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Law System in Growth Diagnostics for Macedonia: Stimulus or Binding Factor?

Abstract
Macedonian economy is under-performing. The key problems with Macedonia's economic policy are elusive growth and huge unemployment. Average real gross domestic product (GDP) is slightly above one percent since transition. The level of the GDP per capita is 65% lower than the average of the European Union. One third of the labour force is unemployed. To overcome these challenges the reforms should be made on use of the scarce resources to maximize future economic growth. The paper applies "growth diagnostics" analytical framework, developed by Hausmann, Rodrik and Velascso (2005), for figuring out the policy priorities. Its goal is to identify the most binding constraints on economic activity, and to set policies that will target these constraints. This strategy is opposite than the prevailing approach today, which is "laundry-list" approach ("any reform is good", "the more areas reformed, the better"). The functioning of the law system in the country is found to be the most binding constraint on Macedonian economy. The analysis also suggests that infrastructure, human capital, and information externalities will be possible binding constraints in the near future.

Keywords: economic growth, law system, economic reform, growth diagnostics, binding constraints, Macedonia.

1 INTRODUCTION

Macedonian economy is small. Nominal gross domestic product (GDP) amounted to 9.6 billion US dollars in 2012. It is an open economy that is highly integrated in international markets. The main features of the economy are: low standard of living (GDP per capita is 65% lower than the EU average in 2010) and huge unemployment (Macedonia, together with Bosnia and Herzegovina and Kosovo has the highest unemployment in Europe). At the same time there is underdeveloped infrastructure, a large informal economy, high level of corruption and organized crime.

This paper aims to propose reform priorities for Macedonian economy for the future period. The growth diagnostics methodology of Hausmann, Rodrik and Velascso (2005) is used. The goal of the

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methodology is to identify the most binding constraints on economic activity, and setting policies that will target these constraints.

In order to identify the constraints the comparisons are made with the other South-eastern European countries (SEE): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Montenegro, Romania and Serbia. Main conclusion of the paper is that functioning of the law system is the key binding constraint for growth. It is found to be a "toy" in the hands of the ruling elite and that it creates insecurity and instability for Macedonian firms and economic stakeholders. Possible binding constraints in the near future will be infrastructure, human capital and information externalities.

The paper is set as follows. Section two discusses the growth diagnostics methodology. Section three applies this methodology to Macedonian economy and identifies the binding constraints on growth. The final section provides conclusions.

2 GROWTH DIAGNOSTICS APPROACH

The "growth diagnostics" approach is developed by Hausmann, Rodrik and Velascso (2005). It is used for an economy that is under-performing. "Growth diagnostics" is a strategy for figuring out the policy priorities. The strategy is aimed at identifying the most binding constraints on economic activity, and setting policies that will target these constraints. This strategy is opposite than the prevailing approach today, which is "laundry-list" approach. It means to simply go for whatever reforms seems to be feasible, practical, political doable and enforceable through conditionality. The "laundry-list" approach is based on the notions: (i) any reform is good; (ii) the more areas reformed, the better; and (iii) the deeper the reform in any area, the better.

Hausmann, Rodrik and Velascso (2005) shows that the "laundry-list" approach is faulty in its economic logic because of three considerations. First, the principle of second-best indicates that we cannot be assured that any given reform taken on its own can be guaranteed to be welfare promoting, in the presence of multitudes of economic distortions.[1] Second, the welfare need not be increasing in the number of areas that are reformed – except in the limiting case of "wholesale" reform.[2] Third, a more extensive reform in any area is as likely to fall because of the presence of the second-best interactions.

[1] The second-best principles concerns what happens when one or more optimality conditions cannot be satisfied. Lipsey & Lancaster (1956) showed that if one optimality condition in an economic model cannot be satisfied, it is possible that the next-best solution involves changing other variables away from the ones that are usually assumed to be optimal. This means that in an economy with some uncorrectable market distortions in one sector, actions to correct market distortions in another related sector with the intent of increasing overall economic efficiency may actually decrease it.

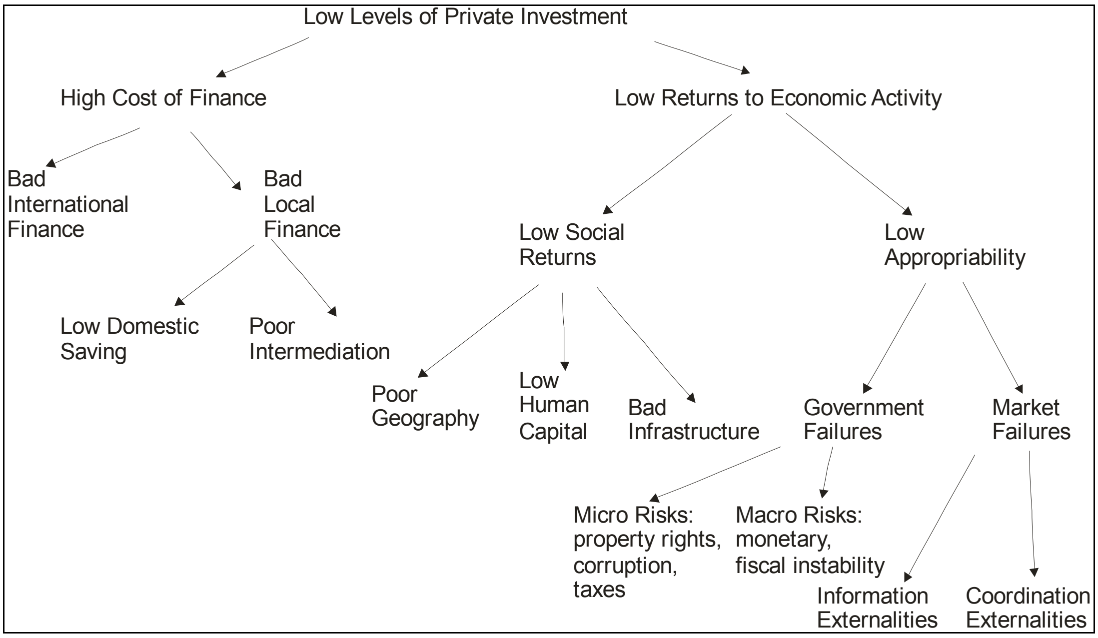
[2] "Wholesale reform" is a strategy to simultaneously eliminate all distortions. The best possible economic growth rate is achieved by eliminating all obstacles that stand in its way. But, in reality this strategy is impossible to implement.

A more sophisticated version of the "laundry-list" approach is the "second-best" reform. It takes into account the second-best interactions. "Second-best" reform strategy is less ambitious than the "wholesale" approach, but that recognizes the presence of the possibility that interactions across distorted markets have the potential to both augment and counter the direct welfare effects. Under this strategy, one would give priority to reforms that engender possitive second-best effects, and downplay or avoid altogether those that cause adverse effects. The problem with this reform strategy is that many of these second-best interacions are very difficult to figure out and quantify ex ante (Hausmann, Rodrik, & Velascso, 2005).

If the second-best interactions cannot be fully figgured out, the approach could be elimination or reduction of the biggest disstortions in the economy. This is an application of what is known as the "concertina method" in the literature on trade theory: order distortions from largest to smallest in proportional terms, start by reducing the largest of these to the level of the next largest, and proceed similarly in the next round. However, this strategy has two severe shortcomings. First, it does require us to have a complete list of distortions, even those that do not take the form of explicit taxes or government interventions. Distortons that arise from market failures or imperfect credibility, for example, are unlikely to show up on our radar screen unless we have reasons to look for them. Second, the concertina method does not guarantee that the reforms with the biggest impacts on economic welfare and growth will be the ones undertaken first (Hausmann, Rodrik, & Velascso, 2005).

The "growth diagnostics" strategy focuses on the most binding constraints. The idea behind the strategy is simple: if (i) for whatever reason the full list of requisite reforms is unknowable or impractical, and (ii) figuring out the second-best interactions across markets is a near-impossible task, the best approach is to focus on the reforms that alleviate the most binding constraints, and hence produce the biggest bang for the reform buck. Rather than utilize a spray-gun approach, in the hope that we will somehow hit the target, focus on the bottlenecks directly. In practice, the approach starts by focusing not on specific distortions (the full list of which is unknowable), but on the proximate determinants on economic growth (saving, investment, education, productivity, infrastructure, and so on). Once we know where to focus, we then look for associated economic distortions whose removal would make the largest contribution to alleviating the constraints on growth.

Figure 1: The Growth Diagnostic Decision Tree



Source: Adapted from Hausmann, Rodrik and Velascso (2005).

The "growth diagnostics" strategy can be conceptualized as a decision tree (Figure 1). A process of elimination can help identify binding versus nonbinding constraints (Moore & Vamvakidis 2007). Economic growth depends on the returns to economic activity and on the cost of finance the economic activity. The first stage of the "growth diagnostics" strategy aims to uncover which of these two factors pose the greater impediment to higher growth. The next stage is to uncover the specific distortions that lie behind the more severe factor. If it is a case of low returns, it could be due to low social returns (insufficient investment in complementary factors of production such as human capital or infrastructure) or poor appropriability, which could be due to public sector problems (high taxation, poor property rights and contract enforcement, corruption, and financial, monetary and fiscal instability) or market failures (learning and coordination externalities). If it is a case of poor finance, the problems could be due to domestic financial markets or external ones. This methodolgy is applied on the Macedonian economy in the next section.

3 IDENTIFICATION OF THE BINDING CONSTRAINTS ON GROWTH

The application of the growth diagnostics methodology is based on two periods: 2003-2006 and 2007-2010. Macedonia achieved lowest gross fixed capital formation, as percentage of GDP, in comparison with other SEE countries in the period 2003 – 2006. In the period 2007-2009, the gross fixed capital formation was not improved. It was second worst in the SEE region (after Bosnia). In both periods

Macedonian private sector investment activity is weakest in the SEE region.

Table 1: Investment activity, 2003-2006 and 2007-2010

Country	Gross fixed capital formation (% of GDP)		Gross fixed capital formation, private sector (% of GDP)	
	2003-2006	2007-2010	2003-2006	2007-2010
Macedonia	17.4	20.8	11.8	17.9
Albania	24.0	29.0	19.0	22.6
Bosnia	20.8	19.7	13.2	20.3
Bulgaria	23.2	24.4	19.0	23.2
Croatia	25.1	24.7	19.9	23.0
Montenegro	17.6	32.5	14.2	24.0
Romania	22.4	30.1	18.5	26.7
Serbia	19.0	23.7	16.0	19.8

Source: World Bank World Development Indicators.

The starting point of growth diagnostic approach is to determine whether low levels of private investments is being inhibited by high cost of finance or low returns to activity. Or with other words, investment and growth is constrained because entrepreneurs and investors cannot get the capital they need to start a business or to expand operations, or because investors do not want to invest as they do not expect to retain a sufficient share of the fruits of their efforts (Enders, 2007).

3.1 High cost of finance?

Is the cost and access to finance has been the binding constraints to growth in Macedonia? The World Bank's Enterprise Surveys (2009) find out that 26.9% of Macedonian firms indentifying access to finance as major business constraint. This is second ranked business constraint (after practices of the informal sector). Therefore the importance of access to finance is analyzed in more details by examination of the role of international finance and domestic finance as constraints of private investments in Macedonia.

Access to international finance is not most important constraint to growth. Macedonia had enjoyed access to international finance. There is significant increase in the external debt. The external debt was 40.8% of GNI in 2003 and increased to 65.1% of GNI in 2010. As comparison, the rate of increase in 2003-2010 period is almost the same as Albania (58.0%), much higher than Serbia (16.2%) and significantly lower than two EU countries Bulgaria (64.9%) and Romania (98.6%). The average interest on new external debt commitments is 3.9% and it slightly higher than the average of the SEE countries (3,8%). However, the country's capability for attracting foreign direct investments is not satisfactory. The average level of foreign direct investment (5.9% of GDP) in 2007-2009 is almost two times lower than the average of SEE region. Also, in the period before Global crisis, 2003-2006, the average level of FDI in Macedonia was significantly lower than the average of SEE countries (4,2% and 7,5%, respectively).

Is it bad domestic finance the binding constraint for growth? The problem of poor domestic finance could be emerged by two reasons: low domestic savings and poor financial intermediation. The gross national savings averaged 18.3% of GDP through 2007-2010. It is higher than all SEE countries, except Croatia (21,4% of GDP) and Romania (20,2% of GDP). The financial deepening in Macedonia, measured as money and quasi money (M2) as percentage of GDP, is bellows the average level of SEE region. There is also an upward trend in the M2 to GDP ratio from 22.5% in 2002 to 50.2% in 2009. Domestic credit to private sector is 44.3% of GDP in 2009, which is 10.4 percentage points lower than SEE average. For example, Croatia has the rate of 66.3% and Bulgaria has the rate of 75.6%. However, domestic credit to private sector is characterized by continual annual growth, which starts with 17.7% of GDP in 2002. These two upward trends (M2 to GDP and domestic credit to private sector) exclude the volume of financial intermediation as the most important constraint to growth in the future.

The spread between lending and deposit rates is a reliable indicator of the efficiency of financial intermediation, with low spreads indicating a more efficient financial system (Sen & Kirkpatrick, 2011). The Macedonia's interest rate spread is lowest in the region. In 2009, the interest rate spread for Macedonia was 3.0% compared to 5.6% in SEE region. In addition, Macedonia's interest rate spread is decreasing with the time, starting with 8.8% in 2002 to 3.0% in 2009. Also, the lending rate in Macedonia is slightly lower than the average rate in SEE through years. For example, in 2009 it is 10.1% in Macedonia and 11.7% in SEE, or in 2005 it is 12.1% in Macedonia and 13.2 in SEE. These facts reject the possibility that the financial intermediation is the key barrier to growth.

3.2 Low return to economic activity?

The analysis focuses in more detail on low returns to economic activity. The low returns to economic activity could be due to low social returns, that is low total economic returns on factor accumulation, regardless of their ultimate recipient, or low "appropriability", i.e. low private returns even if social returns are high because of, for example, taxes, corruption, market failures or some other cause (Moore & Vamvakidis, 2007).

Three factors can explain low social returns: geography, infrastructure and human capital. The first factor is geography. Macedonia is a landlocked country, a geographical characteristic which has often seen as an obstacle to growth (Collier, 2007). The country's energy recourses are poor, with modest hydro energy potential and low potential of fossil fuels, only lignite. However, Macedonia belongs in a temperate climatic zone, a geographical characteristic which is favorable to growth (Sachs, 2003). Finally, the country location, a major transportation corridor from Western and Central Europe to Southern Europe and the Aegean sea, and its proximity to the large European Union market suggest that geography cannot be seen as major obstacle to economic growth.

The second factor for low social returns is the lack of appropriate infrastructure in the country. Infrastructure indicators of EBRD point out that the country's infrastructure is possible key binding constraint for growth. Index of road infrastructure in 2009 is the lowest in the region, together with the indexes of Albania and Montenegro. The value of the index for Macedonia, Albania and Montenegro is 2.3, while Bosnia and Herzegovina, Bulgaria and Serbia have the value of 2.7, and Croatia 3.0 (the index can take value from 1 to 5). The same is situation with the index of railway infrastructure. Index of electric power infrastructure is equal to SEE average. But, the country is faced with very uncertain future in respect to electric power, if the big energy projects are not taking now. The Government is building huge project of monuments and museums instead of building infrastructure, which is obvious example of allocative inefficiency. In the literature major projects like this, that serves to increase the prestige of those who order their undertaking, are so-called white elephants (International Monetary Fund, 1991, p. 30).

The third factor is human capital. The European Commission point out that the level of education and training of labor force is still low and there is significant difference between the qualification profile of the workers and the needs of private sector (European Commission, 2008). Moreover, the Government in the last few years forces the process of opening the faculties in every city. The declarative goal is to increase the percentage of the people with high education. But, opening of the university studies with the questionable quality only improve the situation “on paper”, and in the same time reduce the number of people which are needed in Macedonian economy, especially industry.

The labor market is far from equilibrium. The rate of unemployment is second highest in Europe (32.0%). According to official statistics, the number of employed is 637,855, and the number of unemployed is 300.439 (in 2010). The number of employed for which are paid social contributions are much lower, 413,797. The unemployment is long-term. Huge 81.8% of unemployed are waiting for employment more than 1 year. As comparison, in EU only 34.2% of unemployed are waiting for employment more than 1 year (World Bank, 2010). Also, the long term unemployment in the neighbor country Bulgaria is 43.3%. Moreover, in Macedonian case long term unemployment dominate the unemployed which are waiting for unemployment more than 4 years (63.8% of unemployed). The time of waiting is important indicator of the labor market function. When the labor market is function well, unemployment is short term and the workers easily move from one workplace to another. Long-term unemployment is signal that the obstacles for unemployment are from structural nature. Also, the very long period of waiting for employment influence the reduction of human capital (the workers lose acquired capabilities in the educational process). This leads to conclusion that shortage of skills and low human capital formation is not yet a binding constraint to growth, but it may become so in the foreseeable future.

At the end, the focus is on the factors that may have led to weaknesses in the appropriability of returns, and by doing so, weakened the incentive to invest, especially in high productivity activities. Weaknesses in appropriability of returns could be due to government failures or market failures. With respect to government failures, this could be due to macroeconomic risks such as monetary and fiscal instability, which increase investors' uncertainty about the future path of the economy, or due to microeconomic risks such as high rates of taxation, corruption and regulatory and bureaucratic red tape that may increase the costs of doing business. With respect to market failures, this could be due to absence of informational externalities as a lack of innovation and self-discovery by entrepreneurs or the absence of coordination externalities such as a financial system that does not reward risk-taking (Sen & Kirkpatrick, 2011).

Macroeconomic risks are not binding constraints for the growth. The Central Bank has successfully maintained exchange rate stability and delivered consistently low inflation since the mid-1990s. Fiscal policy of the country meets the Maastricht deficit and debt criteria in the observed period. However, the quality of public spending is not on satisfactory level. The European Commission underline that the overall macroeconomic policy mix suffered from the low quality of government spending, with many measures geared more to election-related promises than to combating the crisis (European Commission, 2009); or, while overall spending has remained largely unchanged, the quality of spending deteriorated (European Commission, 2010). Also, the public debt is increasing without significant investments in the infrastructure.

Microeconomic risks could be due to high rates or taxation, an inefficient tax administration which increases the implicit rate of taxation (due to delays in refunds of VAT proceeds), bureaucratic red tape linked to business licensing or customs administration, corruption, weak enforcement of contracts and property rights. In Macedonia, some elements of these micro risks from the public sector are possible binding constraints for growth. The first element excluded from above statement is the rate of taxation. Tax rates are generally low, with the VAT rate almost as average of SEE region and flat corporate and personal taxes, (both rates are 10%). In some periods significant delays in refunds of VAT proceeds are observed.

Market failures may be due to information externalities related to inability of firms to diversify into and export new products, or coordination failures that may arise from ineffective coordination between the government and the private sector, or between the national and subnational governments (Sen & Kirkpatrick, 2011).

Macedonian export structure is highly concentrated. Export of iron and steel, textiles, and food, beverages and tobacco account for about 60% of total (Gutierrez, 2007). The main characteristics of the Macedonian export are: (1) low level of products processing (mainly intermediate goods and raw materials); (2) the big exporter work in traditional industries with price as primary driver of competitiveness; (3) dependency from import of raw materials. Moreover, the share of Macedonian exports has increased in which is specialized, but these are sectors with a declining share in world manufacturing trade (Gutierrez, 2007). The investment in research and development of Macedonian firms almost do not exist. With the respect of second failure, the recent Global crisis shows serious coordination problems between small and medium enterprises and government. The economic policy lagged behind the needs of the SMEs sector. However, market failures could be in the focus for key binding constraint in the country when functioning of the law system will be solved.

The three aspects of the regulatory apparatus – business licensing, customs and trade regulations, and labor regulations are not seen by the firms as major constraints for growth. In the World Bank's Enterprise Surveys 5.5% of Macedonian firms indentifying business licensing, 1.9% identifying customs and trade regulations and 1% identifying labor regulations as major constraints for growth. These percentages are significantly smaller than percentages of firms identifying practices of the informal sector as major constraint for growth, which is 31.3. The informal sector is estimated to be 40% of GDP. On this constraint, three additional constraints should be added. First constraints is courts system (5,7% of firms identified courts as major constraints for growth). The second constraints is crime, theft and disorder (5,4%). The third constraint is political instability (6,8%). These four constraints together represent the functioning of the law system in the country. In total, 47.4% of Macedonian firms identified functioning of law system as the key binding constraint in Macedonia.

3.2.1. The role of the law system

Transformation of the law system is of utmost importance for every developing economy, such as Macedonia. It is must do activity in order to achieve free market economy, openness, liberalization and competiveness as a prerequisite for joining the European market and creating sustainable and high growth rates. It should have been done in a fast and an efficient way, with clear and consensually accepted direction and with as low as possible mistakes and sacrifices of the economy's resources, capacity and possibilities for the future. However, transformation of the Macedonian law system didn't follow the basic parameters. It was not transparent. Fundamental changes has been done without prior experts and public debates, thus introducing the perception of the stakeholders that the policies are created and brought behind the closed doors. The process itself generated lack of inclusiveness of the respected parties, proving the fact that the ownership of the process is not within the economic subjects, but rather within the political elites. Shortly, the dialogue and partnership was replaced with mono decision making process, solely based on mix of foreign "copy paste" solutions, domestic political and economic elites measures and absence of long term strategy.

Economic growth requires favorable environment, and stable and predictive law system. It should be primarily stimulated and secondly regulated, not controlled and owned by someone. Macedonian case showed that reforms of the law system with regards to economic activity is too frequent, discreet and interruptive and is resulting with instability and uncertainty. Rule of law is a main pillar for democratic state and free market economy. However, in Macedonia, the state of law was replaced with the state in law. That secured the dominant position of the State (Government) in the economy, and prevented the real action of the private sector, especially domestic SME and substantial FDI, that are crucial for growth. Fundamental problem of legal instability and uncertainty was followed by inefficiency and corruption in the Court power, that is directly responsible for bad economic climate, distorted business relations and great opportunity cost for losing domestic and foreign investment. In this context, it is important to note that Economic Freedom of the World (2012) index of judiciary independence place Macedonia at the bottom of the SEE region (together with Serbia) in 2010 (the last year where data are available for this index). The index can take value between 1 and 10, where 1 means that judiciary decisions are strongly influenced by the members of government, companies or citizens, and 7 and above means that the judiciary system is completely independent. The value of this index for Macedonia is 3.1, and it is lower than of the index values of Bulgaria (3.2), Albania (3.3), Bosnia and Herzegovina (3.4), Croatia (3.4), Romania (3.5) and Montenegro (5.3). In comparison, the value of this index for the most powerful European economy, Germany, is 8.9.

Macedonia's political elites does not learn from others and own mistakes. On a contrary, the law system is exercising significant changes every time with the shift in the Government. Some examples only of the frequency of amending the crucial economic laws demonstrates the unpredictability and uncertainty in the law system, with direct negative correlation for the market economy.

There are numerous and significantly different changes in the tax laws, as the Law for VAT tax was amended 15 times in 13 years, the Law on Income tax was changed 22 times in a period of 19 years and Profit Tax was amended 17 times in 20 years. The Law on energy faced 11 different versions for 16 years, as well as the reform of the capital financed pension system was followed by 12 law changes in 11 years. Significant and rather controversial amendments have been done in the Law of public bids, that suffered 6 interventions, for the period of 6 years. Macedonian construction sector has to cope with the vast 11 changes in the Law on construction, just in a 7 years. Finally, Macedonian companies had to comply with 10-15 amendments in Laws that regulates their employers social contributions.

The functioning of the law system must be viewed in the light of the politicization of institutions. Most changes had been done in the Laws for state and public servants, 30 interventions in 13 years. Legal and political fluctuations in the state apparatus are among the crucial factors for "crowding out" the private sector from the Macedonian economy, in which the Government is the largest single employer, contractor and contributor in the investment consumption. Furthermore, this issue could be seen in every European Commission report for Macedonia: (1) the large-scale dismissals of officials following the change of government in 2006 illustrated the politicization of appointments at all levels in the public administration and disrupted its functioning well into 2007. Time and expertise were lost in reorganization and extensive changes of personnel in the public administration (European Commission, 2007); (2) little progress has-been made to ensure that senior recruitments are based on professional qualifications. Staff appraisals and promotions are not transparent and there is insufficient scope for career development. The politicization of the senior levels of the police in some areas raises serious concerns (European Commission, 2008); (3) The increased recruitment of temporary staff, which does not fall under the Law on the Civil Service, undermines merit-based recruitment. Many of the temporary staff are junior, lack appropriate office space and have no clear job descriptions. This practice takes place across State administrative bodies (SABs) and municipalities, and is discouraging for regular civil servants (European Commission, 2009); and (4) Concerns remain regarding politicization of the public service. There have been reports of replacement of trained professionals with appointees of limited experience in several institutions. Also, senior management positions have been filled in the absence of appointment criteria, sometimes with staff under temporary contracts (European Commission, 2010).

4 CONCLUSION

The major research task of this study is to propose reform priorities for the Macedonian economy. The analysis is based on growth diagnostics analytical framework proposed by Hausmann, Rodrick and Velasco.

The idea of the analytical framework is to identify the most binding constraints for growth. It starts by focusing not on specific distortions, but on the proximate determinants on economic growth. A process of elimination helps in identification binding versus nonbinding constraints. The key element for unsatisfactory economic growth is considered to be low level of private investment. This approach is contrary than the prevailing approach today, which is "laundry-list" approach ("any reform is good"; "the more areas reformed, the better"; and "the deeper the reform in any area, the better").

The private investment activity in Macedonia is found to be worst in the region. The growth diagnostics suggest that the distortion of the functioning of the law system is the key binding constraint for growth. It is abused by the ruling political elites. Majority of Macedonian firms point out that practice of informal sector, courts system, crime, theft and disorder, and political instability are major constraints for growth. The law system reforms are not transparent, inclusive, sustainable and long-term orientated. The interventions are significant, numerous, discreet and distorting for free market economy, that is replaced with dependence from the State, thus having State in law, instead State of law. In addition, infrastructure in the country, human capital and information externalities are found to be constraints for growth in the near future. However, any reform must focus in solving functioning of the law system. It does not meter if there is a plenty of cheap credit for the firms, or if the transport and energy infrastructure are improvement significantly, because ruling elite through institutions will distort the functioning of the market and the economic activity will stay locked. There is no investor who wants instability and insecurity.

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