Firm dynamics and job creation in the former Yugoslav Republic of Macedonia

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Executive Summary

Transition and labor reallocation – towards better jobs in the former Yugoslav Republic of Macedonia

1. **Productive employment depends on a dynamic private sector.** Good jobs are in short supply in the former Yugoslav Republic of Macedonia. Sustainable, better employment opportunities must come from higher labor demand from a dynamic and internationally competitive private sector – the result of an advanced economic transition from a state controlled to a market led economy. This note focuses on job creation from the perspective of enterprise sector dynamics in the former Yugoslav Republic of Macedonia. The purpose is to understand, better, the dynamics of job creation – where and how firms and jobs are created – and the most important constraints to job creation from the firm perspective. Drawing on several sources of data, including firm registry, data on entrepreneurship, labor force surveys, and policy indicators, the note contributes to the job diagnostics necessary to devise relevant policy to increase job opportunities in the former Yugoslav Republic of Macedonia and is intended to provide guidance to researchers and policymakers in other countries wishing to understand better the role of the private sector in employment.
2. **Despite some significant business climate reforms, the former Yugoslav Republic of Macedonia has not seen private sector dynamics or "entrepreneurship" improve sufficiently**. In recent years, the former Yugoslav Republic of Macedonia has been taking broad and substantive steps towards reforming its business climate and making especially business entry easier. Reforms have also focused on increasing openness by fostering opportunities for international trade and inflows of foreign direct investment. Nonetheless, the private formal sector remains subdued in the former Yugoslav Republic of Macedonia, accounting for a limited share of employment. Entrepreneurial activity – as measured by self-employment – is also relatively low.
3. **In sum, the transition of workers and jobs from low productivity sectors to higher productivity sectors has stalled in the former Yugoslav Republic of Macedonia.** Prior to the economic crisis, countries which had advanced more in the transition process saw higher productivity growth than the former Yugoslav Republic of Macedonia, more inflows of workers into the services sector, and substantive net job creation. In the former Yugoslav Republic of Macedonia, in contrast, labor reallocation is still incomplete. One fifth of the population remains in low productivity agriculture and one third is informally employed. Between 2007 and 2011 the formal private sector created only 12 percent of all new jobs.

What kind of jobs, in what kind of firms, are created in the formal sector?

4. **Most formal private sector employment is in small firms, with limited growth prospects.** Firm registry data show that in 2011, more than half of all employment was in firms with less than 50 employees, and one third in firms with a turnover below 10 million denars. One in three workers was employed in micro-firms with less than 10 employees.
5. **Job creation in formal private firms fell significantly during the crisis, as young firms stopped creating jobs.** While total employment numbers remained stable, the economic slowdown visibly slowed down job creation in formal firms. Young firms were most volatile: they created the majority

of jobs between 2007 and 2011 on an aggregate level, but their contribution was significantly diminished during the economic crisis. The slowdown in job creation in younger firms is consistent with a slow-down in net firm creation. Firm entry peaked in 2007, when one in five active firms was created that year, but had fallen to half by 2011. Observing poorer survival conditions for firms, fewer persons were prepared to enter a business venture.

6. **Gross job flows indicate a significant level of churning, which in turn points to an unfinished transition process.** The patterns in transition countries have been more or less consistent over time: as old state-led industrial firms went out of business, massive job destruction ensued. With time, as economies stabilized and moved closer to a market economy, gross job creation took up in new sectors of industries and services, and job destruction came down as the reallocation process continued, so that net job creation and gross job creation became more closely aligned. However, job turnover (churning) is still high in the former Yugoslav Republic of Macedonia, compared to more advanced transition countries. That is, high destruction, and high creation of jobs still co-exist.

7. **More productive firms are now creating more jobs.** In the first half of the 2000s, less productive sectors and firms created more jobs. Between 2007 and 2011, overall, the productivity of employment did not increase, as informal employment and employment in low productivity activities like agriculture and trade increased. However, this report shows that since 2007, within the formal enterprise sector, more productive firms have been creating jobs, even during the economic crisis. This is a tentative sign of an acceleration of the reallocation towards a higher productivity structure within the firm sector.

Entrepreneurship and opportunities

8. **The former Yugoslav Republic of Macedonia has relatively low levels of entrepreneurship and entrepreneurship is driven by push factors.** While the absolute numbers differ depending on source, the former Yugoslav Republic of Macedonia consistently displays low overall levels of self-employment or established business ownership, compared to other middle income countries, and even by comparison to other ECA countries. Data from the Global Entrepreneurship Monitor shows that in 2012, only seven percent of adults are in established ownership. Entrepreneurship, moreover, appears to be more necessity than opportunity driven, as 50 percent of those in early stage entrepreneurship reported starting a business for lack of other employment options.

9. **A significant share of those that are wage employed, or not working, would like to be entrepreneurs, but few take steps towards opening a business**. In the former Yugoslav Republic of Macedonia, the share of wage employed that would like to be self-employed is higher than elsewhere, but these latent entrepreneurs are less likely than in other countries to take steps towards opening a business. Women, and poorer workers, are very unlikely to approach entrepreneurship.

10. **These latent entrepreneurs may be hindered by lack of access to productive assets**. In the ECA region, latent as well as actual entrepreneurship is driven by access to credit (where women and poorer workers are likely to be disadvantaged), and by social networks and private sector experience (which women and poorer workers have less of). Moreover, the former Yugoslav Republic of Macedonia may also be in a low entrepreneurship trap: the low level of competitive industries and enterprises as well as the small size of the former Yugoslav Republic of Macedonia contributes to keeping entrepreneurship subdued, for lack of spillover effects and demonstration effects.

Improving the investment climate

11. **What role does the business climate and overall economic conditions play for the former Yugoslav Republic of Macedonia's subdued enterprise sector?** The former Yugoslav Republic of Macedonia has made headway on reforming its economic system: Different indicators of competitiveness, economic transition and more narrowly business environment reforms conclusively show that the former Yugoslav Republic of Macedonia has made important progress compared to its peers and has improved its ranking over the past ten years. However, the agenda is far from complete.

12. **Credit constraints and skills shortages are still important obstacles to business.** Access to credit is considered a major constraint in the former Yugoslav Republic of Macedonia, more so than in other countries. This reinforces the message from that entrepreneurship is also determined by access to credit – both entry, survival and expansion. Skills shortages are a problem for more modern firms. Firms with foreign ownership, and firms in services outside the retail sector, consider lack of an appropriately skilled work force a major issue. Other research shows that skills shortages are, indeed, a constraint to hiring for especially modern and more dynamic firms competing on international markets.

13. **Weak institutions manifest themselves in the investment climate, especially failings in the judiciary sector, and unfair competition from informal firms**. FYR Macedonia's slow transition is both cause and result of insufficiently developed institutions that ensure rule of law, transparency, and more generally good governance. Macedonian firms are small on average, which may partly explain why the practices of informal firms (who are likely to compete with smaller and less established firms) feature as the main constraint to doing business in the former Yugoslav Republic of Macedonia. Perhaps most significantly, the issue of poor governance emerges frequently as a problem. In fact, perceptions of corruption and distrust in the courts system are more significant obstacles according to Macedonian firms than is the case in other ECA countries.

14. **Small firms are more severely affected by these constraints**. Larger firms have a higher internal capacity to deal with red tape, manage bribes, and wait out results from a slow and unpredictable courts system, and have easier access to finance. Thus, young, small and more dynamic firms are likely to be held back by the weak institutions.

Unfinished Business: Going forward

15. **To provide both new jobs and sustainable income opportunities, the former Yugoslav Republic of Macedonia's private sector needs to take off**. Only with higher job creation in the private formal sector can the former Yugoslav Republic of Macedonia look forward to more productive employment opportunities for its work force. To increase labor demand from firms, they need higher demand for the goods and services they could or do produce and better conditions to enter and stay in business. The review of different constraints suggests that while there have been improvements in the overall business climate, progress on deeper reforms has been slow.

16. **Is the former Yugoslav Republic of Macedonia in a low entrepreneurship trap?** Limited size of the domestic market means that the former Yugoslav Republic of Macedonia must become competitive on international markets to sustain higher levels of demand. The small size of the economy also means that in absolute numbers, there are few entrepreneurs, even if firm density is comparable with other countries. Since higher entrepreneurial density tends to increase entrepreneurship further, the

former Yugoslav Republic of Macedonia may need to go further to increase entrepreneurial representation from abroad, by encouraging foreign direct investment and encourage cross-country business ventures. Focusing on production clusters and value chains can be of significant use to small and medium-sized enterprises that often face difficulties in achieving economies of scale in their production.

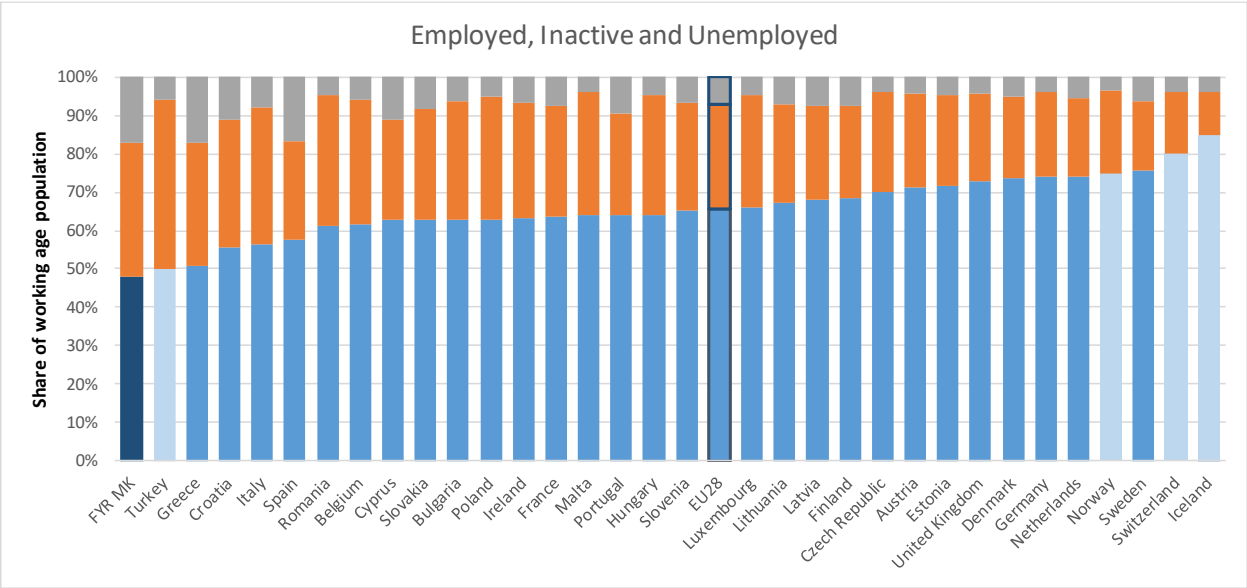
17. **Governance needs strengthening.** The former Yugoslav Republic of Macedonia has embarked on an ambitious reform agenda to encourage private sector investment and growth. However, whereas significant progress has been made on some areas, such as making it easy to open up a business, other areas of reform need more attention to increase firm survival and expansion**.** Weak governance institutions affect business in indirectly and directly: indirectly, because weak institutions hold back the implementation of a relatively ambitious reform agenda, and directly, because poor governance is an important constraints for business, and hit the small and more vulnerable firms more forcefully, especially so courts system and a high incidence of corruption. Reforming the judicial system is also central to the former Yugoslav Republic of Macedonia's EU accession process.

18. **Identifying and building the right kind of skills will be important to insert the former Yugoslav Republic of Macedonia fully in the modern global production chain.** While there is wide recognition that there are not enough skills for the modern economy in the former Yugoslav Republic of Macedonia, there is still limited information regarding what these skills are or should be. As one step in this process, the World Bank has undertaken a Skills Measurement Program (STEP) survey of both demand and supply, analyzing the availability of and demand for skills – in the broadest sense – among the labor force and by private employers.

1. Introduction

19. **More jobs, and more productive jobs, are needed in the former Yugoslav Republic of Macedonia**. Although the Macedonian economy has created employment in recent years, the rate of job creation has not been sufficient to bring FYR Macedonia to employment levels close to those of the European Union. Less than half of the adult population (48 percent) is employed, and only half of those jobs are in the private formal sector. Women and some ethnic minorities, particularly Albanian and Roma, face strikingly poor prospects. In South-eastern and Eastern European region, the global financial crisis tended to slow down job creation significantly after 2008, and many of the young and innovative firms were lost in the process (Arias and others, 2014). The crisis had a smaller effect on labor markets in the former Yugoslav Republic of Macedonia, despite increasing international linkages through trade and investment. Unlike in many neighboring countries many jobs had never transitioned out from the agricultural and informal sectors, and so the potential for a reversal was smaller. Even when compared to countries hit much worse by the crisis, the former Yugoslav Republic of Macedonia is an outlier in Europe in terms of access to productive employment, with only one third of adults in a job. And many of these jobs – almost one third in 2011 – are in the informal sector, whether for self-employed (those working for themselves) or wage workers (working for pay for an enterprise).

Figure 1: Not enough access to employment



Source: Estimates based on Eurostat

20. **This note addresses the formal enterprise sector and its potential to provide more and better jobs in the former Yugoslav Republic of Macedonia.** A host of different factors, including lack of adequate skills in the population and incentive systems that discourage work, influence labor market outcomes in the former Yugoslav Republic of Macedonia. However, lack of dynamism and low demand for labor in the private formal sector is clearly one of the most critical obstacles to increasing jobs and labor earnings. To improve labor market outcomes for the population at large, access to employment must increase, and policy must help improve the productivity of smaller informal activities, including

agriculture. To sustainably improve jobs, the private formal sector must nevertheless become the strong force for economic development.

21. **"Firm dynamics and job creation in the former Yugoslav Republic of Macedonia" forms part of an analytical agenda focused on promoting employment and productivity in the former Yugoslav Republic of Macedonia**. This agenda has included topics of significant relevance to the former Yugoslav Republic of Macedonia such as skills, informality of work, and private sector development. The objective of the note is to provide an understanding of the characteristics of the private formal sector from the perspective of employment. Additionally, the note is intended to serve as a "blueprint" for the former Yugoslav Republic of Macedonia as well as other countries of the kind of demand-side focused analysis that can be undertaken using business registry data and other sources of data in an integrative approach.

22. **To provide both new jobs and sustainable income opportunities, production and employment must shift to firms with higher development potential – notably those with higher productivity levels**. Higher productivity provides a basis for increasing income for employers and employees in firms and is necessary to successfully compete in international markets. Macedonian firms are unlikely to be able to compete in low productivity, low wage sectors, not least because labor costs were increasing fast prior to the crisis. Increasing productivity, based on innovation and constant product and services upgrading, will therefore be a necessary step to expanding markets.

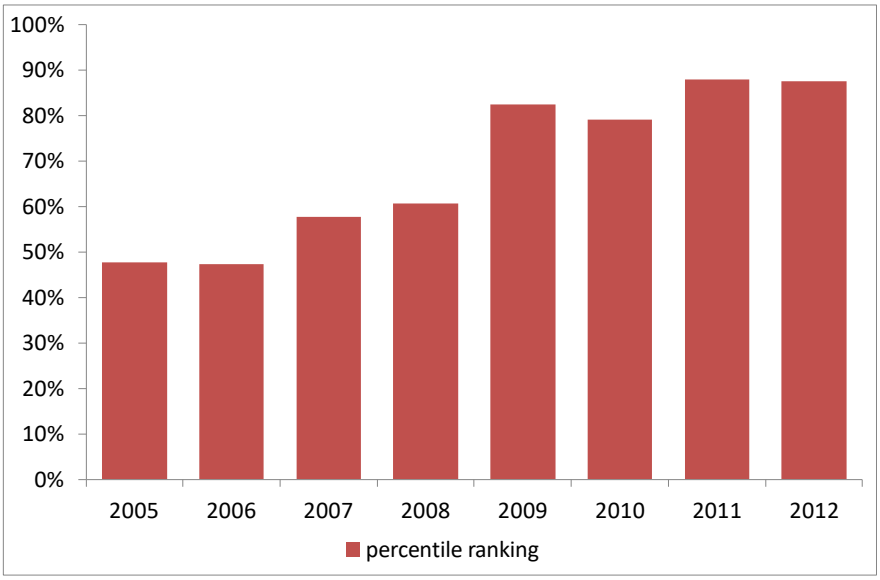
23. **Whether more productive jobs are created will depend on whether there is high enough demand for the goods and services produced by the firms, on whether firms are able to start or develop their business when they face higher potential demand, and on whether firms can opt for more labor-intensive technologies**. From the enterprise perspective, outcomes are thus influenced by overall environment for starting a business and developing business opportunities, and by the costs associated with hiring workers.

24. **The former Yugoslav Republic of Macedonia has made significant progress on the business environment, per various international indices and indicators**. In 2007, 2009 and 2011, The former Yugoslav Republic of Macedonia was among the top ten reforming country in the World Bank's Doing Business indicators. Ranking 75 out of 178 countries in 2006, the former Yugoslav Republic of Macedonia moved up rapidly and consistently and by 2012 had improved its position to number 23 out of 185 countries.

25. **These indicators reflect an ambitious reform program developed to foster private sector growth and job creation.** The reform program has been premised on both improving the business climate more generally (especially since the mid-2000s), and attracting foreign direct investment in key value-adding sectors, in specific Technological Industrial Development Zones. Merchandise exports increased by 11 percent during 2011-2014, largely driven by the automotive industry and associated sectors, and the technological sophistication of exports also increased. So far, there have not been strong spillovers to the local economy, however.[1]

[1] "Positioning fYR Macedonia for the Global Economy: The Impact of Reforms and Investment Promotion in fYR Macedonia's Automotive Components Manufacturing Sector", mimeo, the World Bank, September 2016.

Figure 2: Steady improvements in the former Yugoslav Republic of Macedonia's ranks* in business environment



Source: World Bank Doing Business Indicators. *Percentile rank of the former Yugoslav Republic of Macedonia in the Doing Business Indicators, where 1st percentile includes the worst performers and 100th percentile the best.

26. **So why are job outcomes not improving?** Given the former Yugoslav Republic of Macedonia's strong record on business environment reform, the private sector contribution to job creation is disappointing. Accompanying economic and sector work by the World Bank (Box 1) has shown that jobs remain in the informal and/or low productivity sectors, and that at the same time, Macedonian firms experience a skills shortage. It also shows lack of dynamism and competitiveness on the firm side. Exporting firms are overwhelmingly small, and have low survival rates. Has the former Yugoslav Republic of Macedonia not reformed sufficiently in some critical areas, or are there other factors holding back labor demand and firm growth?

27. **The former Yugoslav Republic of Macedonia's small size – a population of two million, a work force of about 600,000 persons, a minority of which are employed – means that the economy runs into several constraints in terms of critical mass of products, services, and competences.** One such constraint is the very limited domestic market, especially in view of relatively high poverty rates and low access to paid work. As a result, the economy cannot rely exclusively on domestic demand as an engine of growth. A second is that with a small population and work force, there may be a lack of specific competencies needed for production, which must be possible to source outside of the country. A third is that firms depend on imports for much of its production as the country has limited supplies of natural resources and intermediate products. All of this means that the former Yugoslav Republic of Macedonia must look to the rest of the world to complement its skills, products and services base.

28. **This note presents an analysis of the formal enterprise sector and entrepreneurship in the former Yugoslav Republic of Macedonia just before and during the global economic crisis**. It is a data intensive exercise and draws heavily on firm registry and other relevant sources of data on the landscape of firms, as well as on a set of different indicators that measure progress on economic

transition and business climate reform (Box 2). The first part of the paper provides an overview of employment patterns in the formal enterprise sector, how these patterns play out terms of underlying jobs and labor productivity patterns, and on the role of entrepreneurship. The second part looks at different measures of business reform and how these relate to jobs outcomes.

Box 1: Conclusions from recent Economic and Sector Work

The former Yugoslav Republic of Macedonia has managed the global economic crisis well. However, neither the higher growth period preceding the crisis, nor the volatile period from 2008 onwards, has implied any reallocation of work force across economic sectors.

Analysis of the labor force surveys (World Bank, 2013) shows that most jobs were created in low productivity and lower skills sectors over 2000-2011, and that informality has increased. In addition, employment and salaries increased in the public sector, and real wage growth exceeded productivity growth, which in turn hampered competitiveness. Most net job creation has taken place through expansion of wage work rather than firm birth (self-employment).

Exporting firms account for one third of employment in the formal sector and are more productive than other firms (World Bank, 2012). However, exports are relatively unsophisticated, as half are classified as low technology products and especially textiles and apparel are losing competitiveness. Most of the firms are small and survival rates are low. Some share of foreign ownership tends to improve competitiveness, however. Recent analysis show that

Skills are becoming an important constraint, especially to more dynamic firms with an export potential, and for both white collar and blue collar jobs. (World Bank, forthcoming 2016, and 2010).

Hiring workers, especially at the low skill end, is still relatively costly in the former Yugoslav Republic of Macedonia. When asked about labor related constraints, firms in the automotive industry consider the overall wage level the second most important problem, after skills levels (World Bank, forthcoming 2016). Although there have been reforms to lower the personal income taxes and social contributions in recent years, they remain regressive and affect mostly low wage earners.

Source: World Bank (forthcoming 2016, 2013, 2012, 2010).

Box 2: Firm Dynamics and Job Creation in the former Yugoslav Republic of Macedonia: Sources of data

The note incorporates different data-sets to shed light on job creation from the labor demand side of jobs in The former Yugoslav Republic of Macedonia:

- Labor force survey data, from 2007 to 2011.
- Enterprise registry data, from 2004 to 2011, incorporating about 55,000 firms annually.
- Estimates on latent and actual entrepreneurship (non-wage employment) from the Life in Transition Survey, 2010 (LiTS), prepared for the World Bank report *Back to Work: Growing with Jobs in Europe and Central Asia* (Arias et al. 2014).
- Global Entrepreneurship Monitor (GEM), using a representative sample of about 2,000 working adults. the number of months business have been in operation.
- Additional investment climate data from the Global Competitiveness index (World Economic Forum), Enterprise Surveys and Doing Business indicators from the World Bank, the Transition Index (EBRD), and the Life in Transition Survey (EBRD).

2. Transition and the jobs challenge

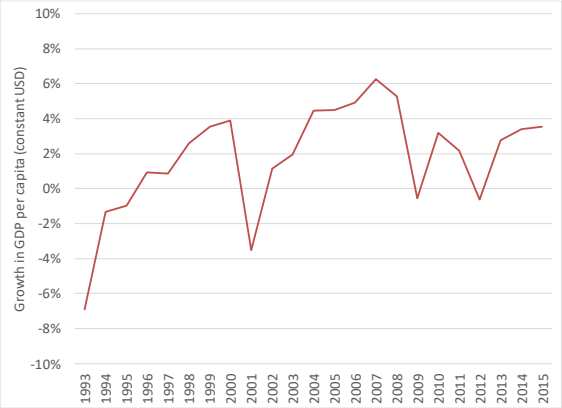
29. **The economic transition process from state led to market economy should be reflected in a move from low to higher productivity jobs, firms and sectors.** In advanced economies, the enterprise sector provides the lion share of employment. This section looks at the extent to which the former Yugoslav Republic of Macedonia has seen a shift towards more productive employment over time by looking at the characteristics of employment, of the firms that provide employment, and at gross job flows across the economy.

2.1. Incomplete structural transformation

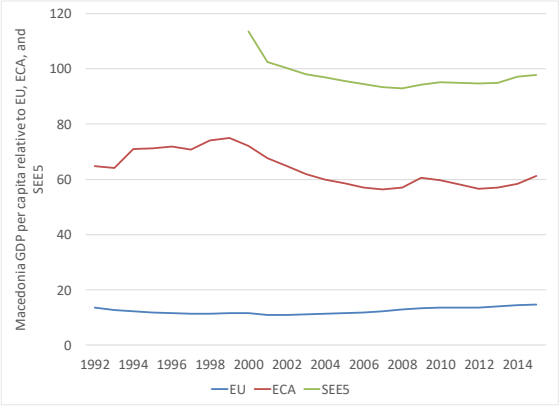
30. **The former Yugoslav Republic of Macedonia has experienced volatile growth with strong set-backs, and economic convergence with comparators has been slow**. Like other transition countries, the former Yugoslav Republic of Macedonia experienced some years of negative growth triggered by the breakdown of the economic system. The recovery towards the end of the 1990s was drastically halted in 2001-2002 as a result of the civil unrest, and a second growth recovery period in the mid-2000s was interrupted by the global financial crisis (Figure 3, left panel). The former Yugoslav Republic of Macedonia has lagged behind the ECA region's average growth levels in the past, and has not caught up with neighboring countries in Southeast Europe since the drop in the early 2000s (Figure 3, right panel).

Figure 3: Volatile growth and slow convergence

Former Yugoslav Republic of Macedonia: Annual growth in GDP per capita (constant USD)



GDP per capita as % share of GDP per capita in EU, ECA, and SEE5*



Source: Estimates based on World Development Indicators. *SEE5=Unweighted average of Albania, Bosnia and Herzegovina, Kosovo, Montenegro, and Serbia.

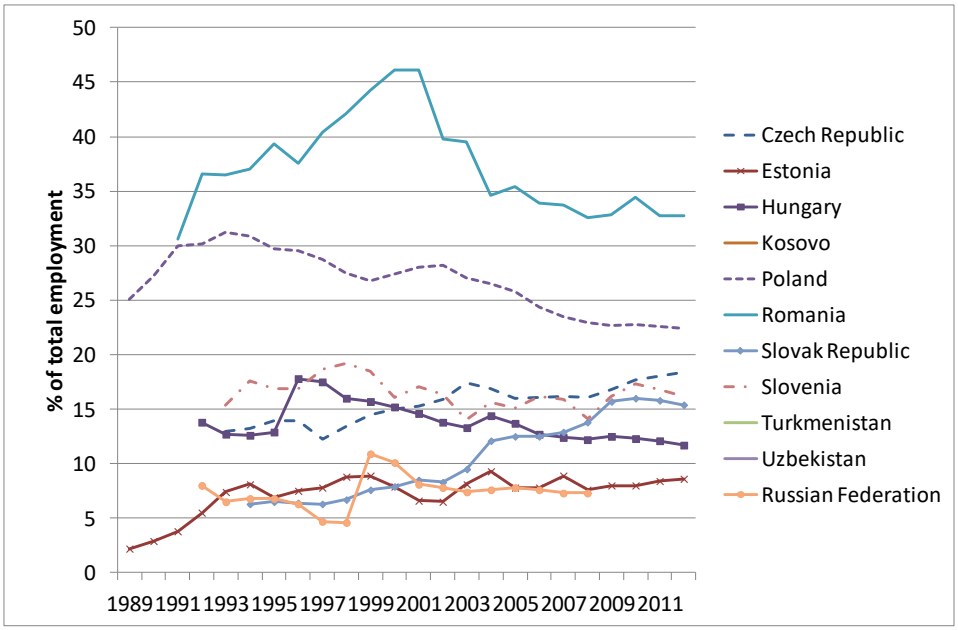
31. **From the employment perspective, restructuring is still ongoing in the former Yugoslav Republic of Macedonia.** The collapse of the state led systems in the former communist countries led to a wide dismantling of production in obsolete and uncompetitive industrial state owned enterprises. In the former Yugoslav Republic of Macedonia some twenty percent of workers are still in the agriculture sector which has the lowest levels of productivity and earnings, and conversely, the services sector is still comparatively small, absorbing around half of the work force. A shift of workers out of agriculture,

especially into the services sector, is consequently a first step towards increasing the productivity of employment. However, restructuring can also take place within sectors, as workers move into more productive firms when less competitive firms reduce or close their business. In the former Yugoslav Republic of Macedonia, both transitions are needed.

32. **Self-employment is also likely to increase in the early and middle stages of transition, and fall as the reallocation process is completed**. As economies develop and the formal wage sector is increasing, self-employment rates would be expected to fall. However, opportunities and necessities both contribute to higher self-employment at the early stages of transition. In state controlled economic systems, self-employment had previously been subdued. Liberalization provided new entrepreneurial opportunities. At the same time, demand for labor in state owned enterprises fell dramatically, while wage employment in modern sectors took time to take off. As a result of these pull and push factors, self-employment consequently increased in many transition economies. In some more advanced economies, formal wage employment in modern sectors has increased (reducing the push-factor) and self-employment has fallen back (Figure 4).

Figure 4: Self-employment – whether entrepreneurial or as employment of last resort – may increase during the transition phase

Self-employment as share of total employment, selected ECA countries



Source: Estimates based on World Development Indicators

33. **From the enterprise perspective, countries in Eastern Europe and Central Asia generally experienced significant net job creation prior to the onset of the global economic crisis**.[2] Countries that had advanced further in the transition process had generally experienced sustained net job creation for some time, while countries with slow restructuring had seen less or no net job

[2] "Net job creation" is the difference between all jobs created in expanding firms, less all jobs lost in contracting firms. Significant reallocation – and productivity growth - can take place without net job creation, if workers leave less productive firms and jobs and are hired by more productive firms.

destruction. Recently established/younger firms generally played an important role in job creation but these same enterprises were also more vulnerable to the crisis (Arias and others, 2014). This is consistent with other evidence that more productive and innovative firms may be more credit constrained and therefore more likely to go under during a crisis (Paci, Revenga and Rijkers, 2012).

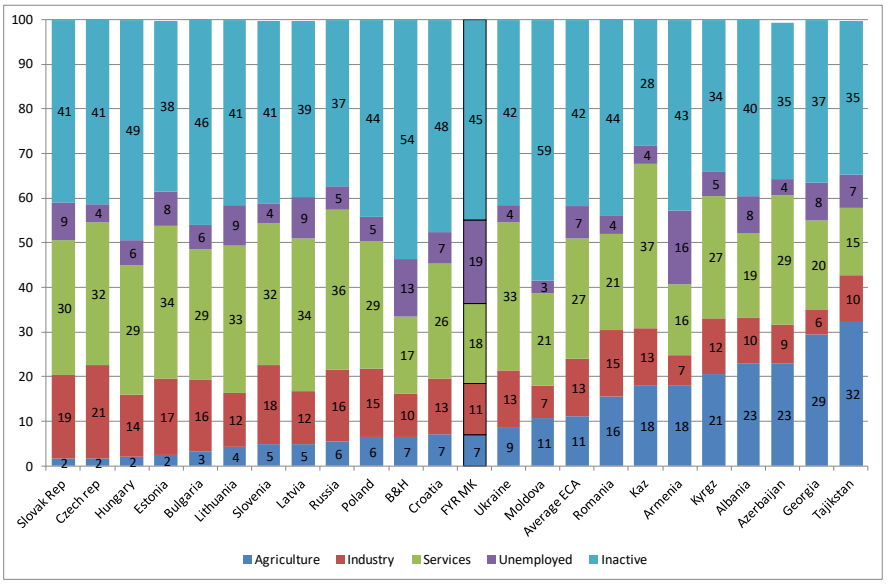
34. **In the former Yugoslav Republic of Macedonia, this has not been the case: work has not shifted into more productive sectors and jobs, self-employment appears to be stagnant, and net job creation was slow in the formal sector.** The former Yugoslav Republic of Macedonia's business environment has improved. After a decade of reform and restructuring, most countries in the ECA region saw productivity growth increase between 1999 and 2005. As workers left the manufacturing industry and took up jobs in the services sector, productivity increased. However, the process of restructuring has not been even throughout the region. Those who embarked later on the reform process, including the former Yugoslav Republic of Macedonia, have still not seen the significant structural shifts needed to move into a functioning market economy (World Bank, 2013).

35. **The global economic crisis played a role in dampening economic growth, firm expansion and employment, but the employment problem appears to be structural rather than cyclical**. In fact, the former Yugoslav Republic of Macedonia did not see significant increases in productive employment in the period of higher economic growth prior to the crisis, either.

36. **After 25 years of economic transition, the reallocation of resources in the Macedonian economy – including labor – is thus incomplete.** First, the former Yugoslav Republic of Macedonia remains an outlier in terms of lack of access to employment. Two in three Macedonian adults are unemployed or inactive (Figure 5). For those that do work, agriculture still absorbs a comparatively large share of the employed by European standards (20 percent of the employed and seven percent of the adult population). The share of adults in the services sector, at 18 percent of the adult population, is among the lowest in the entire ECA region.

Figure 5: Labor has not shifted into more productive work

Adult population 15+: inactive, unemployed, and employed by main economic sector, the former Yugoslav Republic of Macedonia and ECA region.



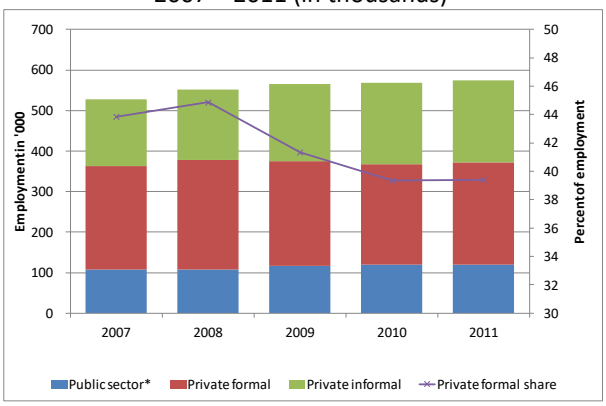
Source: Calculations from World Development Indicators.

37. **The formal private sector is not creating sufficient jobs**. Unlike in more developed economies, most Macedonian's currently find their jobs outside the formal private enterprise sector. The problem is both static and dynamic: the private formal sector is small, and it is still creating fewer jobs than other sectors. In fact, jobs fall out of the private formal sector at both the low and high skill end. The formal sector excluding public administration accounted for less than forty percent of employment in 2011 and its share had been falling as jobs were destroyed between 2007 and 2011 (Figure 6, left).

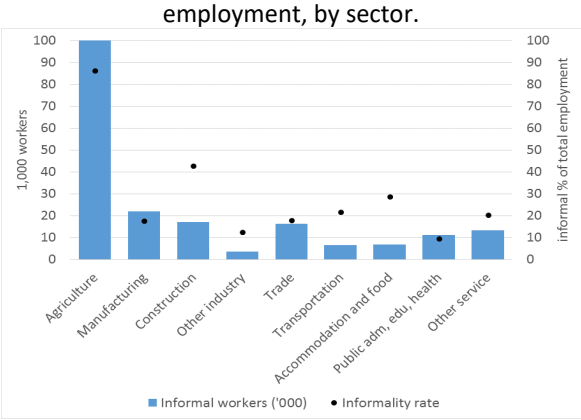
38. **Instead, the informal sector accounted for two thirds of all net employment creation, especially low skill jobs, while public administration became the main employer for tertiary educated workers** (World Bank, 2013). Estimates of shadow economy activities suggest that the informal economy is indeed a significant phenomenon in the former Yugoslav Republic of Macedonia, equivalent to more than one third of GDP, compared to 17 percent of GDP for OECD countries on average (Schneider and others, 2010). Much of informal employment in the former Yugoslav Republic of Macedonia is due to the significant role of the agricultural sector, where half of all informal workers are, and where the rate of informality – the share of informal work in total employment – reaches 86 percent. However, there is also a significant informal work force in the non-agricultural sector, two thirds of them in three sectors only: manufacturing, construction and trade (Figure 6, right).

Figure 6: Informal work increased during and after the economic crisis – but not through self-employment

Contribution to net job creation by different sectors, 2007 – 2011 (in thousands)



Informality, number of workers and share of total employment, by sector.



Source: World Bank (2013), estimates from labor force surveys.

39. **Structural transformation has been limited as labor productivity growth has taken place within sectors rather than through reallocation across sectors.** Between 2002 and 2007, during times of relatively high growth, the economy was characterized by moderate labor productivity growth, very limited employment creation on a net basis, and limited shifts in employment structure (Figure 7). More specifically, employment in the agricultural and industrial sectors contracted while the services sector expanded. As a result, the share of work force engaged in agriculture fell from 24 to 18 percent while that of services increased from 43 to 50 percent (World Bank, 2009).

40. **Labor productivity[3] increased between 2002 and 2007, due to labor productivity gains – together with job destruction - within different sectors.** Aggregate labor productivity increased by about 4.5 percent per year, largely due to an increase in labor productivity within the industrial sector (in particular) and agriculture, as surplus jobs were destroyed in these two sectors. Much less productivity growth was due to reallocation gains, i.e. workers changing from low productivity sectors into higher productivity sectors. In other words, workers did not benefit from aggregate productivity growth with access to better jobs in new sectors (World Bank, 2009).

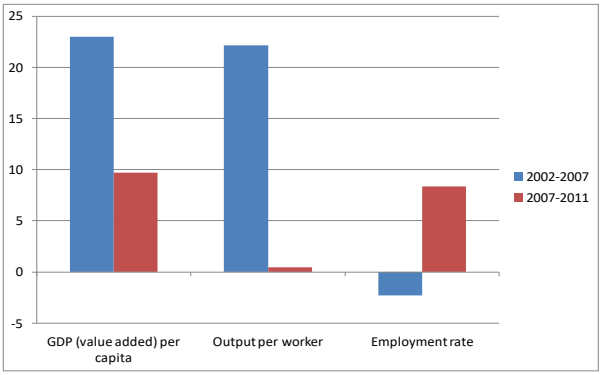
41. **Since 2007, economic growth has been more subdued, the former Yugoslav Republic of Macedonia has seen very little labor productivity growth, and labor reallocation has stalled**. Between 2007 and 2011, employment growth picked up but was not accompanied by an increase in more productive job opportunities. The structural reallocation of workers actually impacted negatively on productivity, as more employment was created in the agricultural sector and the informal sector.

42. **In sum, labor markets have far from completed their transition from low productivity to higher productivity jobs in the former Yugoslav Republic of Macedonia.** Too many people are deprived of any employment at all, and many workers and their families are still dependent on low productivity sectors like agriculture and informal work. The fact that employment patterns do not change significantly in response to global economic volatility bears witness to the fact that the former Yugoslav Republic of Macedonia has still not completed its transition into a more modern economy.

[3] Labor productivity for economic sectors is defined as the ratio of value added over number of workers.

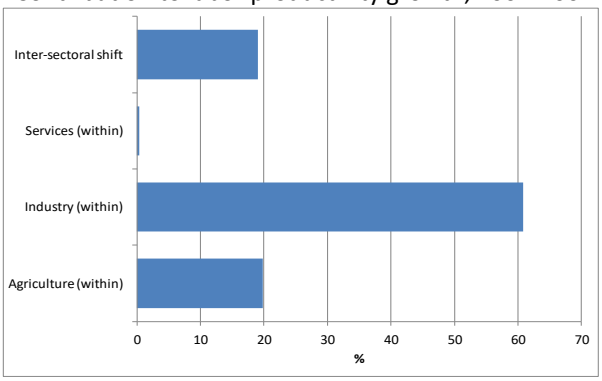
Figure 7: Labor productivity growth is linked to employment destruction and vice versa

Growth in GDP per capita, labor productivity, and the employment-to-population ratio, 2002-2007, 2007-2011.

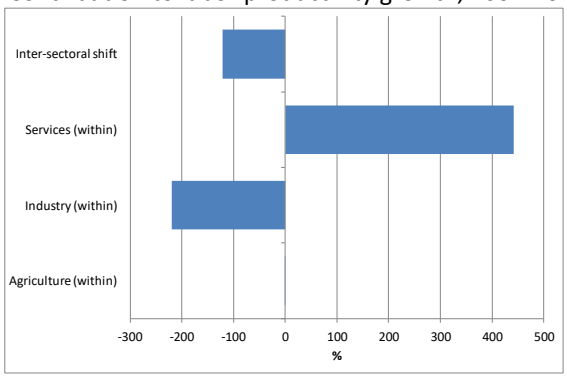


Growth in employment by sector of work, 2002-2007, 2007-2011.

Contribution to labor productivity growth, 2002-2007



Contribution to labor productivity growth, 2007-2011



Source: Estimates based on macroeconomic data and labor force data from the Statistical Office.

2.2. The landscape of formal firms: where are the jobs?

43. **Where and in what kind of enterprises do those in the formal sector work?** This section looks at employment from the perspective of formal firms – those available in Macedonia's firm registry. Arguably there can be very different kinds of dynamics going on within the firm sector, compared to the broader employment picture. The total number of employed in the firm registry amounts to just under 350,000, which corresponds to a little over half of all employment registered in the labor force survey. The registry includes firms of all sizes – most, as will be seen, are in fact very small.

44. **Most employment is in small firms, with limited turnover and low innovation content**. Nine out of ten firms in the former Yugoslav Republic of Macedonia are micro firms, with less than ten employees, and less than two percent of firms have more than 50 employees. More than half of all employees in registered firms work in firms with less than fifty employees, and one third of employees are in micro-firms (Figure 8, a). One third of the work force is in firms with annual turnover of less than 10 million Macedonian denars (about 160,000 euros). About one third of jobs are also among young firms, with less than 6 years in business. Though not shown here, the shares of young and small firms have fallen since 2007.

45. **The firm landscape largely lacks large dynamic firms.** Compared to OECD countries, the former Yugoslav Republic of Macedonia lacks especially large firms (Figure 8, b). The employment share of large firms is smaller than for e.g. Poland, Slovenia, Hungary and the Czech Republic, which otherwise have similar levels of employment in micro and small firms (OECD, 2013). It is important to keep in mind that the size of informal sector matters for these comparisons as the surveys focus on formal sector. An even larger segment of micro-firms is likely to exist in the informal sector.

46. **While all young firms are small, small firms are not necessarily young**. Compared to the OECD, the former Yugoslav Republic of Macedonia also has fewer old firms, and more young firms. Nonetheless, since micro-firms predominate also among older firms, not all small firms are in fact young. Nearly one third of all firms exist since more than a decade, and half of all jobs are in older firms. Many firms simply do not grow beyond micro-size with time. It is nonetheless clear that the small-firm sector is diverse in terms of growth, technology, and employment potential.

Figure 8: Most employment is in small and less dynamic firms

a. Distribution of employment by firm characteristics, 2011

b. Former Yugoslav Republic of Macedonia compared with OECD countries

Source: Estimates based on enterprise registry data and Criscuolo and others (2014).

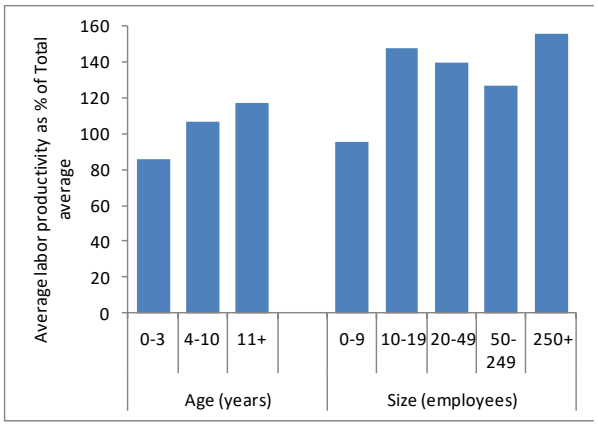
47. **Larger firms are not more productive in the former Yugoslav Republic of Macedonia, a signal that resource allocation is not working well in the economy.** In well-functioning market economies, productive firms should grow faster simply because efficient and more competitive firms have the opportunities to invest and expand, while inefficient ones are held back or forced to exit (see Iacavone and others, 2014). Under such circumstances, larger firms (in terms of employment) in particular should have higher levels of labor productivity. This would be a positive thing from a labor market perspective, since a larger share of employment by consequence would be in firms with higher labor productivity and the ability to provide better wages. The dominance of very small firms in the former Yugoslav Republic of Macedonia already suggests that growth enhancing investment does not pay off. In fact, although labor productivity[4] is somewhat higher among older firms, there is no systematic relationship between size and productivity. As seen in Figure 9 a and b, while labor productivity levels are generally lowest among micro-firms, firms with more than fifty employees are generally less productive (with a distribution skewed to the left in Figure b) than those in firms between 10 and 49.

[4] Labor productivity in enterprises is calculated using total operating revenues per worker

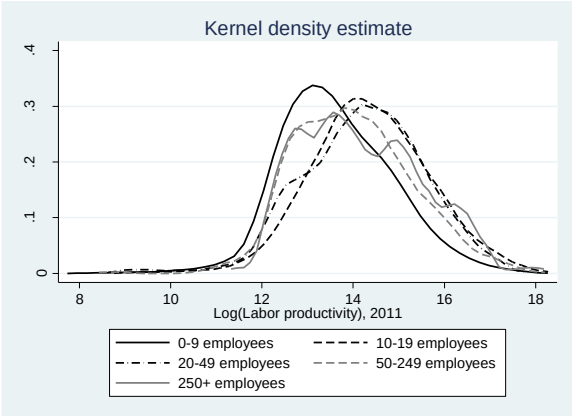
These are signs that that the private sector overall has very limited labor demand (many jobs are in micro-firms) and that more competitive firms are not able to grow further.

Figure 9: More productive firms may face limits to growth

a. Average levels of labor productivity[1], by age and size categories (2011).



b. Density functions of labor productivity by firm size (number of employees)



Source: estimates based on enterprise registry data. Note: Size 1=0-9, 2=10-19, 3=20-49, 4=50-239, 5=25 employees or more. 1. Total operating revenues per worker.

48. **Throughout the crisis, younger firms accounted for a majority of new jobs.** While young firms account for a small share of employment, they contributed much more significantly to job creation in the period 2007 and 2011 – between 60 and 80 percent of all new jobs (on a net basis) were created in firms with less than 4 years of age (Figure 10). This is consistent with evidence from other countries Central and Eastern Europe, where job creation typically was driven by some younger and dynamic firms.

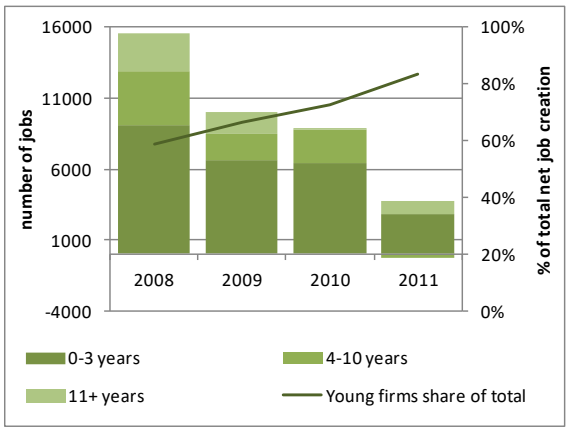
49. **Medium sized firms with between 50 and 249 employees, accounted for much of net job creation.** Between 2007 and 2011, half of all jobs created in formal firms, on a net basis, were created in firms with between 50 and 249 employees, while small (below 50) and large (250 or more) accounted for about one quarter each. employees.

50. **Net job creation fell during the crisis, as younger firms stopped creating new jobs.** As the economic slowdown began to impact demand for labor, job creation slowed down, especially between 2010 and 2011. The main reason for the slowdown was a dramatic drop in job creation among young firms. The low levels of job creation also reflected a general decline in net job creation among medium and large firms, and a significant increase in net job destruction among microfirms.

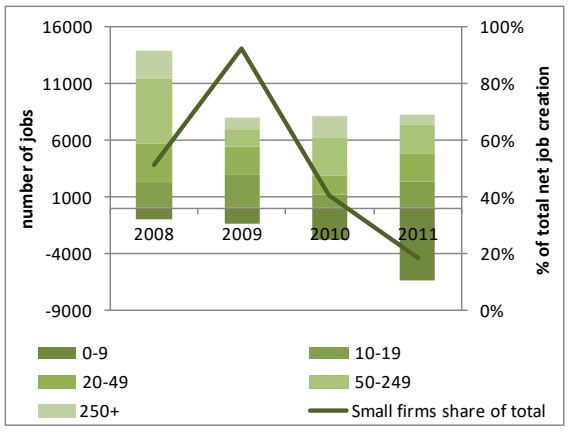
51. **The patterns echo experiences from other Central and Eastern European countries.** In particular, many of the new innovative firms that had been driving employment growth prior to the crisis were stunted or forced to exit. During favorable economic times, such firms would not have been credit constrained. However, more productive firms often operate with smaller margins and as such are more vulnerable to a credit crunch such as was happening after 2008. Thus, many young, dynamic and potentially fast growing firms were forced out of business, while older and larger firms survived.

Figure 10: Young firms contribute significantly to job creation: when they stop, job creation goes down.

a. Net job creation, by age class



b. Net job creation, by employee size class



Source: Estimates based on enterprise registry data. Small firms = with less than 50 employees.

2.3. Beyond net job creation: patterns of creation, destruction and reallocation of jobs

Stagnant employment growth can hide significant dynamics underneath**. Successful reallocation implies that jobs shift from firms in less productive sectors to more productive ones, and that more productive firms within sectors open up or expand while less productive firms contract or exit altogether. In other words, some jobs must also be destroyed while others are created (see**

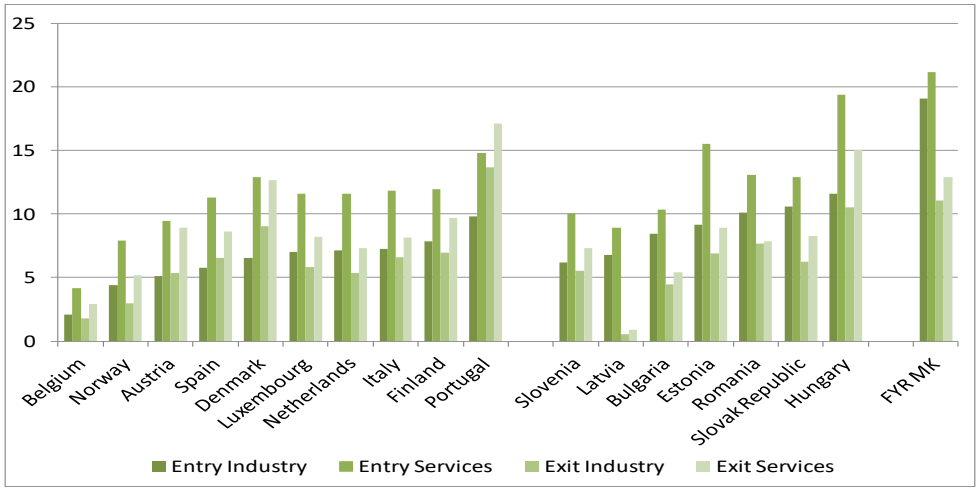
52. Box 3 for a glossary on gross job flows). The economic restructuring process generally starts off with high job destruction in sectors that were important prior to transition, especially heavy industry. With time, new sectors take off, and gross job creation increases. Over time, the role for firm entry and exit in overall job turnover has also diminished. The reallocation, thus, can take place both through firm entry and exit, and through a simultaneous expansion and contraction of existing (and surviving) firms. As is logical, contracting and expanding firms tend to be larger, all else equal, than firms that entry and exit (World Bank, 2009).

53. **High firm and job turnover can be the consequence of competitive pressures or of a dysfunctional business climate.** In many ECA countries, high firm turnover contributed to productivity growth in early transition stages (Alam and others, 2008). High firm entry can be evidence of a dynamic economy: a thriving private business sector and private sector job creation relies on entrepreneurial drive and new business ideas that are expressed in the creation of firms. It is also clear, however, that many small businesses, and especially own account work, are born as the result of "push" factors, such as lack of other employment options given one's endowments and situation in life. In a similar vein, depending on country context, high levels of firm exit could either mean highly competitive circumstances resulting in rapid destruction of unproductive firms, or a bad investment climate that "kills off" firms with potential prematurely.

54. **Firm entry and exit remains high in the former Yugoslav Republic of Macedonia.** Compared to other European countries, firm turnover is high in the former Yugoslav Republic of Macedonia, in both industry and services sectors. In 2007 (a year for which there is comparable data on firm demography in OECD countries), new firms accounted for some twenty percent of the total number of firms in both the industry and services sector, while firm exits accounted for between ten and fifteen percent. These rates are high compared to other European countries, where firm entry rates generally hover between five and ten percent and likely reflect the former Yugoslav Republic of Macedonia's status as a less mature market economy (Figure 11).

Figure 11: Firm turnover is high compared to other European countries

Firm entry and exit, industry and services sectors, as share of total number of existing firms, Macedonia and European comparators, 2007

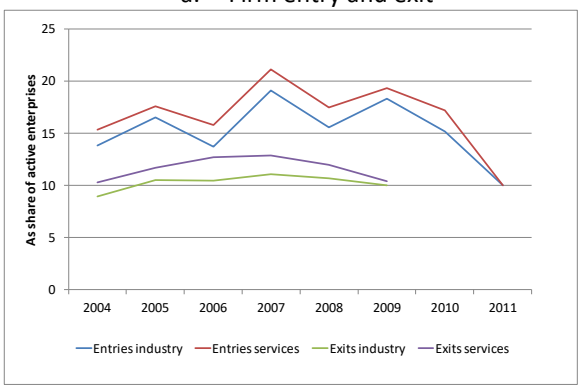


Source: Estimates based on firm registry data (The former Yugoslav Republic of Macedonia) and OECD statistics (other countries)

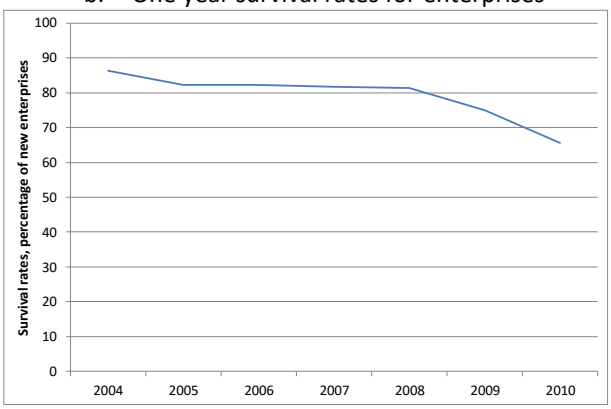
55. **However, firm creation dropped in the former Yugoslav Republic of Macedonia in response to the economic crisis**. The bureaucratic costs, in terms of time, fee, and procedures, of opening up a business are low in the former Yugoslav Republic of Macedonia – in 2016, the country ranks as number two in the world in terms of ease of starting a business (World Bank Doing Business Indicators, 2016). While economic growth slowed down as of 2009, firm entry did not drop until 2011 (Figure 12a). Greater hesitance to start a firm is likely to have been linked to a fall in firm survival rates observed as of 2010, in other words, the probability that a firm that was started in 2009 survived until 2010 was lower than previous years (Figure 12b). This is consistent with the drop in job creation by younger firms in 2011, and the pattern mirrors that of other ECA countries, which also saw a drop in new firm creation in the wake of the crisis.

Figure 12: Firm creation dropped in response to the crisis (and risk of failure)

a. Firm entry and exit*



b. One year survival rates for enterprises**



Source: Estimates based on enterprise registry data. *Entries and exits as percentage of active enterprises**Survival rates for firms started in a particular year.

Box 3: Gross job flows glossary

Gross job creation in one year (in a particular sector) is the sum of all employment gains that year in firms (in that sector) that start up or expand during the year.

Gross job destruction is the sum of all employment losses in firms that contract or shut down (in that sector) during the year.

Net job creation is the difference between gross job creation and gross job destruction.

Gross job reallocation is the sum of gross job creation and gross job destruction, and characterizes the dynamics (extent of job creation and job destruction) of the labor market. Thus it is quite possible to have high gross job reallocation but low net employment growth (if high creation and destruction cancel out).

Such dynamics, while not leading to more jobs, can lead to better/worse jobs, with higher/lower productivity and related earnings possibilities.

Excess job reallocation is the difference between the gross job reallocation and the absolute value of the net employment growth. This measure captures the amount of churning by firms, i.e. how much actual job reallocation exceeds what would be necessary to accommodate the net change in employment.

These indicators are expressed in thousands of jobs or as rates by dividing them by total employment numbers (in a particular sector).

56. **Analysis of gross job flows for the years 2002-2006 undertaken for the 2009 Poverty Assessment showed that job churning was very high in the former Yugoslav Republic of Macedonia**. During one year, about 3 in 5 jobs were reallocated (created or destroyed), and for each job created on a net basis, as many as thirteen jobs had to be reallocated across the economy. The analysis also concluded that while firm turnover was comparatively high in the former Yugoslav Republic of Macedonia even

compared with transition countries, firm survival improved and that most jobs were in fact destroyed through company downsizing (World Bank, 2009). Using more recent data from the period prior to the global crisis, the World Bank's "Back to Work" Report showed that there are significant differences in gross job flows across transition countries and that these differences are related to how far the transition process has come in countries – advanced modernizers, e.g. Estonia and Poland experienced strong gross job creation and some job destruction before the financial crisis, while in countries less advanced on the structural reforms, jobs reallocation was still very significant (Arias and others, 2014).

57. **The former Yugoslav Republic of Macedonia still displays high rates of churning**. Analysis of enterprise level data for 2007 to 2011 shows that in this period, to create 27,000 jobs on a net basis, five times as many jobs had to be created and four times as many destroyed. The degree of churning intensified during the global crisis so that while net job creation in the enterprise sector fell, excess job reallocation increased because gross job destruction increased. Expressed in rates (share of total firm employment), both job creation and job destruction were in 2009 about twice as high as those in Poland and Estonia. Many more jobs were thus created and destroyed across Macedonian labor markets, for a given number of jobs, than in the more advanced economies (Figure 13, a, b and c).

58. **Although job turnover is part of the reallocation process towards more productive employment, such high levels of churning signals inefficiencies**. For example, it may indicate a relative increase in temporary contracts as firms respond to economic uncertainty by avoiding. Alternatively, if jobs turnover is high, but job search and matching mechanisms are inefficient, a large share of workers may be out of a job for lengthy periods of time, although there is demand for labor in the economy.

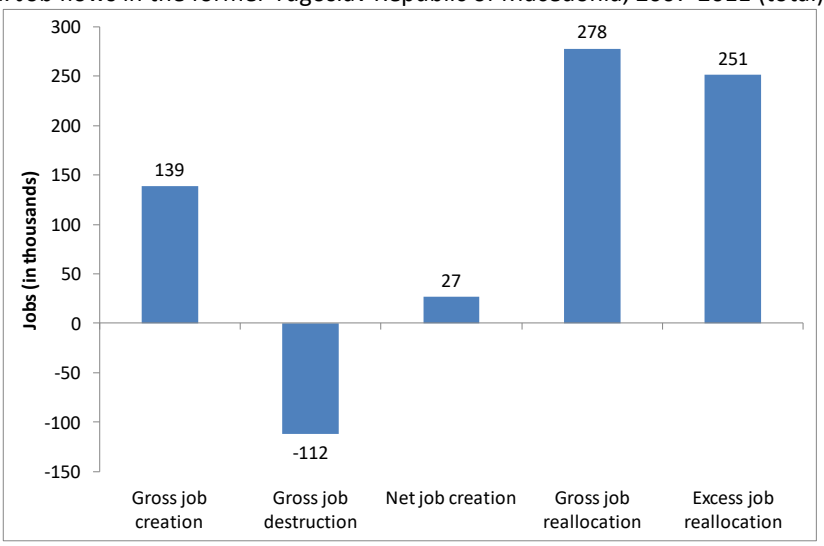
59. **There was more job churning among larger firms than smaller firms**. Firms with more than 50 employees saw some limited net job destruction, but significant churning – job creation and job destruction happening at the same time (Figure 13, d).

60. **Existing, surviving firms account for most of both gross job creation and job destruction.** Jobs can also be created and destroyed through firm creation and firm exit. Adding firm creation and destruction to the picture adds even more dynamics to total jobs turnover, but firms that were and remained in business account for more job flows. Since start-ups are small, and firm survival is lowest among small firms, most gross job creation is likely to come from larger firms that expand in larger chunks. Indeed, expanding firms accounted for more than twice as many new jobs (gross) as those created by new firms. Similarly, more jobs were lost through shedding in larger (but surviving) firms than destroyed by firms going out of business. The fall in net job creation during the crisis reflects mostly an increase in redundancies in existing firms (Figure 13, e).

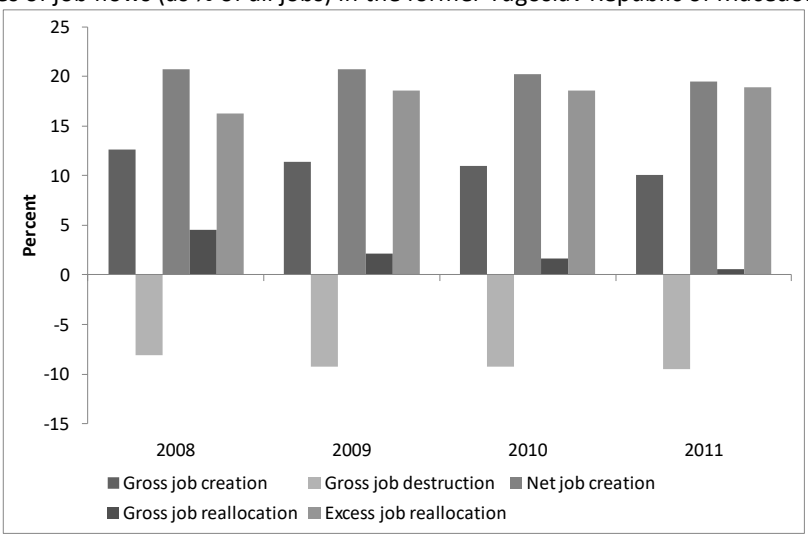
61. **On the positive side, within the formal sector, firms with higher labor productivity created more jobs.** In fact, the twenty percent most productive firms contributed to 60 percent of net job creation between 2007 and 2011 (Figure 13, f). They did so more efficiently than other groups, as their shares of total gross job creation and – in particular – gross job destruction were much smaller. While overall job creation in The former Yugoslav Republic of Macedonia as discussed above was low quality (with an emphasis on agriculture and informal jobs), within the enterprise sector, the quality of jobs may have improved as productive firms survived the economic crisis better.

Figure 13: Net job creation is hiding significant reallocation dynamics where many jobs are destroyed and created simultaneously

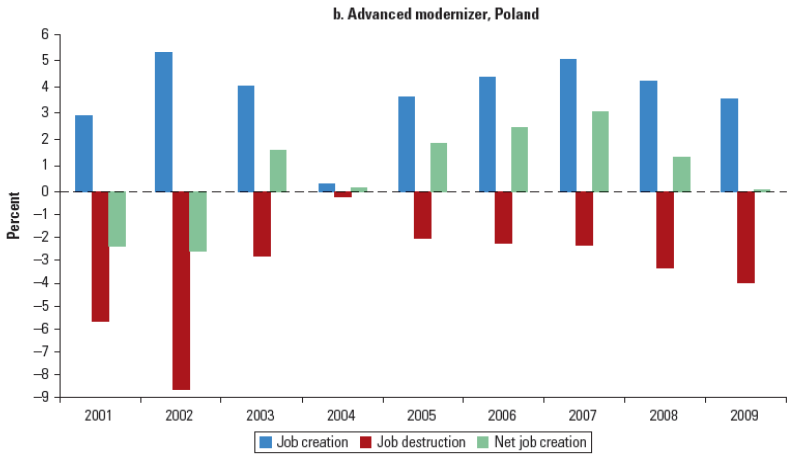
a. Job flows in the former Yugoslav Republic of Macedonia, 2007-2011 (total)



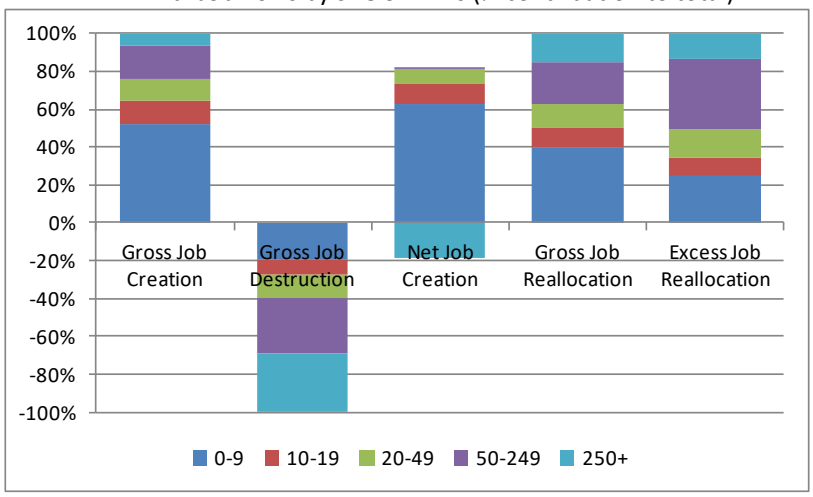
b. Rates of job flows (as % of all jobs) in the former Yugoslav Republic of Macedonia, 2007-2011



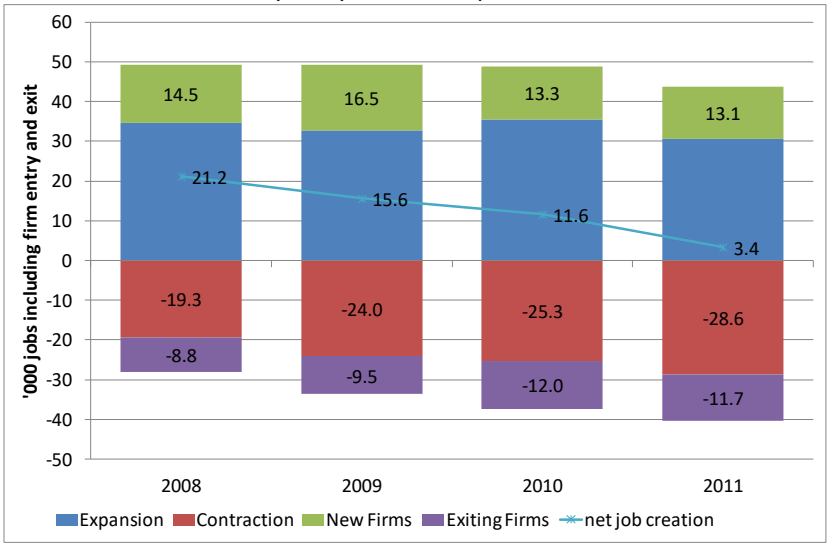
c. Gross job flows, Poland



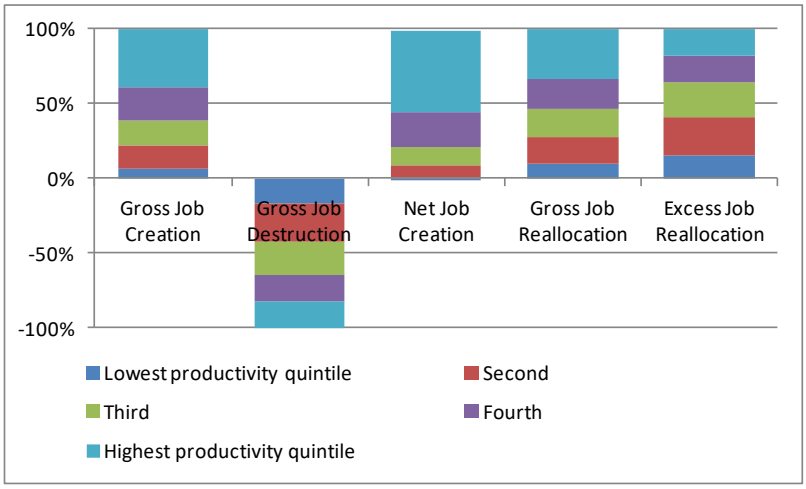
d. Job flows by size of firms (% contribution to total)



e. Job flows by entry/exit and expansion/contraction



f. Gross job flows by productivity quintiles (% contribution to total, 2007-2011)



Source: Estimates based on enterprise registry and Arias and others (2014)

62. **As elsewhere in ECA and in more advanced economies, small share of firms account for a high share of gross job creation**. In more advanced economies so called "Gazelles" – a few specific, often young, innovative and competitive firms – often grow more rapidly in terms of employment than other firms and account, in fact, for the bulk of all jobs (see e.g. Birch and Medoff, 1994, or Henrekson and Johansson, 2011). Unlocking the growth potential of such firms is thus of particular importance to increase labor demand. In the former Yugoslav Republic of Macedonia, job creation was also concentrated among few firms between 2007 and 2011. The five percent of firms that created most jobs in fact accounted for half of all jobs created between 2007 and 2011; the top 20 percent job creating firms accounted for almost three in four jobs (Table 1).

63. **These top job creating firms were significantly more productive than other firms and – while generally small – also larger than the average firm in the former Yugoslav Republic of Macedonia**. Compared to other firms, gazelles were also more likely to be foreign owned. Most of them were active in trade, manufacturing, or construction, but compared to other firms, gazelles are less likely to be in trade, and significantly more likely to be in manufacturing and construction. Overall, this confirms that the group of small firms is diverse in nature, level of productivity, and employment potential.

Table 1: A small number of firms account for a high share of job creation.
Firms belonging to the top 20, 10 and 5 percent of job creating firms <82007-2011)

	Top 20%	Top 10%	Top 5%	All firms
Share of gross job creation	73%	61%	50%	100
Productivity index	211	216	199	100
Median size	7	12	20	2
% with less than 50 employees	90	82	71	98
Median age	6	6	6	6
% foreign owned	8.8	11.7	15.2	3.4
Sector distribution				
Manufacturing	28	32	36	12
Construction	13	13	13	7
Accommodation and food	5	3	2	4
Information and communication	3	3	4	2
Trade	29	26	23	43
Transport and storage	8	6	5	9
Other	14	15	19	23

Source: estimates based on enterprise registry.

3. Promoting firm creation and expansion in the former Yugoslav Republic of Macedonia

64. **How can the former Yugoslav Republic of Macedonia encourage more job creation in firms?** The survival and growth of firms depends on the existence of potential entrepreneurs and on a favorable business climate. How can the "gazelles" identified before be encouraged to form and prosper? Although it is in principal easy to start a business in the former Yugoslav Republic of Macedonia, most firms remain very small, even exports oriented firms, and survival rates are low and have been falling. This section looks at the challenge from both the perspective of firm creation and from that of more incomplete transition reform. It addresses the level of entrepreneurship in the Macedonian economy, and the determinants of why people want to, try to, and succeed in opening a business. It subsequently looks at outstanding areas in economic reforms, with a focus on obstacles that stand out as particularly important for the business sector.

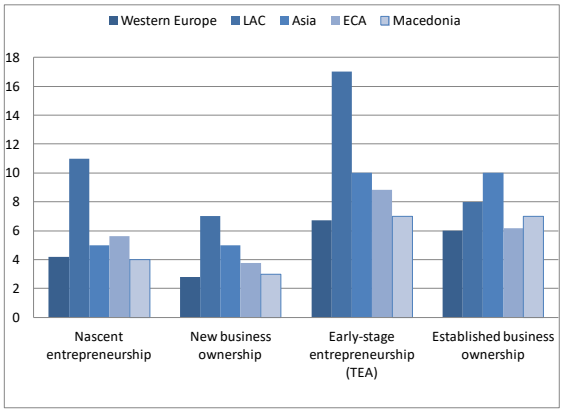
3.1. Fostering entrepreneurship

65. **The former Yugoslav Republic of Macedonia has a relatively low level of "entrepreneurship", in fact similar to the level of advanced economies in Western Europe**. About 7 percent of the adult (15+) population is self-employed – a surprisingly low number, given the relatively high levels of poverty and the lack of other job opportunities witnessed in low employment rates. Data from the Global Entrepreneurship Monitor 2012 show that in The former Yugoslav Republic of Macedonia, a small share of adults have started or are in the process of starting a business (Figure 14a). These low levels of entrepreneurship place the former Yugoslav Republic of Macedonia, a middle income country, alongside more mature market economies with higher levels of employment and welfare. The former Yugoslav Republic of Macedonia is much behind Latin American or Asian countries, and has lower rates of entrepreneurship than the average ECA country at all entrepreneurship stages except established businesses.

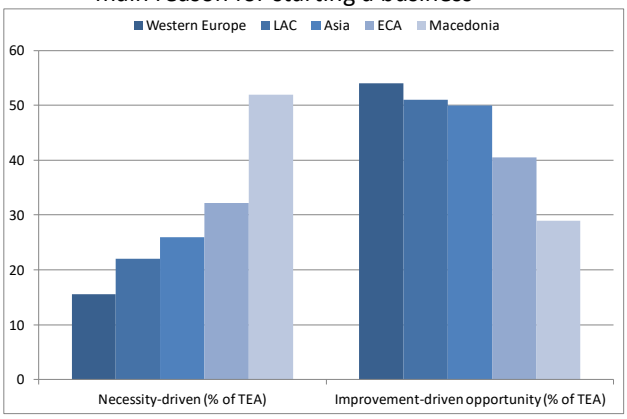
66. **Self-employment in the former Yugoslav Republic of Macedonia is largely the result of necessity and lack of other opportunities**. Moreover, the type of "entrepreneurship" existing in the former Yugoslav Republic of Macedonia appears to be much less driven by the wish to take advantage of business opportunities, than by the necessity of working for oneself for lack of other opportunities (Figure 14b). The relative emphasis on push versus pull factors sets the former Yugoslav Republic of Macedonia further apart from comparators. This is where the former Yugoslav Republic of Macedonia is furthest away from more advanced economies in Western Europe. Where formal wage employment or a supportive safety net is an option, people become entrepreneurs if they see a business opportunity. This is not the case in the former Yugoslav Republic of Macedonia. It would thus appear that the former Yugoslav Republic of Macedonia through the economic transition path would have to increase entrepreneurship rates before returning to the level registered in more advanced economies.

Figure 14: Limited entrepreneurship, and mainly necessity driven.

a. Percentage of all adults



b. Percentage of early stage entrepreneurship, by main reason for starting a business

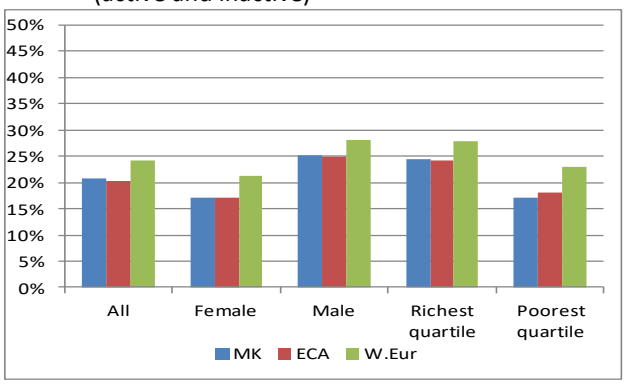


As share of adults 18-64. Nascent entrepreneurs: in the process of starting a business. TEA = the sum of nascent and new business ownership. Source: Global Entrepreneurship Monitor.

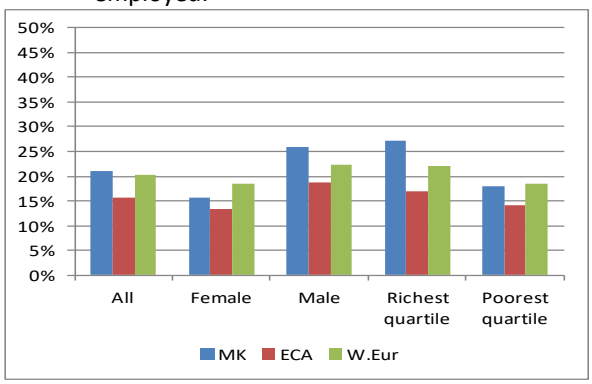
67. **Nonetheless, a significant share of those not working or who are wage employed, are interested in becoming entrepreneurs.** Latent entrepreneurs include all those in the population who, given the option, would wish to be self-employed. According to the Life in Transition Survey, the share of latent entrepreneurs among the wage employed is higher in the former Yugoslav Republic of Macedonia than in other ECA countries. One fifth of those who are wage employed would want to be running their own business in the former Yugoslav Republic of Macedonia, compared to around 15 percent in other European ECA countries. In general, and irrespective of the measure used, women are significantly less likely than men to want to be entrepreneurs. There is also a considerably difference between the poor and the more well-off. These gaps are higher in the former Yugoslav Republic of Macedonia than in other ECA countries or in Western Europe.

Figure 15: Latent entrepreneurship is high

a. % latent entrepreneurs among population (active and inactive)



b. % latent entrepreneurs among wage employed.



Source: Estimates based on Life in Transition Survey, 2010 (LiTS). ECA: Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Kosovo, Montenegro. Western Europe: France, Germany, Great Britain, Italy and Sweden.

68. **What are the hurdles to a more opportunity driven entrepreneurship?** Several explanations emerge from the analysis of entrepreneurship: the difficulties for latent entrepreneurs to move from idea to action, the low survival rate of firms, and – as discussed earlier - the difficulties for more productive firms to flourish.

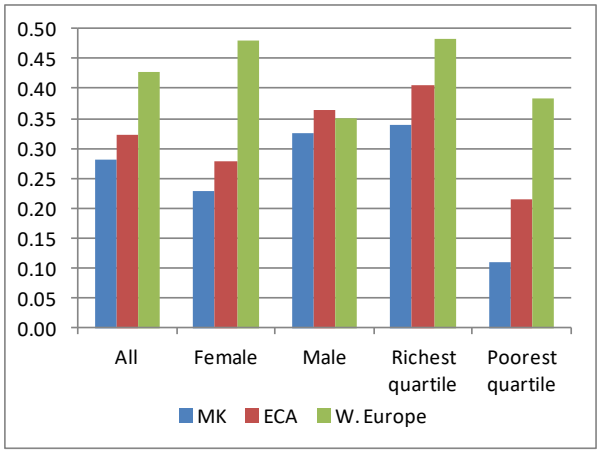
69. **Few latent entrepreneurs moved actively to open their own business.** Relatively few of latent entrepreneurs actually took steps towards opening a firm. The very poorest were the least likely to do so - nine out of ten self-declared latent entrepreneurs in the poorest group (lowest consumption quartile) did not take any steps towards opening a business. This corresponds to half the ratio compared to other ECA countries and one third of that of Western Europe. Female potential entrepreneurs are also much less likely to take steps towards business than in more advanced economies.

70. **A majority of those who attempted to open a firm succeeded in doing so.** The key hurdle appears to be in moving from idea to action – among those who did attempt to establish a business, some 70 percent succeeded. However, success rates are nonetheless lower in the former Yugoslav Republic of Macedonia (and ECA countries in general) than in Western Europe.

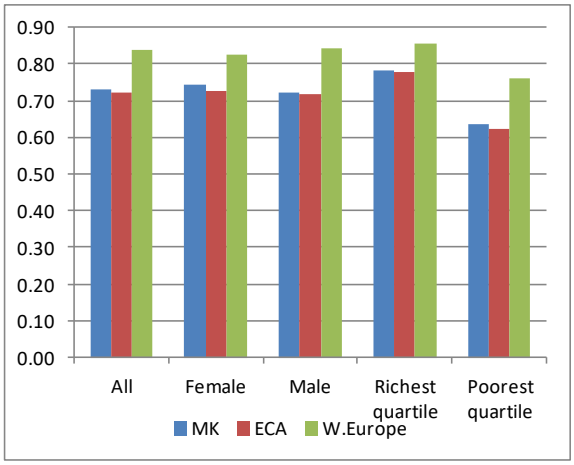
71. **A mix of soft and hard factors matter for entrepreneurship**. Cross country analysis shows that attitudes towards, and actual levels of, entrepreneurships are affected by a number of factors. Access to credit is, unsurprisingly, particularly important for succeeding in setting up a business. Entrepreneurship is also higher among those with private sector experience, and in areas with higher business density. Women entrepreneurs are also more likely to be organized in associations. However, "soft", or personal factors – for example attitudes to risk – also matter greatly (Box 4).

Figure 16: Percentage that took steps towards opening a business, and that succeeded in doing so.

Ratio among latent entrepreneurs that took steps.



Success ratio among those that took steps.



Source: Estimates based on Life in Transition Survey, 2010 (LiTS). Regional definitions, see Figure 14.

Box 4: What determines latent and actual entrepreneurship?

Multivariate analysis of how different factors affect attitudes to entrepreneurship, the decision to become an entrepreneur, and the likelihood to succeed suggests that although hard economic facts matter (in particular access to credit, economic agglomeration, and a favorable business climate), the decision to become and the likelihood to succeed as an entrepreneur are also substantially affected by "softer" factors related to attitudes, social connections, and past employment history.

Demographics: For all types of entrepreneurship (latent, attempted, succeeded), rates are higher among men. And among women, younger women tend to have more successful transitions from *attempting to start a business* to *successfully starting a business* than older ones. A possible hypothesis is that this may have something to do with competing commitments during the childbearing years that lead to lower levels of labor market attachment among older women. Latent entrepreneurs are also more likely to be older, married, have higher consumption per capita.

Private sector experience: Those in the private sector more likely to be latent entrepreneurs. Such private sector experience seems very important. Conditional on being a latent entrepreneur, whether one *attempts to start a business* is significantly associated with private sector employment. Successful transitions from attempting to start a business to actually starting a business also associated significantly with private sector experience.

Networks: Social networks are important but active membership in organizations are much more important for women. In fact, such memberships are also significantly associated with *attempting* to start a business. One possibility: because women tend to have lower LFP, active memberships offset the lack of labor market networks.

Attitudes towards risk: Risk preferences are very important and they dominate other attitudinal measures (including trust in institutions, trust in courts, etc,) Those at the top of the risk scale (1 to 10) are 16 percent more likely to be latent entrepreneurs. Are these risk measures meaningful? I would argue that they are -- preference for a high-risk job and willingness to move abroad are also associated with latent entrepreneurship.

Economic geography and agglomeration: Business density matters: where there are more entrepreneurs, we see more latent entrepreneurship. The implication if entrepreneurship is generally desirable: some communities may be locked in a bad equilibrium.

Credit: Access to finance is extremely important: The most successful business starters are the ones who were able to borrow money - they are 35 percent more likely to succeed than other firms.

Ease of doing business: The cost (in time and money) of starting a business, the level of investor protection, and the cost involved with resolving insolvency, are all strongly related to the level of latent entrepreneurships.

Source: Arias and others, 2014.

3.2. Unfinished Business: Remaining constraints to firm creation, survival and expansion

72. **How can the investment climate in the former Yugoslav Republic of Macedonia best support the creation and growth of firms and jobs?** If there is latent entrepreneurship in the former Yugoslav Republic of Macedonia, what would be needed to unleash it? How can the former Yugoslav Republic of Macedonia foster more jobs by more productive and competitive firms? This section looks at different aspects of business environment and how these constraints affect firms in the former Yugoslav Republic of Macedonia, drawing on a set of sources of information. The Global Competitiveness (GCI) by the World Economic Forum measures the broad set of endowments, institutions and policies that foster competitiveness, on the premise that competitiveness is the key to productivity growth and economic prosperity (Box 5). The Transition Index (TI) produced by the

European Bank for Reconstruction and Development, measures more narrowly progress on different market oriented economic reforms. The World Bank's Doing Business Indicators (DB) and enterprise surveys (ES) focus more specifically on the business climate. The DB, GCI and ES include both hard (quantitative) and soft (qualitative, subjective) data from surveys of enterprise managers.

73. **Overall, the former Yugoslav Republic of Macedonia has made significant reforms improve its competitiveness and conditions for private sector development**. Progress on business environment reform is visible in a range of different indicators, including the World Bank's Doing Business Indicators (DBI), the Transition Index, and the Global Competitiveness Index.

74. **According to the Global Competitiveness Index (GCI), the former Yugoslav Republic of Macedonia has improved its international competitiveness in recent years but is lagging behind its regional peers.** The former Yugoslav Republic of Macedonia now ranks number 73 out of 148 countries, compared to 84 out of 122 countries in 2006. Over time, the former Yugoslav Republic of Macedonia has thus successively shifted into the more competitive half of countries included in the index (Figure 17, a). Nonetheless, the country remains behind a majority of neighboring countries in Central and Eastern Europe.

Box 5: Nuts and Bolts of the Global Competitiveness Index

The Global Competitiveness Index is built around different pillars of competitiveness. The emphasis on different policy areas for sustaining and increasing competitiveness depends on countries' levels of development.

Countries at early stages of development compete on account of their factor endowments, generally unskilled labor and natural resources. They depend on basic requirements like strong public and private institutions, well developed infrastructure, macroeconomic stability, and a healthy work force with at least basic education.

As countries develop, they can no longer compete on cheap labor and natural resources alone. In the efficiency driven stage of development, competitiveness is driven by a set of efficiency enhancers: higher education and training, efficient goods markets and labor markets, developed financial markets, ability to absorb new technology, and access to large markets (domestic or foreign).

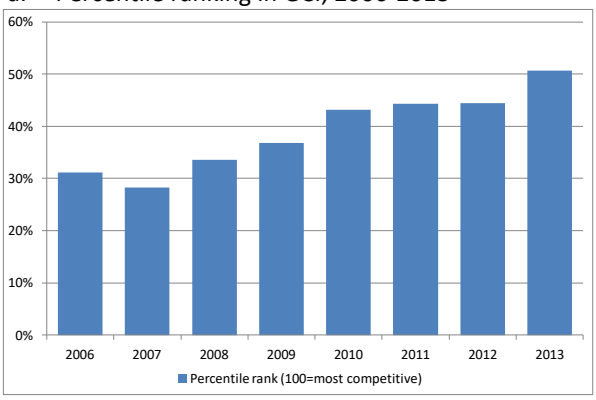
Countries at high levels of development, finally, draw their competitive strength from new and unique products and services, applying new and sophisticated business processes, and with constant innovation.

Source: World Economic Forum (2013)

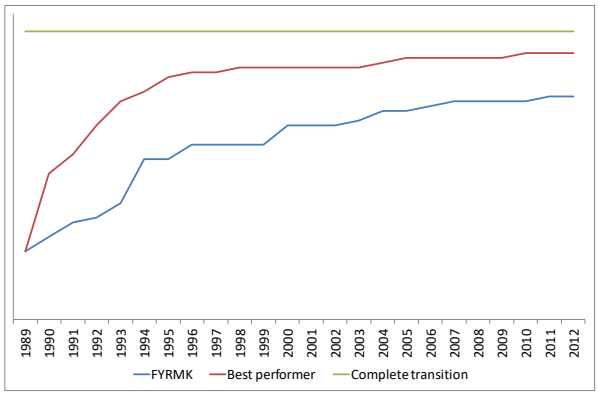
75. **Other measures also show evidence of business friendly reforms**. For example, the EBRD's transition reform index, measuring progress in different market economy reforms, shows that the former Yugoslav Republic of Macedonia has been steadily moving towards market economy principles, although reform pace has leveled out in the past five years (Figure 17, b). As seen in Figure 2 above, its ranking in the Doing Business Index has steadily improved. According to the DBI, in 2006, the former Yugoslav Republic of Macedonia's business climate was at par with Kenya, Ghana and Mongolia. By 2013, The former Yugoslav Republic of Macedonia ranked number 25 out of 189 countries, had surpassed the Netherlands (ranked 28) and Japan (ranked 27), and was approaching Germany (ranked 21).

Figure 17: Steady improvements in competitiveness and reform indices

a. Percentile ranking in GCI, 2006-2013



b. Transition index 1989-2012



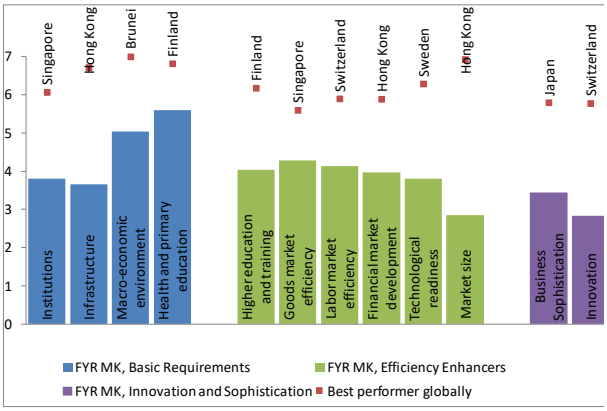
Source: Calculations based on WEF (2013) (left), calculations based on EBRD (2012), right. The transition index is the unweighted index of scores (from 1 to 4+) in the following areas: small and large scale privatization, price liberalization, trade and forex systems, governance and enterprise restructuring, and competition policy

76. **Whereas the former Yugoslav Republic of Macedonia's fundamental conditions for economic activity are in place, there is considerable way to go to develop into a more modern economy.** According to the GCI, the former Yugoslav Republic of Macedonia gets some of the most important fundamentals right for building a competitive economy, is generally weaker in terms of the efficiency enhancers that matter for more advanced economies, and has a considerably way to go to develop into a more innovative economy. The country benefitted until recently from a strong and predictable macroeconomic and political environment, and basic health and education standards are relatively high. However, road and railway infrastructure is weak (Figure 18, a). The policy analysis underpinning the CGI highlight that a large number of youth pass through tertiary education but quality problems prevail and further skills development is weak. Another major problem is the constraints posed by a very small domestic market and limited access to foreign markets. Goods and services are not particularly competitive. While there is high trust in the financial system, access to credit is limited. Macedonia also lacks the premises for innovation: there is no strong regional or product specialization, and the capacity to innovate is limited (Figure 18, a, and Annex Table 1).

77. **After some rapid gains earlier in the transition process, the former Yugoslav Republic of Macedonia's progress towards transition has leveled out.** The former Yugoslav Republic of Macedonia was making rapid progress, approaching the best performer of the transition countries. However, most gains were made early on, while less progress has been made between 2000 and 2012. (Figure 18, b).

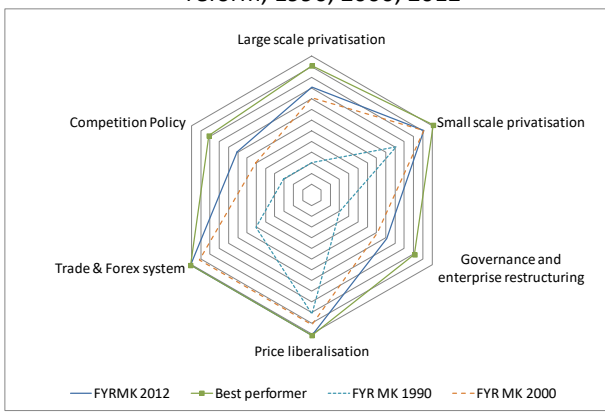
Figure 18: Progress on different areas of business climate is uneven.

a. Percentile ranking in GCI, 2006-2013



Source: Calculations based on WEF (2013)

b. Progress in different areas of market economy reform, 1990, 2000, 2012



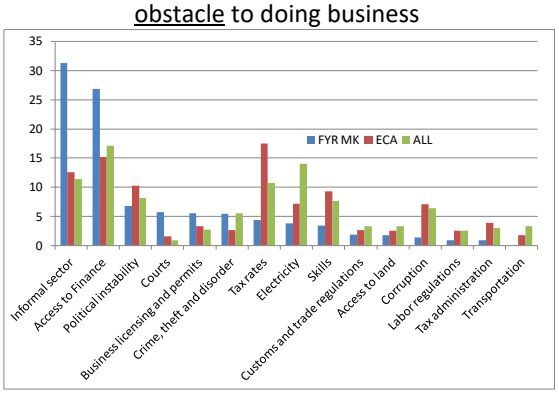
Source: Calculations based on EBRD (2012). The outer corners of the diamond represents full transition

78. **Narrowing in on individual areas of business constraints reveals some significant lacunas, especially credit, skills, and weak institutions.** Two key dimensions stand out. The first dimension covers financial and human capital: in other words, the availability of credit and adequate work force skills. The second dimension concerns institutional failings in the former Yugoslav Republic of Macedonia. Different perspectives of business conditions - the Transition Index, the Global Competitiveness Index, Enterprise Surveys – converge on the assessment that weaknesses with the economic and political governance system works against a level playing field for firms in the former Yugoslav Republic of Macedonia. These institutional failures manifest themselves in both the high levels of informality co-existing alongside formal firms and providing unfair competition, and the impact of corruption and what is widely seen as an unreliable judiciary system.

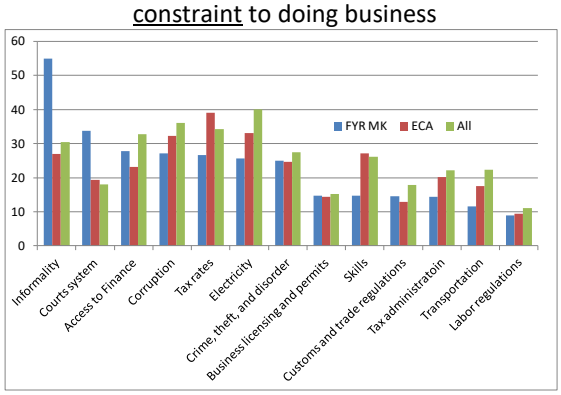
79. **Access to finance is a key issue for firms in the former Yugoslav Republic of Macedonia.** On average, finance is cited as the most important constraint among all countries in the World Bank's enterprise surveys. However, a much higher share of firms consider it the most important constraint in the former Yugoslav Republic of Macedonia than is the case in peer countries. (The number of potentially viable firms that never come into being because of credit constraints may be even higher.) Notwithstanding improvements noted in access to credit in the DBI, over one fourth of all firms in enterprise surveys cite finance as the key problem to doing business, compared to one sixth in ECA countries. Some 20 percent of firms consider it a major obstacle (Figure 19, a and b). Financial deepening is low in the former Yugoslav Republic of Macedonia, which may go some way towards explaining lack of credit (IMF, 2013).

Figure 19: Informality, access to finance, and courts system appear to be major issues in the former Yugoslav Republic of Macedonia.

a. Percentage of firms considering area biggest obstacle to doing business



b. Percentage of firms considering area major constraint to doing business

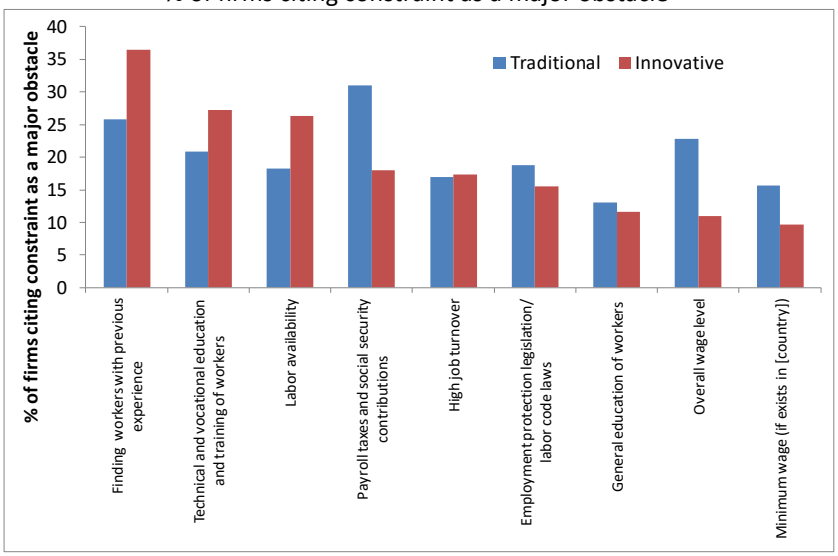


Source: Estimates based on World Bank Enterprise Surveys (a, b).

80. **Skills are considered an important problem for more modern firms.** In the ES, skills do not emerge as a major issue in general. However, for firms with some foreign ownership, and for firms in services outside retail (which is dominated by small scale firms), skills are more of an obstacle. The former Yugoslav Republic of Macedonia Demand for Skills Survey also suggested that skills shortages were the main source of hiring difficulties for firms, and that they affected mainly modern and more dynamic firms that competed internationally (World Bank, 2010, see Box 1). Preliminary analysis of the World Bank STEP Employer Survey also supports the notion of lack of skills more generally, and that innovative firms in particular are more likely to find worker experience insufficient and the vocational education and training system lacking with respect to their needs (Figure 20). More generally, while only one third of firms reported difficulties in finding workers for different jobs, a large majority of those that did considered lack of adequate skills the main reason for difficulties in hiring (World Bank, forthcoming 2016).

Figure 20: Innovative firms complain that workers lack adequate experience and that vocational education and training systems are not serving their needs

% of firms citing constraint as a major obstacle



Source: World Bank, forthcoming (2016)

81. **Increasing labor costs may also be affecting the international competitiveness of Macedonian firms**. For firms with lower innovative content, labor costs – the overall wage level, together with payroll and social security contributions – are a more significant obstacle than skills. New evidence suggests that after 2007, real wages have increased more than would have been allowed by productivity gains, further eroding competitiveness of firms needing to compete on international markets (Trepski and others, 2016).

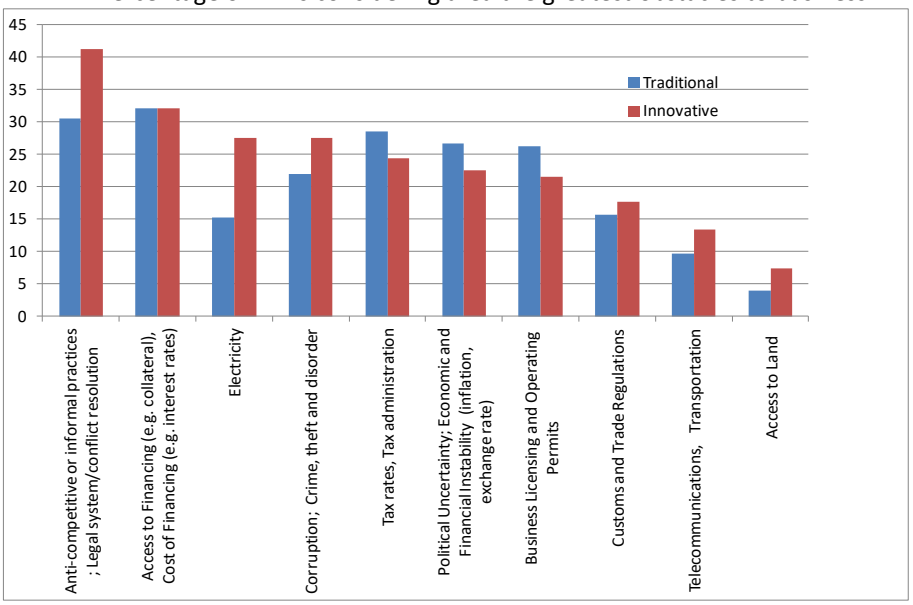
82. **Firm responses in the World Bank's enterprise surveys support the notion that poor economic and political governance, together with competition with informal sector and access to finance, are major obstacles to business operations**. One out of three firms in the former Yugoslav Republic of Macedonia's enterprise surveys considered courts systems a major obstacle to business, compared with less than one in five in the ECA region as a whole (Figure 19 above). The STEP Employer survey also confirms the importance of anti-competitive practices – poor judiciary, informality, etc. – as a major deterrent to business and in fact more so for more dynamic firms than for others (Figure 21). Distrust in the courts system is widespread in the population at large. The second Life in Transition Survey (LITS II) from 2010 showed that while religious institutions, armed forces, policy and the financial system are held in comparatively high trust, less than one in five say that they trust the courts (compared to one in two in Western Europe). Only one in five believe that the former Yugoslav Republic of Macedonia's courts system defends individual rights against the abuse of the state (EBRD, 2012). More generally, the former Yugoslav Republic of Macedonia has improved its standing in governance indicators as in other areas of business, economic and political management. Nonetheless, the country remains below the global median in government effectiveness and rule of law (World Bank, 2012).

83. **There is thus a need for progress in deep institutional reforms, and especially the judiciary appears to be a critical area for improvement.** The former Yugoslav Republic of Macedonia has successfully improved in different areas of facilitating doing business, but less progress has been seen in reducing

the costs of importing or exporting, in registering property and in investor protection, and virtually none in areas related to insolvency or enforcing contracts. The recovery rate for insolvency is below 50 percent (compared to 70 percent for OECD countries), the average cost for enforcing contracts is about 30 percent of the underlying claim, and it takes almost two years. The inefficiency of the court systems reflects slow and long procedures, insufficient impartiality of the judiciary, and poor performing courts within Skopje especially, all of which discourages recourse to legal systems (UNCTAD, 2011). As seen earlier, not only the costs associated with starting a business, but also those incurred during management and – potentially – closure of a firm, matter significantly for how prone people are to want to become entrepreneurs.

Figure 21: Anti-competitive informal practices and legal system/conflict resolutions are important problems

Percentage of firms considering area the greatest obstacles to business



Source: Estimates based on World Bank (forthcoming 2016)

84. **High informality makes for unfair competition and a lack of level playing field in the former Yugoslav Republic of Macedonia**. As shown above, formal sector firms are very concerned about the practices of competing firms in the informal sector. In fact, a third of all firms consider informality the most important obstacle to doing business, over and above of access to finance and electricity which tend to top the list for the average survey country. The preoccupation with informality very likely reflects the small size and relatively unsophisticated goods and services of formal enterprises in general in the former Yugoslav Republic of Macedonia, suggesting that they face real competition from the informal sector – which in turn, as shown above, is significant in size.

85. **Firm characteristics matter for what constraints are most binding. There are different implications depending on** whether the firms are large or small employers, whether they are based in Skopje or in other regions, whether they partake in international trade or receive finance from abroad, and what sector they are in (manufacturing, retail, or other). More particularly, large firms (which are not necessarily the most productive in the former Yugoslav Republic of Macedonia) are less affected by all forms of constraints than small and medium sized firms, with the exception of high tax rates. The

differences between large firms and others are starkest for courts systems, corruption, informality and finance, all of which affect business for smaller enterprises considerably.

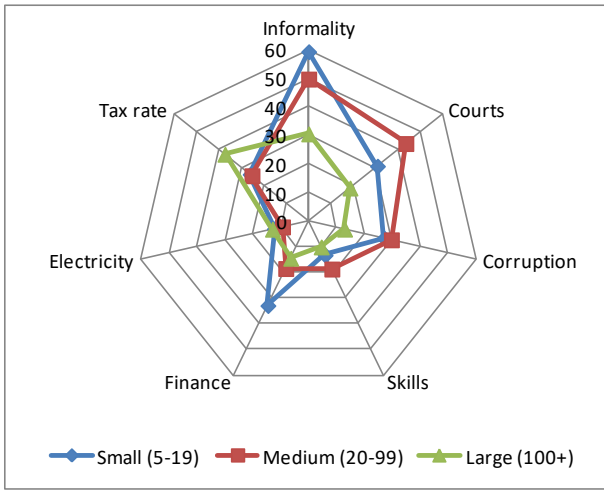
86. **Small, non-exporting firms in the services sector are most exposed to the competition from informal sector.** A majority of firms in all size categories are de facto exposed to competition from informal contenders – as much as 60 percent of foreign-owned, exporting, as well as larger (more than 100 employees) firms, report facing competition from informal firms. Unsurprisingly, however, the effects are strongest felt by smaller service sector firms that cater to domestic markets, of whom nearly 80 percent deal with informal sector competition in the area. There is also a strong regional dimension, as firms in the northwestern and western regions bordering Kosovo*[5] and Albania are worst affected by informality.

87. **Small and medium sized firms are also more concerned by the negative effects of corruption and the weak judiciary system and are significantly more credit constrained.** Weak governance structures, with weak rule of law, political influence in courts, and considerable levels of corruption, affect smaller businesses more than others, as they have less resources (human and financial) to devote to navigating thorny structures. Unsurprisingly, domestically oriented firms and SMEs are also finding more difficulties to access finance.

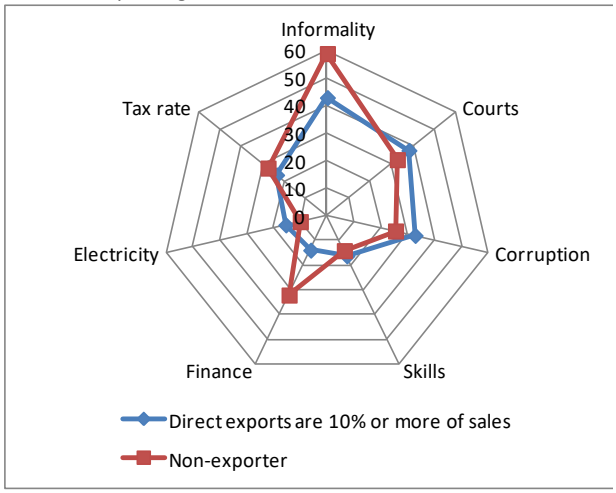
[5] *"This designation is without prejudice to positions on status, and is in line with UNSC 1244 and the ICJ Opinion on the Kosovo Declaration of Independence".

Figure 22: Firm characteristics and major constraints.

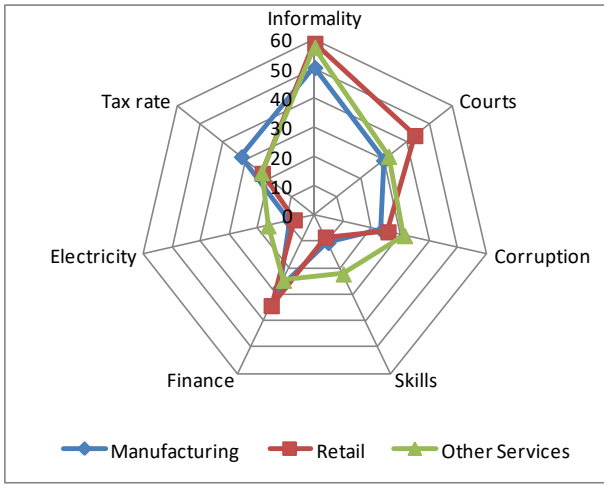
a. Size



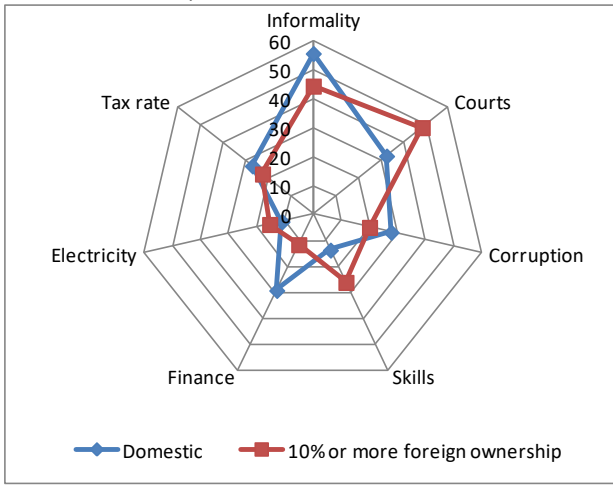
b. Exporting characteristics



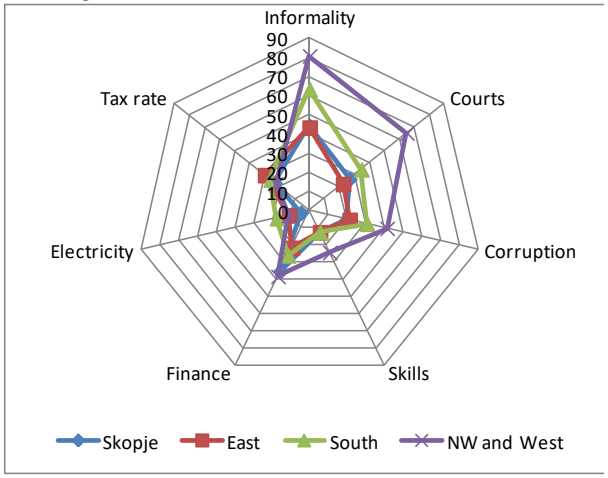
c. Economic sector



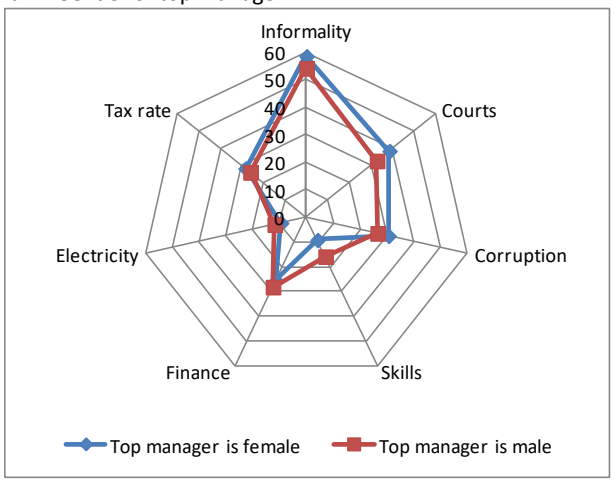
d. Ownership



a. Region



b. Gender of top manager



Source: Estimates based on World Bank Enterprise Surveys

4. Going forward: Unfinished business

88. **The transition process of the former Yugoslav Republic of Macedonia is not complete**. Anchored in the EU accession process, the former Yugoslav Republic of Macedonia has put in place an ambitious but challenging reform agenda to foster a more vibrant private sector that can create better jobs for its population. Despite these efforts, the economic transition, referring to the move from state-led to market-based economic system, is incomplete. Workers have not moved sufficiently into more productive and modern activities. There is still high churning (simultaneous gross creation and gross destruction) among both jobs and firms. Many adults signal that they would like to become entrepreneurs, and the former Yugoslav Republic of Macedonia is a global leader in terms of facilitating the start-up of businesses. Yet, net firm creation and firm survival is low. Most formal firms remain small with limited capacity to create more jobs and although employment has been increasing, the share of formal jobs in total employment has been falling.

89. **Productive firms are held back, limiting the potential for the creation of better jobs**. Unlike in the past, more productive firms created jobs in the formal enterprise sector between 2007 and 2011. A small share of these firms (20 percent) are leaders, "gazelles", that account for a vast majority of new jobs. The analysis shows that these firms are young and still small. At the same time, it appears that these more productive firms are held back compared to their potential for job creation. In the former Yugoslav Republic of Macedonia, larger firms are not necessarily more productive. This suggests that productive firms are not able to expand as they would in an economic environment more favorable to entrepreneurship and private business. What explains this lack of dynamism and how can more productive and job creating firms be encouraged?

90. **While the former Yugoslav Republic of Macedonia's strong progress on many areas of economic reforms must be recognized, there are still significant obstacles present in the business climate.** The analysis suggests that promoting entrepreneurship, facilitating access to physical and human capital, especially credit and the need for a skilled work force, and more broadly improving economic and political governance would favor fair competition and productivity growth, and thus job creation and economic growth.

91. **There is a cause for reviewing how to foster entrepreneurial mind-sets in the former Yugoslav Republic of Macedonia, as well as the remaining constraints to starting, running, expanding, and closing businesses**. The analysis shows that becoming entrepreneurs holds significant appeal for many, but that the interest rarely comes to fruition. Potential entrepreneurs factor in both start-up costs, success rates and the cost of potential failures, before they venture into new business. While start-up is relatively easy in the former Yugoslav Republic of Macedonia, other factors, including access to credit and the risks of unfair competition, are likely to influence the degree of entrepreneurship. It is also possible that the general view of risk taking, and exposure to business development, need to increase. It is possible to help develop entrepreneurial mind-sets by including this as early as in basic education.

92. **Credit is a key factor for success**. All over Europe and Central Asia, young firms were slowed down in their job creation during the global crisis, where credit crunch together with the trickle down effects of the European recession are likely to have played key roles. More dynamic firms, including the

potential gazelles, may suffer more significantly from credit constraints if they e.g. invest more heavily. The former Yugoslav Republic of Macedonia has a low level of financial deepening, suggesting significant untapped demand for financing. The Government has recently launched a subsidized lending program which is target at the micro, small and medium sized firms sector, but with low loan ceilings (9,000 Euros maximum). More broadly, there is potential for alleviating structural impediments to credit supply by the private financial sector. A particularly promising avenue is to work with SMEs to improve accounting practices, to the effect of increasing transparency in terms of business management and potential, and reducing the need for collateral including accounting practices of SMEs. Evidence from other countries also supports the notion that comprehensive entrepreneurship programs, including both finance and training, are more successful in terms of business expansion (Cunningham and others, 2010).

93. **Skills shortages are a problem for more modern firms**. Innovative firms, firms with foreign ownership, and firms in services outside the retail sector, consider lack of an appropriately skilled work force a major problem in expanding their businesses, and skills shortages are, indeed, a constraint to hiring for especially modern and more dynamic firms competing on international markets. Education and training policy needs to consider how to equip the population with more, and more relevant, skills. A key issue is to involve employers in the skills development system. Their engagement is necessary to ensure that relevant skills are taught, that there is a practical content and exposure to the world of work, and that information as to areas and competencies in demand flow to students and educators. Efforts can focus on strengthening industrial associations and their voice regarding skills and other business climate issues, stakeholder representation in the development of curricula and teaching methods, and more directly through educational paths that involve firm-based training (apprenticeships and internships).

94. **Continued international integration will help the former Yugoslav Republic of Macedonia develop a more competitive and successful private sector.** The small size of the former Yugoslav Republic of Macedonia's internal market is a limit to the development of competitive industry and services and a continued move towards integration in international markets is important. Economic agglomeration and critical mass matters for entrepreneurship dynamics as well as for economic production, innovation, and other important factors for competitiveness and growth. Where entrepreneurship rates are already high, more people become entrepreneurs, holding other aspects, including the business climate, constant. There may be a need to focus on helping SMEs increase their integration and competitiveness in global value chains, by increasing firm capability, fostering innovation, and provide more information on market demand and technologies.

95. **A strong message on the importance of improving governance emerges from the analysis.** Governance areas broadly, and especially courts systems, and corruption, are indeed considered significant obstacles to firm expansion in the former Yugoslav Republic of Macedonia. The long time and high cost of entering legal processes, and the impression that political and personal favoritism still plays a role, contributes to the lack of trust in courts systems. Small and young firms are more severely affected by these constraints. Larger firms have a higher internal capacity and external clout to deal with red tape, manage bribes, and wait out results from a slow and unpredictable courts system. Addressing this issues involves a deeper reform agenda much beyond investment incentives and trade promotion. Institutional strengthening, higher accountability and more transparency, as well as judiciary reform should become a priority.

96. **Weak institutions are both cause and effect of low formality.** Low trust in institutions is causing informality, in several ways. Lack of confidence that tax money will be put to efficient use or that

social security payments will pay off is a disincentive for both employers and workers to formalize. Similarly, confidence that legal requirements cannot or will not be enforced and can be circumvented, lowers the risk of not formalizing. But conversely, low formality also directly translates into lower tax income. Low formality also implies distorted competition, poor resource allocation and lower productivity growth, and an economy with a large share of production and employment tied to informal jobs is consequently likely to grow slower. Thus, informality potentially undermines reform progress through both direct and indirect channels.

97. **More analytical work is needed to develop an understanding of how to best promote private sector development and job creation in the former Yugoslav Republic of Macedonia.** This note not intended to provide a full-scale review of the existing policy framework for private sector development, but to highlight the kind of analysis that can help further the reform agenda for more and better jobs in the private formal sector. Complementary work will be needed to do this, including:

- **Update the analysis with more recent data**. Key sources of analysis used in this report date from 2011. Whereas they are likely to represent many of the long-term structural problems afflicting the former Yugoslav Republic of Macedonia, analysis of more recent data would help shed light on how private sector employment has responded to phenomena like the economic recovery in EU after 2011, more recent economic reforms, and the current political and economic uncertainty in FYR Macedonia.
- **Analysis of effect of social contribution reforms and tax reforms.** Inactivity and unemployment can be related to social welfare or labor costs that affect the incentives to enter work or to start a firm. Reforms around social contributions are too recent to be captured by data available to the team, and an analysis of more recent labor force and firm-based data would help shed light on the effects of these policy changes, and for whom.
- **Review of the existing portfolio of active labor market programs (ALMPs) with a view to increasing effectiveness and efficiency.** A stocktaking of the existing set of interventions to help foster formal job creation could include a mapping between constraints and programs, analysis of existing evaluations on effectiveness, if any, and a comparison with good practice internationally. This includes programs related to training and skills development, start-up support for entrepreneurs-to-be, as well as job intermediation services. Ways to promote efficiency in skills development, for example by performance based contracting, could be considered, as well as pilot projects to incorporate firm-based learning in especially vocational and technical training.

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Annex Table 1: Global Competitiveness Report: Assessment of the former Yugoslav Republic of Macedonia.

	Strengths	**Weaknesses**
BASIC REQUIREMENTS		
Institutions	Stability: Low business costs of crime, violence, terrorism.	Trust in public sector's efficiency and corruption: Public trust in politicians, Favoritism in decisions of government officials, wastefulness of government spending, judicial independence, efficiency of legal framework.
Infrastructure	Good electricity and air infrastructure,	Road/railroad infrastructure is very weak
Macro	Good	--
Health and primary education	Good health standards	Poor achievements in net primary education only
EFFICIENCY ENHANCERS		
Higher education and training	Enrolment is high	Quality of education, and on-the-job training.
Goods market efficiency	Start-up is fast	Competitiveness conditions
Labor market efficiency	Flexibility	Limited use of talent: Brain drain, low management capacity, low participation of women Weak relationship between pay and productivity
Financial Mkt Development	Sound banking system, legal rights	Availability and affordability of credit and financial services, lack of venture capital
Technological readiness	Access to technology	Limited use of ICT, low technology firms
Market size		Small domestic market and limited access to foreign markets
INNOVATION AND SOPHISTICATION		
Business sophistication		Lack of strong products, services, lack of production process sophistication, lack of clusters
Innovation		Low innovation capacity, little spending on research and development