit approval procedures and for strengthening the corporate governance of banks. Finally, to address the issue of public confidence directly, the government introduced a new guarantee scheme whereby savings of up to 1,500 EUR were fully guaranteed by the government, and 90% were guaranteed up to 7,600 EUR.

These measures, together with increasing interest of foreign investors in FYROM banks, are providing the right stimuli to competition in the sector, although it will also take time for the influence of bank privatisation to be translated into a broader range of services for SMEs. There are specific areas, such as the provision of micro-finance, which would need dedicated support, as the techniques of very small lending operations are unlikely to be developed independently by local banks.

7. RECOMMENDATIONS

The CAAP process has generated a number of priority recommendations that have the capacity to promote SME development in a rapid and effective manner – they can be realistically implemented by the Government and related SME institutions (see Figure 2 for an illustration of the possible new institutional environment to support enterprise development). These recommendations offer the prospect of further progress in unlocking the potential of SMEs as the driving force for economic growth in FYROM.

7.1 Institutional Capacity-Building Measures

Recommendation 1: Establishment of an SME Policy Co-ordination Forum

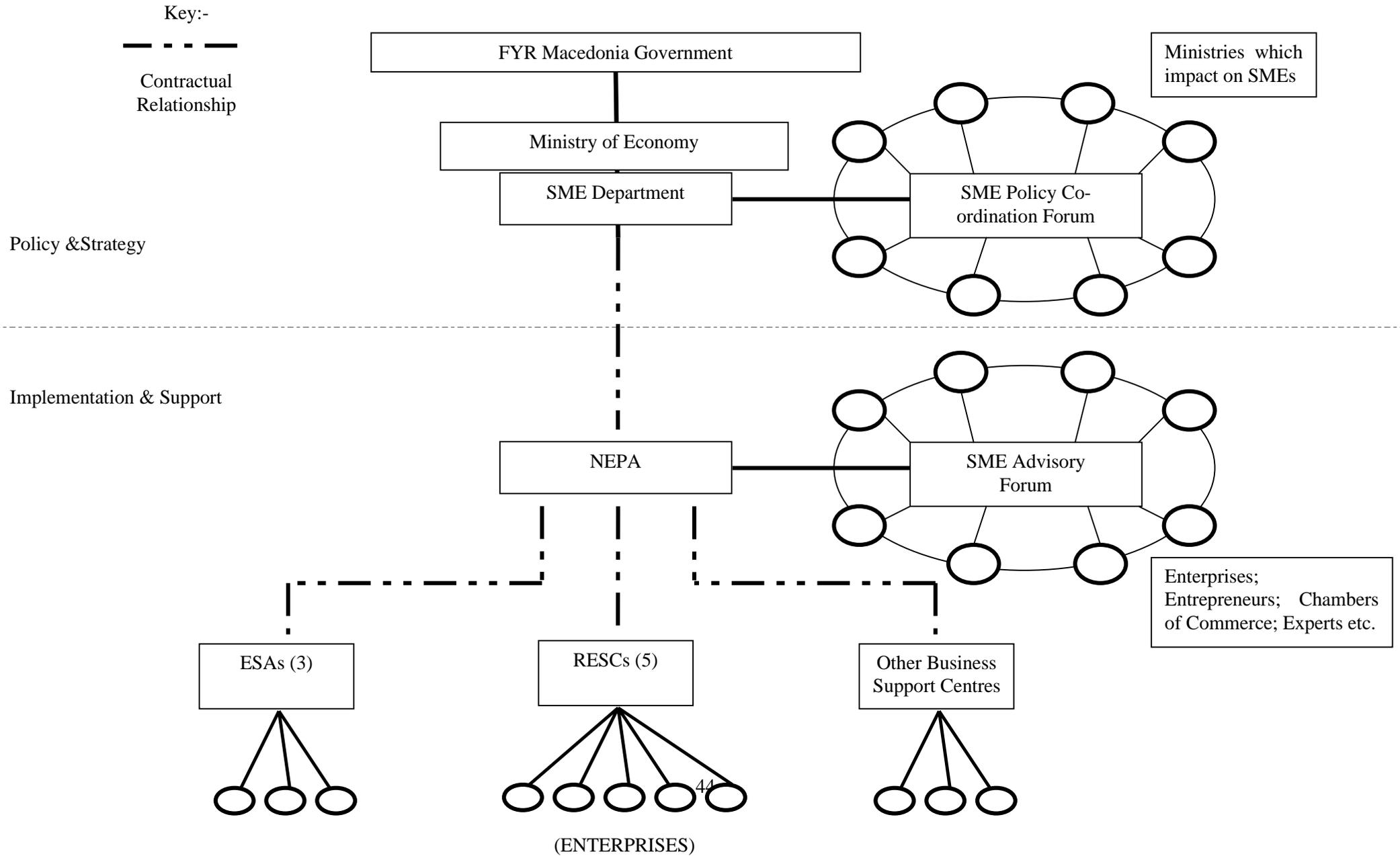
The FYROM Government created the National Steering Committee for SME Development Policy, headed by the Deputy Prime Minister, which sought to support the SME sector by ensuring that the formulation and implementation of SME policy was pushed as high up the political agenda as possible. This committee has not met since the Kosovo crisis, although there is a need for such a body. Despite the evidence of the importance of SMEs as the driving force for economic growth in FYROM, there is insufficient action on the part of the Government to insist that all relevant ministries and other governmental agencies consider the potential impact of their work on enterprises, and there appears to be very little interministerial co-ordination in this area. The **creation of an SME Policy Co-ordination Forum** is recommended, headed by a senior politician, with a clear agenda: tracking and registering all existing and proposed regulations affecting businesses; prioritising and co-ordinating SME-oriented policies and initiatives; acting in an ex-ante advisory capacity and assuming an ex-post monitoring and review role in order to evaluate the effectiveness of enterprise policies. Without becoming overly bureaucratic, the forum should meet regularly, involve all relevant ministries and agencies as well as entrepreneurs, with the SME Department of the Ministry of Economy providing secretariat services.

Recommendation 2: Capacity-Building for the SME Department of the Ministry of Economy

There is a clear lack of **institutional capacity** to promote SME development within the Ministry of Economy, the national government body responsible for promoting enterprises. The Ministry of Economy's SME Department consists of new staff under serious pressure to promote the SME sector. Doing this more effectively than hitherto requires that the Ministry's internal capacity to support the SME development process be strengthened and steered towards the ability to act flexibly and transparently. Technical assistance is required, especially for the following:

- creation of a national SME strategy, a goal which has never been fully achieved. Consultation should be programmed for the development of this strategy, not least by inviting all donor organisations to co-ordinate their efforts in this area. Equally important is the establishment of a mechanism to ensure that such a strategy defines clear objectives which will enable an objective assessment of the SME Department's progress in implementing the strategy (for example, by the Policy Co-ordination Forum mentioned above).
- identifying and co-ordinating action to simplify regulations and other bureaucratic obstacles to SME development (see also recommendations 5 and 6).

Figure 2. Possible SME Institutional Framework



- identifying and developing appropriate legislation / reforms for the SME sector, including an appropriate consultation process to ensure that business priorities are considered.
- effective management of the SME policy network, in particular more effective co-operation with NEPA since this relationship needs to be strengthened (see also recommendations 3 and 4).
- assistance with technical topics such as cluster development and network promotion of selected growth-oriented sectors, technology transfer and upgrading (including FDI), technology parks, etc.

The above recommendations for technical assistance are not exhaustive and it is to be hoped that the SME Department's staff will remain in place, thus enabling them to benefit from the proposed programme of assistance.

Recommendation 3: Reform of the Role of the National Enterprise Promotion Agency (NEPA)

The role of NEPA has been problematic since its inception. There are a number of recommendations which would result in a much more effective institutional structure for SME support in FYROM:

1. Closer Ties with the Ministry of Economy

The SME Department's role is to define national policy and strategy for SMEs. NEPA's role is to implement the strategy. This model has been successfully promoted in other transition countries, but in FYROM the institutional link between NEPA and the Ministry of Economy needs to be more clear and transparent, with regular communication and with both sides understanding what is required of them. This is particularly important now that the senior staff in the Ministry of Economy and NEPA are newly appointed. Monthly **consultative meetings** would enable this relationship to develop constructively and progressively, so that the government's SME strategy could be seamlessly converted into operational action on the ground.

2. Reform of NEPA's Committee Structure

NEPA's three committees are not operating effectively. They do not meet regularly, do not have appropriately qualified appointees, do not adequately represent the SME community (e.g. lack of private sector representation), and do not provide relevant strategic advice to NEPA. A **streamlining of committee structures** is recommended. In addition, it should be possible to develop appropriate criteria for appointment, remuneration and period of service so that people with appropriate skills could be appointed. Lastly, it is particularly important for the Ministry of Economy to play an active role in NEPA's official committees, since NEPA is its implementing agent, thus working towards a fuller and more effective partnership than hitherto.

3. Long-Term Future for NEPA

A number of NEPA's difficulties since inception have been directly related to funding uncertainties. This problem persists and will continue to be an issue once the Privatisation Agency's remit is completed. So long as the government remains committed to NEPA and values the role it performs, commensurate resources must be found to secure its future operation post-Phare/Privatisation Agency funding. NEPA could operate separately from the Ministry of Economy (or any other organisation), as long as the reforms discussed in 2. above allow for effective and transparent reporting structures. NEPA would operate under a **contractual relationship** with the Ministry of Economy, which would mean that NEPA's annual programme of activities would be negotiated with the Ministry, and NEPA would have an incentive to deliver outputs as efficiently as possible. If the Ministry decided that NEPA's performance was inadequate, there would be various mechanisms to influence its organisation and performance. The ultimate sanction for non-performance would be termination of the contractual relationship, although the likely consequence would be that the SME sector would be deprived of important institutional support.

4. Refocusing on its Key Role

NEPA is a governmental agency responsible for assisting in the implementation of SME policy. This role is highly demanding and currently imperfectly fulfilled. At the same time, NEPA has been given responsibility for managing the Phare micro-credit line – indeed, the latest draft legislation being prepared by the Ministry of Economy envisages NEPA's role being extended to management of the proposed State Guarantee Fund. As a result NEPA is losing focus, and its image is being distorted as far as entrepreneurs and enterprises are concerned. Although this new role may make sense in enabling the agency to generate income at a time of budgetary uncertainty, NEPA's comparative advantage does not lie in its functioning as a financial institution. It is recommended to **transfer responsibility for the micro-credit line** as soon as convenient to a specialised institution. NEPA has too much to do to (re)gain its credibility to be distracted by non-core responsibilities.

5. Training of NEPA Staff

NEPA currently has a range of responsibilities, including: liaison with various players involved in the SME sector (enterprises, ministries and interest groups); training and workshops; monitoring and co-ordination of business support networks; and (currently) operation of credit lines. In view of this highly diverse set of responsibilities, **NEPA staff require ongoing training**. It is understood that this training will continue to be delivered until 2002, partly through the Phare contract. Other donors also have a role to play in this area.

Recommendation 4: Reform of the Role of the Business Support Centres

The network of business support centres (RESCs, ESAs and others) has been established now for a few years. It has received substantial donor support in the foundation/registration process, staff recruitment, training and business development, but this support is expected to terminate, on a tapered basis, by 2002. The business support centres remain the sole organisations, other than private sector consultancy firms, offering support to entrepreneurs. A number of policy recommendations would assist in improving the operation of this network and in securing sustainability once donor funding has ended.

1. Long-Term Funding

There has to be recognition that the original plan, namely that these organisations would become independent of donor funds, is not going to be achieved within the timescale foreseen. This means that although income generation activities (such as business planning, training and advisory) will continue to be important to the business support centres, it should be recognised that they are unlikely to be able to fulfil this objective as well as their wider remit (such as information services and outreach work). The decision needs to be made now as to whether they will continue to be partially funded through public support (as often happens in OECD Member countries) or whether they should be freed up to seek survival by competing in the private consultancy market. If they are to be supported further to perform services which are of a public service nature, then the planning process must begin now for state, local government or other financial support once donor funding has ceased. Such a decision would ensure that the centres' future is secure, that the business advisors already invested in do not leave, and that these institutions can work on a more secure basis than at present. Becoming independent and sustainable organisations must be their long-term focus.

2. Monitoring and Co-ordination

As long as the business support centres receive public support, there is a role for NEPA to monitor and co-ordinate these organisations in order to ensure that resources are being used effectively and transparently. This formal relationship currently applies to the RESC network, which receives support from Phare, but is not the case for those organisations supported by bilateral donors. This monitoring and co-ordination function is currently weak, and both NEPA and the RESCs would benefit from **NEPA representation (non-voting status) on the managing board** of each RESC. This involvement would

enable NEPA to understand the priorities and functioning of each RESC (at present NEPA receives only a monthly financial report) and would allow the RESCs to build a more fruitful relationship with NEPA through regular contacts. Overall, NEPA would be able to perform its monitoring and co-ordination role in an effective manner, thus generating greater accountability in the system. Although the RESCs are independent foundations, they are likely to respond positively to this suggestion if it is coupled with the prospect of a more financially secure and long-term relationship. Similar moves should be initiated with the remainder of the business support centres. These centres are currently operated through donors, but the logic and added-value of an integrated network of business support centres would be persuasive arguments.

3. Performance-Related Contracts

Each RESC operates on the basis of a contractual agreement with NEPA – the contract and the associated monthly payment is on a flat-rate basis. This means that all RESCs are paid regardless of output, innovation, success and effort. This type of contract rewards non-performers and under-performers and penalises the others, and as a result motivation and effectiveness are reduced. It would be more effective to move towards **longer-term, performance-related contracts**. Such contracts would be negotiated with each RESC to undertake a specific package of services, thus building the capacity and expertise of the RESCs as well as offering on-the-ground support to SMEs. This arrangement would result in a more customised set of priorities and services per region and in a long-term SME perspective for the RESCs. NEPA would gain by being able to influence the package of services and, through regular monitoring of performance, ensure that services are being delivered to SMEs.

7.2 Business Environment Measures

Recommendation 5: Comprehensive Reform Agenda of Legal and Administrative Barriers

One of the areas in which FYROM has made the least progress has been the removal of legal and administrative barriers to enterprise development. There is no lack of evidence of the plethora of issues which still need to be tackled in order to create a more business-friendly environment which encourages start-ups and expansions while at the same time reducing the incentives for bribery, corruption and continued operation in the grey economy.

There are numerous studies and proposed recommendations on these issues, such as EC/Phare reports, the FIAS report on foreign direct investment, and the FYROM Government report on stimulating investment by removing barriers to trade and investment. There is little to be gained in adding to these studies and recommendations, but there is a need to **carry out a comprehensive assessment** of these reports to enable the preparation of a government-approved prioritised set of actions and timescales. This action plan would be designed to tackle the issues associated with, for example, registering enterprises/one-stop shops, simplifying or reducing the number of permits, creating functioning land registration and spatial planning systems, and removing the courts from the business registration process. Various ministries and agencies should be assigned responsibility for implementing the action plan within specified timescales, which could then be monitored by the SME Co-ordination Forum mentioned in recommendation 1 above. Such a development would provide FYROM with a sound basis for aligning itself with those countries already making progress in accession negotiations with the EU.

Recommendation 6: Establishment of an SME Advisory Forum

Policy development and implementation thus far have not placed much emphasis on consultation with the parties most likely to be affected by the proposed laws, taxes and regulations. There is an increasing awareness that this approach is no longer appropriate, as the government is not sufficiently aware of the

likely costs of compliance and of the implications and incentives (positive and negative, intended and unintended) on the target group most affected by new laws, taxes and regulations.

Given the high degree of non-compliance with state laws and taxes, as well as the use of bribery and other forms of corruption, the creation of an SME Advisory Forum is recommended. This forum would convene regularly in order to **review proposals, provide independent advice to ministers, assess and vet draft government legislation, regulations and tax proposals** prior to finalisation, consult with businesses and citizens, identify existing problems, prioritise activities, propose solutions, allocate responsibilities and monitor progress against deadlines. Such a forum, supported through NEPA, could result in a fuller and more transparent process of consultation with respect to SME-related activities. It should ultimately result in a more dynamic enterprise sector, since costs of compliance would be reduced (simplification) and formalisation of the grey economy encouraged (better tax system). If properly constituted and represented, such a forum could be of value in terms of both preparing new legislation / tax / regulations and reviewing the existing system.

7.3 Financial Support Capacity-Building Measures

Recommendation 7a: Provision of Micro-Enterprise Finance through Local Commercial Banks

The financial system in FYROM currently fails to provide the needed finance to the enterprise sector. In particular, the micro and small-sized enterprises have access to only very limited and short-term bank loans at still relatively high cost and accompanied by very high collateral requirements. Commercial banks explain their lack of interest in the sector by saying that there are insufficient investment opportunities. At the same time, entrepreneurs complain that this is so primarily because banks have so far failed to fully understand enterprises. They suggest that there is a need for banks to employ specialists and to adopt a more client-oriented approach.

Following a number of micro-finance programmes implemented through NGOs, or by donors on a non-commercial basis, the first **micro-finance programme operated through banks** has just been initiated in FYROM. KfW has recently started to implement a micro-lending programme with Tutunska Banka and is also considering the involvement of Export Kredit Banka. First loans are expected to be extended in July 2001. The performance of this programme will be critical to understanding whether the extension of micro-finance can rely entirely on existing banks or would benefit from the complementary support of a new dedicated micro-finance bank. In particular, the degree of commitment of these banks to the significant changes in lending approach and internal management required to make a success of micro and small-sized enterprise (MSE) finance will be critical to drawing any conclusion on this issue. IFIs consider this element as a key indicator for elaborating their strategy for the provision of MSE finance, in particular as regards the choice of financial intermediary used: existing local banks solely or supplemented by a dedicated MSE institution.

Recommendation 7b: Micro-Enterprise Finance via Local Banks and a Micro-Finance Institution

Following an initial period of implementation of KfW's MSE programme, if there were doubts about local banks' commitment to micro-finance or if the extension of micro-finance was negatively affected by structural weaknesses of participating banks or of the banking system as a whole, the IFIs should **consider adopting a dual approach to MSE finance**, namely working with existing banks and a stand-alone micro-finance institution (MFI). MFIs can guarantee a long-term MSE target group orientation, together with financial stability and high standards of corporate governance. Where the above risks are significant, working with both existing banks and a stand-alone MFI could therefore provide increased assurance of greater access to finance and quality of services for MSEs in the country as a whole.

In addition, the special focus of a dedicated MFI could significantly increase competitive pressure in the sector, while expanding the overall resources available to service MSEs. Given the scale of needs in relation to suppliers, this would not lead to poaching of clients or pressure to lend at unattractive rates. Instead, experiences in other transition countries (such as Russia and Ukraine) suggest that the existence of competitive pressure increases management attention and therefore the effectiveness and outreach of the programmes pursued by existing participating banks themselves. While the market thus created would still serve only a relatively small proportion of total needs, the net effect would be greater than the increase in financing from the MFI alone.

If the IFIs choose to adopt a dual approach, it is important that the FYROM Government facilitates the implementation of their strategy by modifying the legal and regulatory system as necessary. In particular, it would be essential to grant the new MFI exceptional status as far as the minimum capital requirement is concerned.

Recommendation 8: Providing Incentives and Facilitating the Creation of Mutual Guarantee Schemes

The banking system in FYROM is seriously impaired in its dealings with the enterprise sector by the lack of information on its potential borrowers. The existence of a payment operations office system has de facto impeded banks in their information-gathering. Although this system is finally being dismantled, the Macedonian banking sector suffers from a more serious asymmetric information problem than the banking sector in other transition countries.

One possible way of improving the banks' knowledge of the enterprise sector would be to **promote the introduction of local mutual guarantee schemes**, following for example the German or Italian model (see OECD, 2000b). These schemes have the benefit of reducing the risk associated with small enterprises by pooling information on the enterprises to a single institution (the local guarantee fund) which provides an alternative to collateral in loan application to banks. Local banks can participate in the fund by having a seat on the board, which allows them to gain important information. The reduction of the asymmetry in information and the presence of a pool of funds that can be used instead of collateral can facilitate SME access to bank finance by reducing the perceived risk linked to enterprises, as well as easing the collateral requirement for borrowers. Once local mutual guarantee schemes are in place, they can in turn be pooled into regional schemes and later into a national guarantee fund. Donor funds can be utilised to supplement the existing pool of funds collected by enterprises. Governments can also use these guarantee funds to provide specific finance to enhance the pool for selected sectors or regions as an industrial policy tool. It is therefore recommended that support be sought on the development of mutual guarantee schemes in FYROM, for example from the European Association for Mutual Guarantee Societies.

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