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CLIR REPORT  
**FROM LAW TO PRACTICE: MACEDONIA'S  
IMPLEMENTATION CHALLENGE**  
A U.S. SUPPORTED STUDY ON COMMERCIAL LEGISLATION



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# EXECUTIVE SUMMARY

## OVERVIEW

If the old proverb is true that we reap what we sow, then Macedonia is clearly beginning to reap its investment in legal and institutional reform. In most areas, the 2005 Commercial Legal and Institutional Reform Assessment highlights progress and improvements, many of them quite significant. When contrasted with poor recent performance in economic growth and development, the positive scores emphasize a critical point: healthy commerce, investment and trade depend on much more than good laws. Reaping the harvest of improved economic vitality continues to require substantial effort and additional investment, primarily in improving institutional capacity and performance.

The greatest reform weakness to date is the judiciary. Virtually all stakeholders recognize that the failure of the judiciary to effectively resolve commercial disputes and enforce commercial claims harms the commercial environment. Few, however, understand why. Economic actors must balance costs, risks and revenues in order to survive and prosper. If there is no reliable system for peaceful resolution and enforcement of obligations, then costs of collection and risks of non-collection increase dramatically. These increased costs and risks lead to higher interest rates, more restrictive credit terms, less availability of reasonable credit, lower sales, lower profitability, lower tax revenues, lower economic growth, and even disinvestment.

Macedonian and foreign investors readily understand the connection between the crisis in the judiciary with their ability to prosper. Fortunately, there is hope for improvement on the horizon due to legislative changes coming into effect in 2006. Improvements in other institutions – discussed in this assessment – suggest that the hope for change is reasonable. Properly implemented, changes in the courts will have a measurable impact on economic development. Already, the crisis has led to much needed development of missing parts of a healthy enforcement system, with the appearance of self-help, private collection services, and the beginnings of a credit information system since 2003. The lynchpin, however, is the judiciary.

## LEGAL FRAMEWORK

The record of success in legal reform is impressive. Framework laws continue to improve substantially through large and small-scale amendments. All areas now score at 90% or better, indicating substantial compliance with European standards. For example, Bankruptcy and Company Law have both moved into the top percentiles since 2003, with Bankruptcy increasing by 6 points from 89% to 95%, and Company Law catapulting 13 points from 80% in 2002 to 93% today. Collateral Law, which had already earned a grade of 91% during the last assessment, was carefully amended on only a few, significant particulars.

Together, these reforms demonstrate growth and maturity in the lawmaking process itself, not just in the results. Systemic overhauls have been part of the landscape since independence, but tailored refinements, such as those in Collateral Law, represent an important advance that indicates a greater sensitivity to private sector need. The participatory process employed in drafting legal changes, especially in such areas as Company Law, has also moved Macedonia closer to a self-sustaining model of democratic lawmaking. The next step is to create a mandatory participatory process; today it is voluntary and often donor-driven.

## IMPLEMENTING INSTITUTIONS

With the exception of the Pledge Registry (Collateral Law) and courts (throughout), all Implementing Institutions are improving and have substantial room for additional improvement. Indeed, many of these agencies are still nascent or tentative. Several also depend heavily on reform of the judiciary and the enforcement system: Bankruptcy directly depends on effective courts; Competition currently depends on courts for enforcement but will eventually have its own enforcement powers. One Implementing Institution is in a state of complete transition –company registration has grown less effective in recent months as courts have prematurely shifted resources out of registration in preparation for the move of all registration services to the Central Registry. Once completed, this change should lead to substantial improvements in cost, efficiency, and information access for the business sector while simultaneously reducing costs to government.

The Pledge Registry did not improve in this assessment because it has insufficient room for improvement – it has performed at optimal levels (98%) for several years. The courts, on the other hand, did not improve their scores because they failed to improve their performance. The only improvements came in the area of enforcement, but because new mechanisms were established for avoiding the courts. Even so, substantial reforms are slated for 2006 that will have a substantial impact on every area of the assessment for courts.

## SUPPORTING INSTITUTIONS

Improvements in Supporting Institutions outpaced advances in other areas, with most improving their scores by more than 10%. Much of the improvement was driven by the appearance of several new organizations. Two independent think tanks have been established in the last two years and are already providing analysis and input for policy making. Several new business associations have also arisen that actively advocate reforms, while advocacy has improved among others. In addition, the formerly moribund Chamber of Economy lost its right to mandatory fees and is now a voluntary organization. The change is dramatic and the new incentive structure appears to be bringing about a more meaningful customer-service approach to services offered.

All of these changes have resulted in improved advocacy and improved dissemination of information regarding changes underway. In some cases, the new or established organizations are offering training and seminars not previously available. Even so, education – including continuing legal education – continues to be a weak point in the institutional environment. One law faculty has recently introduced a master's degree program, with teaching and input from the international community. Unfortunately, the overall level of curriculum in light of changing laws is insufficient to prepare graduates for present reality. In fact, few areas of law have been updated to capture recent amendments, so that today's degree in law can almost be characterized as a degree in legal history, not current legislation.

## MARKET FOR REFORM

It is tempting to attribute the drive for reform to donor pressure. While donor's have clearly played an important role in advising, strategizing, directing and even pressuring the various stakeholders involved with reform, such analysis is inadequate. Many other countries with equivalent donor pressure have not achieved the level of reforms attained recently by Macedonia. Macedonians and foreign advisors together note that many of the reforms are directly attributable to local leadership, dedication and political will. Much of the pressure for change has been internal, such as the desire to join the WTO and comply with its requirements. Customs administration has been reformed by a succession of directors who took tremendous personal and political risks in rooting out entrenched corruption. Donor assistance and domestic determination have been key elements in moving ahead.

There is, of course, resistance. Entrenched interests still actively seek to undermine reforms, whether based on ideological misunderstandings or economic incentives. Moreover, government is not yet able to supply the reforms at desirable, sustainable levels due to the thin layer of human resource capacity and tax revenues. One can be met through improved training and education; the other will require ongoing reforms that bring more revenue-producing producers and suppliers into the formal economy.

# INTRODUCTION

## OVERVIEW

In July 2000, the United States Agency for International Development (USAID) conducted a diagnostic assessment of the commercial law and institutional reform (CLIR) environment for Macedonia. The assessment was performed to assist the USAID Mission in Skopje in setting priorities for technical assistance and focused on seven key areas of commercial law and practice: bankruptcy, collateral, competition, company, contract, foreign direct investment (FDI) and trade). The assessment team found relatively low levels of development in most of the seven areas of study. The average score for Legal Frameworks was only 79%, with Implementing and Supporting Institutions far behind, at 55% and 49% respectively.

In October 2003, USAID updated the original assessment to determine whether there had been any significant progress in reforms, and to identify continuing needs and priorities for additional assistance. That assessment found significant improvements, primarily at the level of legal frameworks, which had risen significantly to an average score of 86%. Additional improvements were made at the institutional level, with Implementing Institutions rising 65% and Supporting Institutions to 65%, but not to levels of self-sustaining development. Notably, with the exception of courts, improvements correlated very closely to donor assistance projects. That is, the assessment indicated that donor assistance (other than for the courts) was clearly bringing about improvements.

In October 2005, USAID commissioned another follow-up assessment to track ongoing changes and challenges. As detailed below, this 2005 Assessment echoes the recent findings of the European Union regarding Macedonia's membership request: the country has made significant progress over the past five years. These improvements indicate consistent commitment to reform, even though much reform is still needed. Macedonia has continued to upgrade its commercial legal and institutional environment in accordance with international standards, especially with respect to legislation. Today, all areas of law score 90% or better, with an average score of 92%. Implementation of new laws, however, still lags substantially, especially in the courts, which have not yet improved their performance at all. Implementing Institutions have improved slightly, to 69%, while Supporting Institutions have jumped 10 points, to 68%. With laws complying substantially with European standards, future investment should constitute on upgrading the institutional dimension to ensure the establishment of self-sustaining reform and implementation capacity.

It should be noted that the improvement in laws correlates directly to donor assistance. Bankruptcy, Company, Competition, and Trade all made dramatic gains, and all were directly supported by donor projects during the periods of improvement. Clearly, technical assistance can achieve much over the medium term if there is political will to adopt the recommended changes. Implementing these changes, however, is not so easy. Courts (a critical Implementing Institution) have also received ongoing assistance during this period, but showed no gains at all in their performance over the past five years. This may change soon: fundamental changes to the judicial system have been passed into law but do not come into effect until early 2006. It is quite likely that scores will change dramatically over the next two years as these new laws are translated into new practices. In other words, it will have taken about 7 years to attain the same level of institutional achievement as was possible in 2-5 years for legislative change.

One other significant observation can be made from these average scores. Implementing Institutions are entirely government institutions. Supporting Institutions include government bodies, but are mostly private sector organizations. Improvements in Supporting Institutions far outstripped those at the implementing level. Many of the changes were market reactions in which private sector groups initiated these improvements, often without any

donor support. Government institutions have been slower to respond, often bogged down by bureaucratic obstacles and funding difficulties, even though donors have often provided significant assistance. Again, reform of public institutions requires long-term commitment and assistance.

The overall positive findings of this assessment should be carefully balanced against economic reality. To paraphrase an old joke: the operation was successful but the patient is far from well. As further discussed below, good laws do not mean that there will be investment. Economic actors balance costs, risks, and revenues to determine whether to invest, disinvest, expand or give-up. Macedonia’s growth has slowed in recent years, even while laws improved, because various risks and costs have risen without any attendant capacity for increased revenues. The legislative changes reflected in this assessment provide positive proof that change can happen, but until more implementation is underway, investors must be forgiven for remaining wary. Therein lies the challenge for the future.

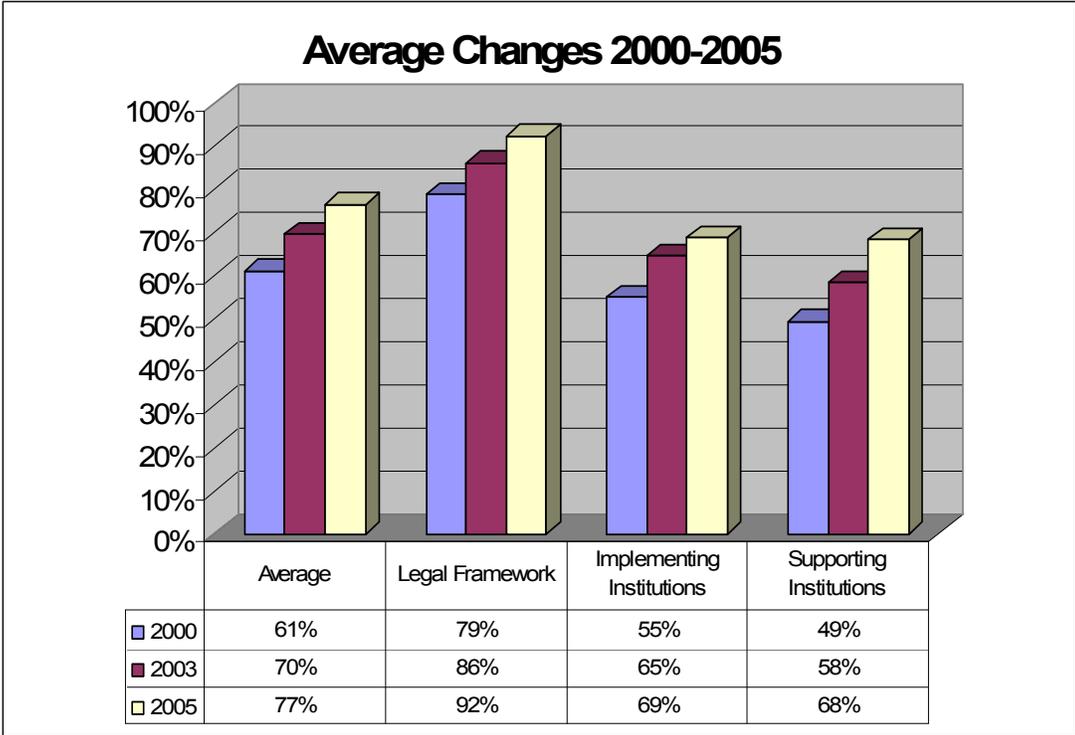


Figure 1 - Average Changes 2000 - 2005

**BACKGROUND ON THE CLIR DIAGNOSTIC**

The CLIR diagnostic methodology was created by USAID to address frustrations from earlier legal reform efforts that produced disappointing results. Beginning in 1989, USAID and a number of other donors began investing substantial amounts to assist transition countries move to a market-oriented commercial structure. At first, much of the focus was on laws, but the new laws seldom seemed to be implemented. New investments were then made in the government institutions in charge of implementing laws, such as courts, anti-monopoly agencies, and investment promotion organizations. Still, the impact on implementation did not achieve expectations.

In 1998, USAID began developing a wider approach to commercial law reform, looking at the entire system needed for effective change and implementation. This included the civil society components such as bar associations, business associations, notaries, banking organizations and the numerous other groups normally involved in a democratic system of reform. In addition, they focused more carefully on the “market for reform” or social dynamics affecting the ability of reformers to achieve their goals. Using an institutional economic approach, they developed analytical tools for identifying weaknesses and strengths on the supply side of the equation (government’s ability to produce thoughtful policy and well-drafted law) along with the demand side (the needs of the private sector to achieve economic development and growth).

This analytical approach was then captured by a series of questions designed to explore the essential aspects of each dimension of the commercial legal system. For Framework Laws (those laws that define a certain area, such as bankruptcy), the questions allow legal specialists to grade the existing law in light of emerging international standards relevant to the region (for example, European standards in a civil law country). Second, the diagnostic examines the structure and performance of the Implementing Institutions responsible for each area. Another section looks at the existence, capability, and involvement of Supporting Institutions - various private sector associations, NGOs and even subsidiary government agencies (such as the Customs Agency) to determine their ability to provide input, support and implementation of commercial reforms. Finally – and perhaps foremost – the methodology examines the social dynamics for reform to determine the manner in which vested interests, political will, and even basic economic understanding may affect the ability of the country to achieve market-oriented reforms.

Each area of law is examined along these four dimensions using a combination of qualitative and quantitative tools. The starting point is often an examination of published laws and policies, local scholarly articles, and other high level documentation and analyses. Knowing that the “law in the books” is not always the same as the way those laws are applied, a diagnostic team will spend extensive time interviewing stakeholders from all areas of the commercial and official community, including ministry officials, lawyers, judges, businesses, foreign investors, bankers, court clerks and numerous others to confirm and validate information received while also identifying conflicting information and common themes and impressions. This work is reduced to a set of scores based on hundreds of questions and, more importantly, to a written analysis of the areas covered.

A caveat on the scores is necessary. The primary purpose of the scoring tool is to ensure integrity and discipline in a highly qualitative process, not to provide a scientific, statistically “correct” grade. The written analysis is much more important than the numerical one. Even so, experience has now shown that the scores effectively capture the status of the CLIR environment, providing a reliable indicator of where further work is needed. The Macedonian experience is illustrative. Improvements or reverses of scores between 2000 and 2005 indicate the dynamic change that is taking place, and further indicate the positive nature of the general changes, while identifying continuing systemic weaknesses. They are not scientifically accurate, however, in capturing the exact amount of change or impact. For example, a single clause in the 2002 bankruptcy amendments put extremely important limits on timing for submission of claims, with tremendous positive impact on management of bankruptcy cases (if applied). The statistical impact is less than a one-point change. The question, however, identified this important element and highlighted it in the earlier assessment as a needed reform.

A second caveat is also needed. Scores show a consistent improvement in Macedonia’s commercial legal and institutional environment from 2000 to 2005. During the same period, rates of investment and economic growth have fallen. Various factors – from recent military conflict to competitive improvements in neighboring countries – can and do have as great an impact on decisions to invest in a country as the commercial legal environment. In addition, the improvements represent a reduction of serious dissatisfaction by the business community, which is not the same as being satisfied. Investors have stated very clearly that additional changes – especially effective judicial reform – are needed before a significant increase in investment can be expected.

Finally, it should be noted that each assessment captures a static picture of dynamic change. Scores cannot adequately represent upcoming changes that are underway but not yet official. For example, the judicial system has

received terrible scores due to consistently poor performance over the last five years. However, within a few months after the assessment laws will go into affect that should have a dramatic impact on performance over the next two years. Although the narrative captures these advances, they cannot be reflected in the numbers. Consequently, the assessment has a much more positive view of judicial reform than the numbers support.

## THE 2005 MACEDONIA DIAGNOSTIC

This report represents the second update of the July 2000 CLIR assessment. USAID Corporate Governance and Company Law Project has performed these updates in 2003 and now in 2005. The updates serve two principle purposes. First, the updates identify ongoing areas in which reform is needed, allowing appropriate parties to focus resources to meet those challenges. Second, the updates have proven useful in determining whether technical assistance by various donors over the periods covered has had any measurable impact. As this report shows, both objectives have been achieved: new and ongoing assistance needs have been identified, and a number of assistance projects have clearly helped Macedonia to improve the commercial legal environment. Both of these themes are addressed throughout the report.

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The 2005 Assessment was carried out by a team of legal specialists from the CG&CL project being implemented by Emerging Markets Group. These specialists, assisted by interns, conducted the assessment over a period of five weeks, starting in early October. The team analyzed laws, reports, and various assessments to provide the foundation for more qualitative information. With this background, they interviewed government officials, business leaders, business and professional associations, lawyers,

judges, foreign investors, and foreign donor organizations. They also conducted a survey of commercial lawyers. The result is a combination of quantitative and qualitative analysis providing a strong basis for further recommendations.

# CROSS-CUTTING THEMES

## INTRODUCTION

Comparisons of findings in the seven specific areas of law lead to identification of common themes and issues that cut across the narrow fields being examined. These are examined here by dimension, and, where useful, re-emphasized in the separate chapters. In some cases, the cross-cutting issues are much more important than the findings on a specific law, because they tend to involve systemic problems, which, if addressed, would have a positive impact on all areas. It is often difficult, however, to create stand-alone assistance on broad areas such as the need for better education. Consequently, this report seeks to connect the broad themes to specific areas in which the problems can be addressed.

## A BUSINESS PERSPECTIVE ON THE COMMERCIAL ENVIRONMENT

The law-by-law approach of the CLIR assessment was designed by and for project planners and implementers. It does not capture the way that business people think about the problems which affect the ability of businesses to prosper, or problems that restrain their ability to achieve and drive economic development and growth. To understand the impact of the various laws and institutions, it is necessary to employ a different approach.

Economic actors see the world in terms of their ability to prosper. If they cannot prosper, then they will not invest and may even disinvest. Reasonable profitability permits them to grow steadily and securely, and in doing so, to employ more people, to pay more taxes, to increase the quality and quantity of goods and services, and inspire more investment by others. Their job is not to reduce unemployment or improve the tax base, but both of these are a result of a prosperous business environment.

To achieve profitability and prosperity, businesses must balance three factors: costs, risks, and revenues. Laws and institutions affect all three factors, and therefore affect the economic health of the businesses and the country in which they operate. As risks and costs rise, revenue must rise to offset them. High risks will drive out conservative investments, and high costs will reduce economic health. In a global or even regional economy, it is simply not possible to raise prices to cover these: costs and risks must be reduced or competitiveness will suffer as well.

In Macedonia, businesses perceive high risks, high costs, and limited revenue potential. With these perceptions, it is not surprising that growth has slowed. Macedonia is a relatively low-income country, so that the domestic market provides only a limited revenue capacity. Substantial growth depends on exports to neighboring countries and the international marketplace at competitive prices and quality. Unless Macedonia can reduce costs and risks, the economic situation will not improve.

According to the private sector, the three most significant problems for domestic and foreign investors currently are:

- Inability to enforce commercial obligations
- High costs of finance
- Labor inflexibility

The first two obstacles are interconnected. The failure of the courts to enforce contracts in a timely and reasonable manner results in serious negative consequences for both banks and businesses:

- Higher risk (and incidence) of non-payment
- Higher risk that enforcement actions will fail
- Higher costs of collection for non-payment

For banks, the higher costs and risks must be covered through higher interest rates, less favorable terms, and higher collateral requirements. In other words, failure in the judiciary leads directly to decreased availability of capital at reasonable rates. In turn, higher cost financing increases costs to business, in a climate where it is already difficult to obtain a sufficient return on investment. Effective courts are a critical part of the foundation for economic growth. From a business and economic growth perspective, the judiciary is the number one priority for reform. As further discussed elsewhere in this assessment, the problem is being addressed, but reformers would do well to understand the economic implications as they pursue changes.

Labor inflexibility has cost and risk implications as well. In Macedonia, the cost of employment through various contribution requirements is quite high, especially in light of the overall economic situation. To make matters worse, it is very difficult to remove employees because of highly protective practices. While these protections from termination may seem to favor employment, they have the opposite impact. Companies are unable to respond effectively to market changes that require increases and decreases in the work force. Because of this, they decline to hire new workers to meet increased demand, especially seasonal demand, because they may not be able to terminate them when no longer needed. Instead, they keep the company smaller and either forego new opportunities or use gray market labor to meet shifting demands. The net effect is lower overall employment, lower contributions to social security funds, lower tax revenues, and lower growth for companies.

Recently, the Labor Code was amended. Investors were hopeful that many of their concerns would be addressed. Instead, they were deeply disappointed: reforms were well below expectation and continue to produce undesirably high costs and risks. Moreover, the process of adopting the law was disappointing. After initially seeking comments, the drafters did not permit any meaningful participation or debate over the final product. Numerous stakeholders felt that the process was far too closed, secretive and non-transparent, going against the trend of lawmaking for other important business laws.

Some risks have improved. Standard & Poor's has upgraded its assessment of Macedonia based on reduced political risk and improved macroeconomic stability. This echoes the findings of the European Union that Macedonia has made significant progress in the last five years, so much so that the EU is now willing to permit Macedonia to begin the process of seeking membership. This positive finding also reduces investor concerns. Approximation of EU laws and practices will also lower costs.

Numerous other costs and risks were identified during the 2005 Assessment. These are addressed in the body of this report in the context of the various areas of law.

## FRAMEWORK LAWS

The business community and the legal profession agree that the commercial laws of Macedonia are now generally adequate to support the development of business, trade and investment and the economic development of the country. While many of the reforms have been tailored to the existing base of Yugoslav traditions, increasingly the drafters are looking farther abroad for models and input. The unifying theme in the past two years – more so than in the previous assessment – is that laws must be consistent with European standards in preparation for eventual membership in the European Union. The overall scores indicate that Macedonia is achieving great success in achieving their goals.

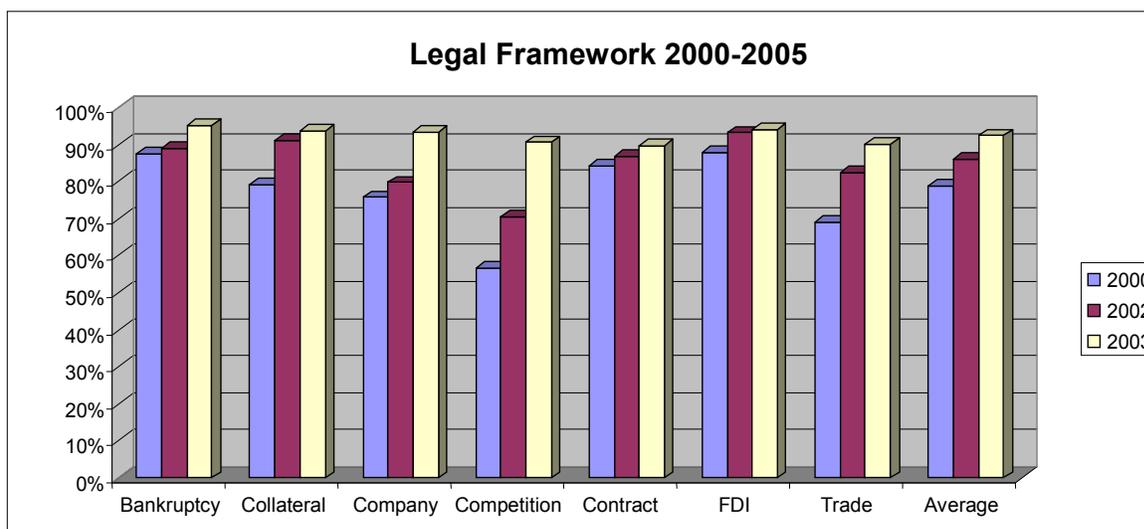


Figure 2 - Legal Framework 2000 - 2005

The process of lawmaking – with some notable exceptions – has also improved. The 2003 Assessment identified serious problems in legislative process, principally in the lack of regular or effective participation by civil society in the drafting of laws and regulations. During the 2005 Assessment, numerous stakeholders expressed strong satisfaction with improvements in this area. Some noted that certain laws – such as the amendments to the Law on Litigation Procedure – were well vetted among relevant stakeholders. Others commented on the apparent commitment by several ministries to increase the use of participatory drafting and feedback mechanisms. Still others reported that various Supporting Institutions were now regularly asked for input on legislation. The effect of the improved approach can be clearly seen in several of the CLIR Framework Laws. Company Law has jumped 14 points in the last two years (a 17% improvement) to a score of 93%. Bankruptcy has moved an additional 6 points since 2003, bringing it to 95% compliance with international standards. Reforms in these laws were the direct result of substantial investment in a methodical participatory drafting process that included a wide range and large number of stakeholders. Drafting was done with active input from local and expatriate experts, and an exhaustive process of participatory analysis and discussion. The very significant advances in these laws come as no surprise when considering the process employed for reform.

Advances in Trade (21 points since 2000, or a 31% improvement, with an 8 point gain since 2003) are directly attributable to project assistance and political will in meeting the standards required by WTO membership. WTO compliance demands have not always permitted the same level of participatory drafting as achieved in Company Law, yet participation and feedback from stakeholders have been a significant component of changes undertaken.

In addition, private sector Supporting Institutions have provided firm support as well as specific input on many changes, helping to ensure adoption of reforms.

There were also significant improvements that resulted in only minor changes in scores, but reflect major changes in approach. Whereas Bankruptcy, Company and Trade involved overhauling large gaps or fundamental flaws, Collateral and FDI have produced refined, targeted changes. Instead of engaging in systemic change, reformers were able to work from recent systemic reforms to amend areas that have not worked out properly in practice. These seemingly insignificant revisions represent a major change in Macedonia's approach to law. Previously, small changes have generally had to wait until an entire body of law could be revised. This tailored approach is much more efficient and effective once the basic framework is in place.

Lawmaking represents a risk factor for business. When the lawmaking system permits "surprise" laws that appear without prior warning or input, the underlying basis for investment can collapse, with no time to adjust. Participatory lawmaking allows business – through associations and professional organizations (Supporting Institutions) to advocate changes and negotiate compromises with government that protects their investment base. If the law is changed in a way that increases their costs (such as laws on taxes, employment, or environmental standards, for example), a participatory process will normally provide stakeholders with one or more years to adjust to the new rules.

The lawmaking system in Macedonia has improved significantly, but is still weak. As one respondent pointed out, the system is based on the goodwill of officials in charge of drafting, or on pressures from the donor funding the particular reform efforts. There is no mandatory legal requirement that the Parliament include stakeholders in lawmaking in any meaningful way. Instead, the law makes it voluntary, and thus completely subject to shifting whims – or shifting personnel – in the area of reform. For example, the Ministry of Justice provided substantial opportunity for input in the new Code of Civil Procedure, while the recent Labor Law started with participatory input, but was then perceived to be drafted and finalized in an atmosphere of utmost secrecy, with substantial unexpected surprises when finally passed. Two years ago, the Bankruptcy Law was almost destroyed by a misguided attempt at non-transparent legislative reform. Once discovered, stakeholders and donors were able to stop the reforms and insist on a participatory analytical drafting model.

Momentum for a change to mandatory participatory lawmaking seems to be growing. As noted, several ministries are consistently and habitually using a participatory method, and donors – much more than in many other countries – are requiring and funding a participatory process. Stakeholders are demanding more input through increasingly active associations and think tanks. The next step is to amend the Rules of Procedure of the Assembly of the Republic of Macedonia to ensure these gains in "goodwill" are captured through permanent, mandatory changes to the system.

Formal legislation is only one layer of the framework. Many laws call for implementing regulations before they can be applied. Many of those regulations have been slow to appear. However, the 2005 Assessment noted a number of instances where regulations are receiving high levels of attention before the onset of implementation. The Company Registry, for example, and the new Law on Enforcement are being accompanied by the regulations and materials necessary for the implementing institutions to function from the outset.

Access to laws is also improving. Two years ago, Macedonia did not yet have its official gazette online or even accessible electronically. That is no longer true: laws are available electronically on a subscription basis. Some legal professionals complain that they cannot afford the subscription, but they recognize that laws are now more available, whether on line or printed. The Ministry of Economy has translated or assembled translations of many laws as a service to foreign investors, and has these available on-line ([www.economy.gov.mk](http://www.economy.gov.mk)). On the whole, access to laws is substantially better than two years ago, even if a number of legal professionals have not yet been able to afford the investment of updating their own libraries.

Not all changes have been positive since 2003. Detailed scores also indicate consistent resistance to reforms and even some performance reversals among several institutions. The courts continue to be the weakest of the

institutions in terms of change. Although scores have improved in the area of enforcement, the improvements arise from new enforcement mechanisms that operate outside the courts. Of course, such cases do not belong in the courts, so the system as a whole has improved through more effective reallocation of resources.

Other negative performance changes have been noted in Bankruptcy and Company Law. For Bankruptcy, earlier reforms failed to establish comprehensive regulations for bankruptcy trustees, leading to a significant decline in the performance and integrity of trustees. Business and legal professionals unanimously agreed that the trustees were becoming increasingly untrustworthy under the existing system. During the past year, this gap has been addressed by the CG&CL Project, which has applied its well established participatory drafting approach to the problem. New regulations are currently in Parliament for adoption. In other words, the incomplete early reforms led to a new wave of corrective reforms, suggesting that the reform system itself is beginning to function more effectively.

Company Law has been marked by very strong successes on a number of levels. However, one of the long-term successes is now marred by (hopefully) temporary short-term reversals. Courts, which will no longer be responsible for company registration as of January 2006, have already reallocated resources previously dedicated to registration in preparation for the change. As a result, average registration times have jumped from 5 to 25 days in the past few months, a situation that will likely stay the same or even get worse until the new system begins. The problem arose from unfortunate managerial decisions, which should now be highlighted as a case study for better transition in future reforms.

## **IMPLEMENTING INSTITUTIONS**

Implementing Institutions continue to show improvements, but not strength. Some of the gains in the 2005 assessment are attributable to creation of planned institutions, such as MacInvest, Macedonia's recently established investment promotion agency, and the newly created Commission for Protection of Competition. Others arise from improvements in the institutions. On the whole, however, the improvements have been limited – 14 points since 2000 and 4 points since 2003 – with an overall average of only 69%. There is much room for additional improvements.

Numerous stakeholders have expressed concern that one of the greatest challenges facing the public sector is a thin layer of qualified personnel. Both public and private sector respondents noted the difficulty of attracting and maintaining high-quality, experienced candidates for jobs in these institutions. Implementing Institutions must compete with both the private sector and overseas markets to fill their ranks. This is a complex challenge requiring complex interventions, but it clearly points to the need for investment in training and education of government officials and employees. If the pool of candidates is too shallow to provide appropriate entry-level candidates, then new hires need to receive consistent, ongoing input to ensure that they will meet the demands of the job.

Many Macedonians also note that low salary levels in the public sector make it difficult to attract enough high quality officials. This factor, while significant for some, is not the only issue. Many people are willing to take lower salaries in exchange for job security, or for the opportunity to make a difference in their community, region or country. Job security is reasonably strong in the Macedonian public sector, but job satisfaction is not. A number of talented officials who provided input for the 2003 assessment had moved on by 2005, and some recent hires from the private sector expressed disappointment at the work ethic and effectiveness of some institutions. Under such circumstances, salaries alone will not lead to long-term stability – deeper civil service reforms are needed.

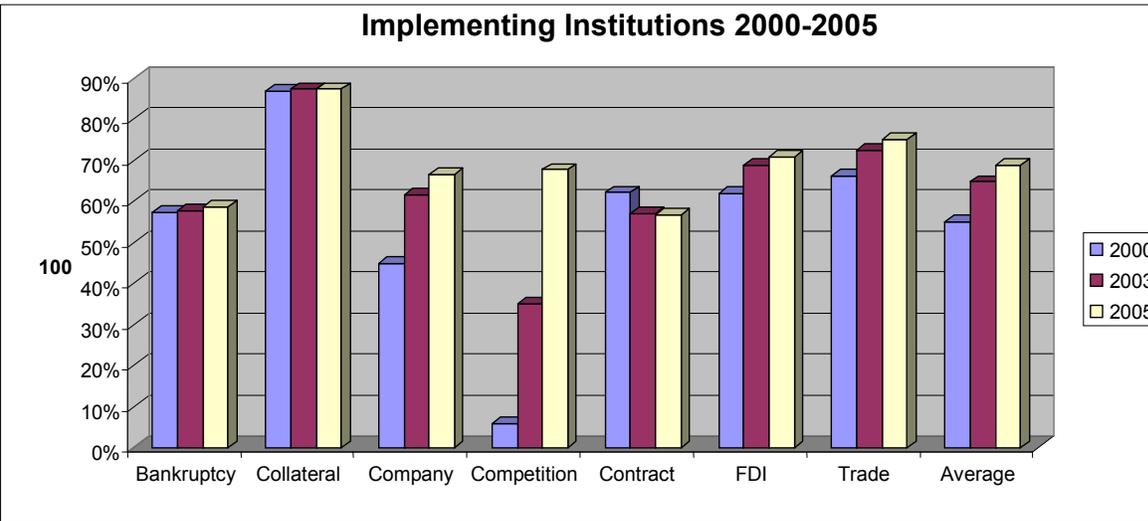


Figure 3 - Implementing Institutions 2000 - 2005

A recurring theme in *Implementing Institutions* is the fundamental importance of courts to all areas of law. Commercial obligations rely upon a healthy judiciary as the basis for developing a full array of enforcement and dispute resolution tools. Courts reduce both costs and risks and ensure greater capacity for collecting revenues. As discussed more fully in *Contracts: Implementing Institutions*, the judiciary has yet to achieve performance improvements. This has tremendous social and economic impact. Fortunately, this is about to change. The dysfunctional Yugoslav system inherited at independence is being replaced with one that better allocates responsibilities and incentives to make parties more responsive and courts more effective. Once implemented, scores for courts should improve dramatically.

Implementation of court reforms, however, is a much slower and more labor-intensive project than merely amending the laws. As of today, no one has experience in the new system, because it has never before existed. This means that all participants – judges, attorneys, corporate counsel and notaries – will have to be trained and educated. New curriculum will need to be developed for law school and continuing legal education courses. The news media and public will need to understand the new system as well if civil society is to function effectively in its support and monitoring roles. Recent experience in Bosnia suggests implementation should take two or three years before noticeable changes can be seen. More realistically, reformers should plan on five years of wide ranging interventions to propel the courts through the legislative changes into full functionality. Otherwise, the reforms are likely to be stillborn. Macedonia cannot afford to lose ground in this area.

## SUPPORTING INSTITUTIONS

Supporting Institutions have shown the most significant growth over the past five years. From 49% in 2000, they moved nine points to 58% in 2003 and another 10 points since then to finish at 68% in the 2005 Assessment. The growth is remarkable because comparatively few donor resources are geared directly toward the private sector institutions that comprise the bulk of the Supporting Institutions. Whereas Legal Framework and Implementing Institutions are deliberate targets of the numerous projects in legal and economic reform, much of the advance in Supporting Institutions was a result of market responses. This raises the question of how much more impact might be possible with additional resources for these organizations.

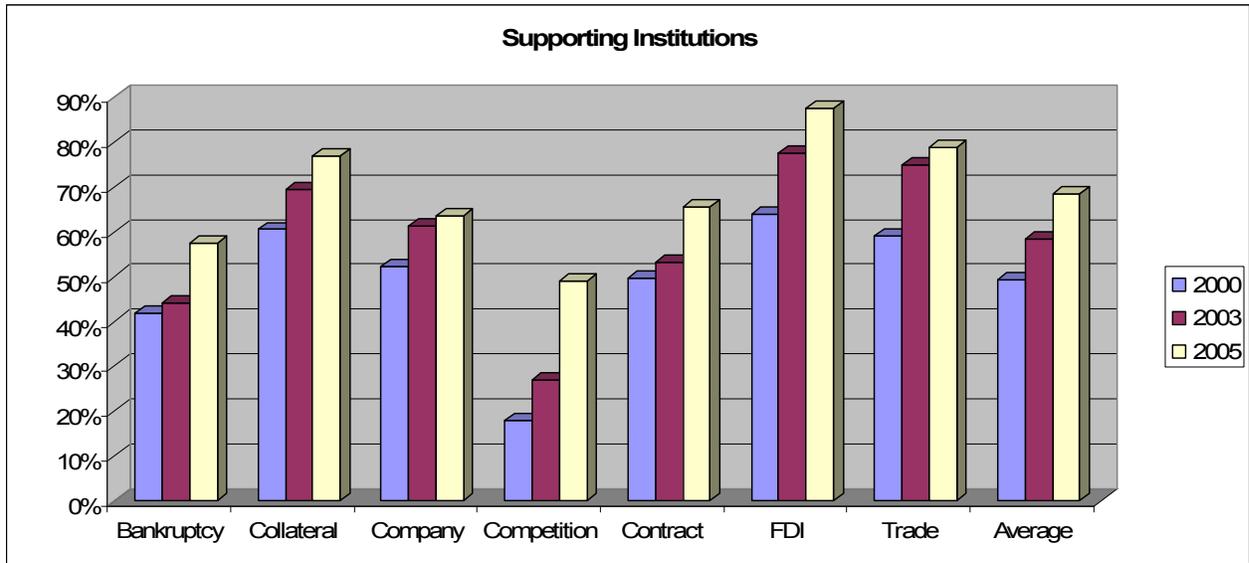


Figure 4 - Supporting Institutions

Not all of the changes were independent of donor support. Some organizations depend directly or indirectly on donor funding, not simply membership funding or other independent support. Others are at least enhanced by various co-sponsored activities, such as trainings, in which donor organizations provide technical and financial resources that bolster the sometimes sparse resources of these local associations. And, in other cases, direct donor assistance has little impact, such as the Macedonian Bankers Association, which has yet to live up to expectations or even become a significant voice in advocating reform. In short, the appearance and growth of a variety of Supporting Institutions seems linked to changes in the overall reform environment, but enhanced by the availability of donor resources.

Supporting Institutions take a variety of forms, from public agencies like the Customs Administration to quasi-public services like notaries to purely private sector organizations such as business associations. Strong Supporting Institutions serve an essential role for investors, other businesspeople and civil society generally by providing focal points for reform efforts and advocacy. An active business association, for example, will lower the cost of advocacy by uniting multiple voices, combining their resources efficiently and effectively, and providing government with a single point of contact for dialogue regarding proposed changes. In addition, such organizations can lower risks in an immature democracy by allowing the organization to become the public face of dissent, rather than individual members who are more susceptible to vendettas or anti-democratic reprisals for speaking out.

One of the ongoing success stories among Macedonia's Supporting Institutions is notaries. Although the 2003 Assessment expressed doubts about recent reforms that expanded the role of notaries in enforcement of commercial obligations, users of notary services have been generally quite satisfied with those services, and even attribute improvements in the commercial environment to the involvement of notaries in creating enforceable documents and enforcing the obligations created. Notaries have worked effectively among themselves and with other members of the legal profession to ensure appropriate implementation. These reforms have lowered the risks of some forms of commercial transactions along with the costs of collection.

Business associations have also seen some successes. The International Council of Investors has become more prominent as a voice of reform over the past two years. ICI now prints an annual report outlining reform priorities to address Macedonia's economic problems. The reports are well reasoned and provide an excellent resource for reform strategy and prioritization. ICI also holds regular meetings with government officials to

advocate the reforms they have identified. Because it represents some of the largest foreign investors in the country, ICI is taken seriously.

Since the 2003 Assessment, several new organizations have appeared that hold promise for market-oriented reform. The European Business Association brings together Northern European investors and business interests with strong support from their embassies. Its members also include other business organizations, such as the American Chamber of Commerce (AmCham), to combine forces more effectively for common goals and interests. The EAB is actively advocating economic and legal reforms through well reasoned, written policy papers that are presented to appropriate government officials with backing from the European diplomatic community.

On the domestic front, there have been two significant developments. First, the Macedonian Chamber of Economy has been transformed from a mandatory, fee paid organization to a voluntary, member-funded business association. This has had a dramatic impact on the focus and activities of the MCE, which now must earn its living based on its ability to provide worthwhile services to its members. (Previously, mandatory, non-accountable funding had created a relatively ineffective, sometimes moribund organization.) The MCE now regularly does membership surveys, training in areas of importance to members and advocacy for legislative change. In the past year, government has turned increasingly to the MCE for input on legislative initiatives. While this is an improvement in legislative process, MCE officials recognize that it is only a half-step because the vetting is voluntary, not mandatory. There is now interest in advocating changes to legislative policy to ensure that business organizations such as MCE have a right to provide input on legislation prior to passage.

MCE tends to represent the interests of larger businesses in the country. With mandatory fees eliminated, a new business group has formed to address the needs of small and medium enterprises. The Association of Chambers of Commerce works as a federation of chambers for trade, industry and services. Their stated mission is “[c]onstantly increasing the competitiveness of member companies, improving Macedonia’s business environment and expanding sales of our products in the global market.” As part of that mission, they are actively identifying and analyzing constraints to business activity and advocating reform. If it can succeed in attracting paying members over the long-term, the ACC will provide a much-needed voice for the SME sector and can serve as a valuable initiator and counterpart for training, public education and reform.

Other advances have occurred in the area of think tanks. Such research institutes are capable of marshalling resources to identify constraints and provide analytical justification and orientation for their removal, thus supporting the reform agenda needed for economic growth. Their work can reduce the risk of ineffective or misguided policy initiatives that waste resources and reduce growth.

Two new organizations have been formed since the 2003 Assessment. First, the Center for Economic Analysis (ECA) conducts cost/benefit and other studies in support of policy recommendations. Their study on the impact of tariff adjustments was used to justify successful efforts to reduce tariffs. This may have been the first use of locally prepared economic impact studies in support of policy reform. Second, the Center for Research and Policy Making (CRPM) brings together social scientists, economists and legal experts to conduct impact studies and make recommendations for policy change. Both organizations are still in their start-up stages and benefit from direct or indirect donor funding for studies undertaken. If regulations on legislative and policy process were changed to require impact studies prior to passage of laws, the consequent demand for the work of these institutions might well ensure their longevity.

The Institute for Sociological, Political and Juridical Research continues to operate effectively as an independent research organization. They conduct polls, surveys and studies on numerous areas of socio-economic concern and were responsible for shepherding revised legislation on NGOs through the policy process. This legislative effort included extensive input from the NGO community and other stakeholders to ensure better design, acceptance and implementation. As a result, the laws governing NGOs are now better suited for Macedonia’s needs. The only significant gap in the current NGO legal and regulatory regime is in governance; several stakeholders have

complained of “captive” or “alter-ego” NGOs that tend to be started or dominated by a single individual, but without having reporting and transparency requirements that would provide appropriate insight into their affairs.

The area of education has yielded mixed results in the past two years. For investors, the educational system is critical to their competitive standing. If schools and universities produce substandard graduates – compared with other countries competing in the same market – they will have to incur the cost of re-educating or otherwise bringing their new employees up to standard, which undermines their ability to compete. This also has an impact on employees, whose investment of years in their own education is compromised by the quality of that education and costs them earnings and opportunities.

The Faculty of Law in Skopje is slowly improving some of its course offerings through curriculum development, often with the aid or at the insistence of donor projects. This includes the recent launch of a Masters of Law degree (LLM), which used both expatriate resident consultants and tenured professors for lectures and training. This particular endeavor is an excellent example of positive collaboration between donors and the university community, and could serve as a model for ongoing reform of the system. Much change is still needed to bring the curriculum – both in content and pedagogy – up to date with legislative reforms and international standards.

Continuing legal education (CLE) has not improved significantly over the past two years. Although many excellent courses have been offered to legal professionals with valuable participation of the Macedonian Business Lawyers Association and others, Macedonia lacks incentives for life-long learning. Unfortunately, there is no mandatory CLE requirement for legal professionals. Without this requirement, demand for new courses is essentially donor driven with insufficient permanent, domestic demand to support the development of competitive, self-sufficient service providers. Macedonian lawyers interviewed for this and the prior assessment unanimously and enthusiastically support the adoption of mandatory CLE requirements to ensure absorption of legal changes through the development of relevant courses and materials. Much of the legal reform underway will atrophy or otherwise be wasted or neutralized unless the legal profession is brought up to date through practical CLE courses.

One other positive advance is worth noting because of the opportunities it creates. Macedonia is a signatory to the Bologna Convention on education and has begun to recognize courses and degrees offered by competing educational institutions. Students can now transfer credits and degrees between different faculties, which will increase the competition to attract students, as they are no longer held hostage to inferior offerings. Donors could provide invaluable assistance not only by directly funding curriculum and pedagogical reforms, but by working closely with providers of education to incorporate or otherwise use the numerous reports, training materials and other outputs of their projects into the local curriculum.

Legal reforms such as those studied in this Assessment clearly require support and participation of a wide range of Supporting Institutions. One of the most important watchdogs and advocates of reform can be the bar association. Unfortunately, the Macedonia Bar Association (MBA) has still not risen to this task. Because of ongoing problems in the bar and dissatisfaction among the mandatory membership, it is worth reconsidering the role and structure of the bar.

In many countries, functions of the bar include licensing and professional discipline together with services such as CLE, legal materials, legislative analysis and advocacy. In others, these functions are split between mandatory bodies (the “Bar”) responsible for licensing and discipline and voluntary organizations (“bar associations”) that provide member services. The MBA has not ever functioned effectively as a “bar association” but could conceivably function well as a licensing and disciplinary organization. It may be time to re-evaluate the role of the MBA and consider amending the law to limit its functions while empowering voluntary organizations, such as the MBLA, to better serve the ongoing needs of the legal profession.

## THE MARKET FOR REFORM

The dynamics of a transition country such as Macedonia are by nature complex. Reform and resistance compete to define the short- and long-term destiny of the country. Much of the reform ongoing today is driven by a widely held desire of both politicians and the general public to join the European Union and NATO. Donor assistance from all sources has been designed to achieve these goals, supported by significant political will of those with the capacity to promote or retard the necessary changes.

Even so, there is considerable opposition to some of the reforms affected by the areas under study in this Assessment. Some of the opposition arises from simple ignorance and misunderstanding. Elsewhere, the resistance comes from vested interests attempting to protect their entrenched positions in the economy. Both can and must be addressed.

Ignorance of market economics and market-oriented approaches to reform is widespread in transition countries. Macedonia is no exception. For example, labor inflexibility and costs are often justified as an attempt to protect labor, when in fact they lower the level of employment overall by creating costs and risks that cannot be met through pricing of goods and services. As a result, many employers and employees prefer the gray economy with its lower costs and risks. Bankruptcy procedures are often misunderstood as the cause of unemployment when bankrupt companies lay off hundreds or thousands of workers. To the contrary, bankruptcy can be used to protect jobs and businesses through reorganization – it is a cure, not the disease.

These misunderstandings must be met through improved, targeted, deliberate public education. Campaigns that include press and media coverage, briefings for leaders, cost/benefit studies, curriculum reform at all levels of schooling and prolonged advertising are needed to begin changing traditional misunderstandings and mindsets. As Einstein once said, “We are all ignorant, just in different areas.” This is good news, because ignorance can be reduced through better education.

Vested interests present a somewhat more serious problem. In the commercial sector, there are well established cartels and market dominant actors that regularly attempt to impede any reforms that will affect their positions. Many government services are beset by petty and large-scale corruption that resists improvements in efficiency and transparency. Sometimes, resistance comes from those who simply are not paid sufficiently – at least in their estimation – to put in the extra work needed to upgrade curriculum, training materials or management methods needed for self-sustaining reform of institutions and the economy.

All of these cases require strong dedication and leadership from those responsible for reform in using all appropriate enforcement techniques available to mandate and impose changes. Macedonia already has proven that it is possible to overcome vested interests: the Customs Administration has substantially reduced corruption and inefficiency through dedicated leaders; the Ministry of Justice has overcome strong resistance to judicial reform and has now replaced the dysfunctional court system inherited from Yugoslavia with one designed to hold debtors accountable for their commercial obligations.

One of the most effective tools in successful legal reform in Macedonia has been participatory legislative process. Frequently, laws are passed with little or no input from affected stakeholders, who then resist the new laws because they feel no obligation to support a system that has excluded them. Participatory lawmaking builds consensus in the process of reforming laws by including competing stakeholders in constructive analysis and discussion of the various interests affected by the law. This provides an educational function as well, through the numerous public debates by experts who explain the reasoning behind the changes. This approach does not eliminate vested interests, but it does undermine the ability of those interests to appeal to the ignorance of others in justifying their unjustified positions.

The difference between implementation and enforcement is consensus. When parties agree to an approach – whether in a commercial contract for sale of goods or a social contract for restructuring society through law –

there is no need to enforce, only to implement according to the agreement. Enforcement is only needed when there is disagreement or rejection of the approach. Recent participatory lawmaking in the field of company law, bankruptcy reform, and NGO law demonstrate that this approach can be highly effective in Macedonia. It requires more funding at the outset – for developing the law – but much less later on, because the parties can implement their agreement voluntarily. Law by fiat creates a higher risk of failure and erodes respect for law generally. Macedonia cannot afford the expense of this approach.

# BANKRUPTCY

## OVERVIEW

When the 2003 CLIR was being completed the Bankruptcy law and practice were under imminent threat. The Ministry of Finance was supporting an initiative that, if successful, would have undermined essential elements of the bankruptcy system. In particular, it would have placed secured and unsecured creditors on an equal footing and employees would be given first priority, with a pre-emptive right over any claims by commercial creditors including registered, secured creditors. The drafting initiative was pushed forward behind closed doors. Fortunately, enough people became aware of the proposed changes to circumvent implementation. The Ministry of Economy and, in particular, the Industry and Structural Reforms Department, lobbied to take control of the legislative drafting responsibilities with respect to the Bankruptcy Law.

Although the Ministry of Finance was behind the previous drafting initiative, formal responsibility for the Law rested with the Ministry of Justice. The Ministry of Economy entered the fray out of concern over the impact of the proposed amendments and out of frustration over the failure to resolve longstanding problems with bankruptcy procedures. On March 30, 2005, the Ministry of Economy adopted a resolution for the appointment of an inter-sector drafting group with the express purpose of:

... review of the international legislation and EU regulation governing the relationships of the insolvent companies, and the positive and negative effects resulting from the application of the existing Bankruptcy Law, and to draft a new Bankruptcy Law.

The 1997 Bankruptcy Law, with subsequent amendments in 2002, was basically a sound law. Most experts would agree that the difficulties underlying the Macedonian bankruptcy system are institutional. However, the Ministry of Economy decided it was desirable to conduct a wholesale review and re-write of the Law as part of its overall assessment of the bankruptcy system.

While some may have considered this an unnecessary step, it had a substantial benefit. The Ministry of Economy had worked with the Corporate Governance and Company Law Project in the drafting of the Company Law. That process introduced open, public consultation (27 public hearings on the draft law). The overwhelmingly positive reception by the business community and the logistical support provided by the Project prompted the Ministry to engage the Project in the planning and implementation of the bankruptcy review. A drafting and public consultation schedule was prepared that would provide for a two reading process with public hearings scheduled prior to the First and Second Readings. At the time of writing, the Bankruptcy Law had passed First Reading (September 17th). Seven public hearings were held prior to First Reading and four had been completed during the second phase as of this writing.

The rewrite is targeting institutional reform. Unlicensed trustees, a vestige of the 1989 Bankruptcy Law, continue to administer pre-1997 bankruptcy proceedings. One objective is to close down this loophole. Further, there is the perception that there has been collusion between judges and certain licensed trustees to the detriment of creditors

in certain proceedings initiated since 1997. The Ministry’s goal is to establish a streamlined bankruptcy process that places primary responsibility in the hands of skilled trustees, prevents multi-court litigation flowing from the bankruptcy process and clearly defines the respective authorities of the judge, bankruptcy council, creditors and trustee. The overabundance and lack of skill of trustees is, in part, due to lax admission requirements. The trustee system will be overhauled as part of the reform of the Bankruptcy Law.

The Macedonia Bankruptcy Association continues to provide continuing legal education, reform advocacy and other valuable services to the bankruptcy profession. The courts have worsened. Judges trained in bankruptcy procedure have been transferred from bankruptcy to other functional areas leaving an unskilled bench to deal with complex bankruptcy litigation. There is hope that the judicial reform strategy currently being implemented by the Ministry of Justice will result in a refocusing of court specialization and changes to human resource policies. In particular, whether through a dedicated division of the existing courts or through a new specialized court, the expectation is that judges will be appointed, trained and retained as bankruptcy specialists rather than freely being rotated to other divisions in short order.

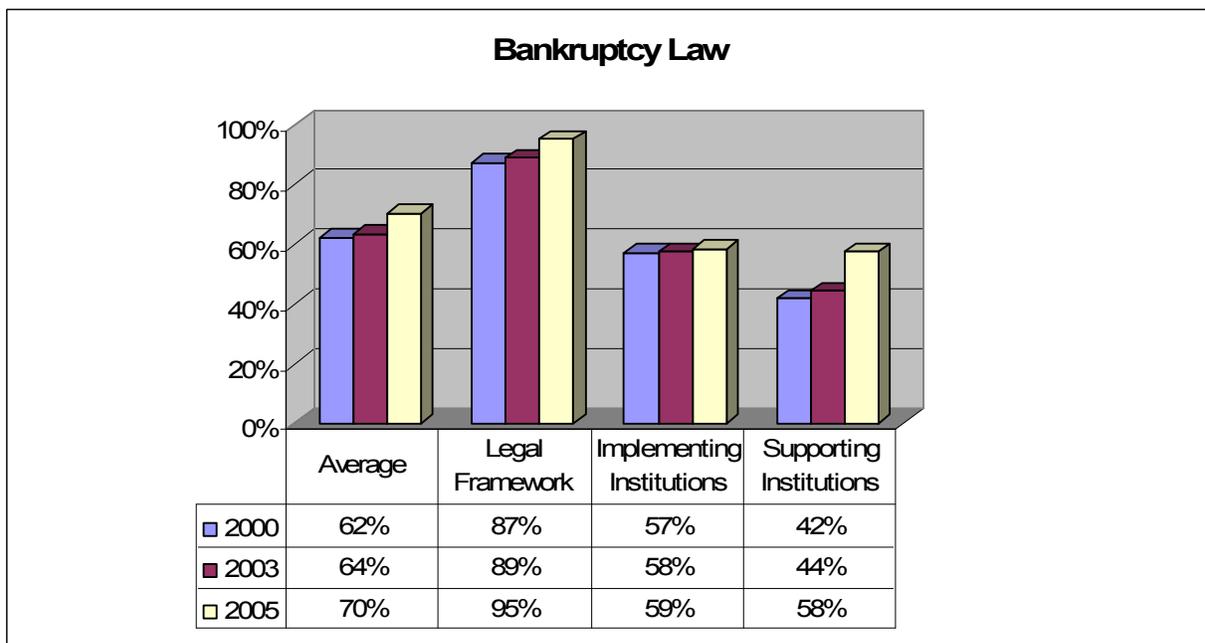


Figure 5 – Bankruptcy Law Comparative Scores

## LEGAL FRAMEWORK

**RECENT CHANGES.** A new Law on Bankruptcy is expected to be adopted prior to year-end. It has been passed at First Reading and the Ministry of Economy has submitted revisions for consideration by Parliament based on feedback received from two rounds of public hearings. There are a number of changes in the Law that should improve the overall bankruptcy climate.

- **Appeal Modifications.** The Bankruptcy Council has been reformulated as the primary appeal panel for contested actions within the bankruptcy proceeding. Consideration of an appeal is subject to strict

timelines and, in most instances, the appeal is final. This will avoid delays in proceedings due to backlogs at the appellate court level.

- **Consolidation of Proceedings.** In the past, a major source of delay related to transactions that were contested after commencement of the bankruptcy proceeding. For example, the debtor might allege that a particular claim of a creditor was false. The debtor might initiate an action against the creditor. This action would be heard at a court that regularly deals with commercial contests (i.e. a court other than the court dealing with the bankruptcy proceeding). This could happen many times over between any of the parties of the proceeding and thereby lead to considerable delays in the bankruptcy proceeding. Because these cases operate outside the bankruptcy process, the judge presiding essentially loses control over the proceeding. Under the new Law, judges from the bankruptcy council will assume the jurisdiction to hear these cases. This will avoid loss of control over the process and ensure that the contested cases are considered in a timely manner.
- **Clearly Defined Jurisdiction.** There is a shift in power from the judge to the trustee and creditors. Business decisions during the bankruptcy period will be made by the trustee and creditors – not the judge. The judge will assess compliance with the law. The trustee will administer the bankruptcy estate.
- **Electronic Notification.** Advertising and notice requirements are improved. Under the Law on the One-Stop Shop System and the Maintenance of Registers of Business and Other Legal Entities, the Central Registry is required to maintain all publicly mandated registers. Key announcements in the bankruptcy proceeding will now be posted and publicly accessible from the Central Registry's website. The effective date of a notice published on the website will, in most instances, be the day following the date of publication.
- **Strict Claims Timeline.** There is a strict time period within which a creditor must submit a claim to be included in the proceedings. Failure to submit the claim within the timeframe will disqualify the claim. (This simply restates amendments passed in 2002.)
- **Triggering Events.** The bankruptcy proceeding is triggered when payment has not been made after a demand for payment from a payment institution. A system is now in place where the banks report on payment transactions to the Central Registry. The Central Registry will be able to confirm the state of a payment transaction. As with the 2002 amendment to the Bankruptcy Law, presentation of invoices or other reliable documents as evidence of an obligation and testimony alleging failure to pay will not be sufficient to trigger the opening of the proceeding. While this limits the potential for debtor challenges of the basis used to open the proceeding, it also limits the range of evidence that may be presented by creditors who wish to seek redress through the bankruptcy process.
- **Trustee Indemnity.** The Law recognizes corporate and individual bankruptcy trustees. Corporate trustees must carry a minimum professional liability insurance cover of 100,000 Euro. Individual trustees (other than the employees of corporate trustees who are covered by the corporate policy) must carry a minimum insurance cover of 25,000 Euro.
- **Sale Standards.** Standards for the sale of property will be prescribed by the Ministry of Economy.
- **Chamber of Trustees.** The law provides a structure for the organizing, supervision, training, licensing and disciplining of bankruptcy trustees. The Ministry of Economy will approve the new Trustees Chamber charter, code of conduct and professional standards. It will prescribe the examination and issue the licenses. The Chamber will be responsible for monitoring adherence to professional standards, establishing continuing education programs and exacting discipline. There are now express provisions in the law that deal with license removal due to, for example, trustee inactivity or failure to complete required continuing education.

- **Procedural Safeguards.** The law clearly defines procedural requirements, time limits and thresholds so as to ensure the bankruptcy process moves forward efficiently. For example, most permitted appeals must be decided within eight days.
- **Statutory Priorities.** A new Labour Law was passed in 2005. Unlike with the Bankruptcy and Company Laws, there was not an open drafting process. Statutory priorities are stipulated in the Labour Law and, as a result, have been reflected in the Bankruptcy Law for employees of insolvent companies. A higher rank priority is applicable for unpaid wages and other benefits payable for the last three months before the bankruptcy procedure has been opened, compensations for injuries that the employee suffered while working for the debtor, as well as for professional illnesses, and compensations for unused vacation pay in respect of the current year.
- **Cross Border Bankruptcy Provisions.** UNCITRAL compliant cross border bankruptcy provisions have been added to the Bankruptcy Law.
- **EU Compliance.** The Law has been drafted to comply with applicable EU Directives including Directives covering financial collateral arrangements. The one exception is with respect to the requirement to provide a guarantee fund for outstanding employee claims. The Ministry of Economy considered this to be a requirement that should be dealt with under a separate law, likely under the jurisdiction of the Ministry of Labor and, therefore, did not incorporate guarantee fund provisions in the bankruptcy legislation.

Overall, the legal framework has improved compared to the CLIR 2003 assessment. Particular improvements are noted as follows:

- Improved availability of information to adequately identify the property of the debtor;
- Ready identification of secured transactions;
- Reporting of secured claims at the beginning of the proceeding;
- Trustee ability to assign contractual rights and step into the shoes of the directors and management;
- Increased qualification standards for trustees;
- Creditors right to nominate a trustee and to set aside the judge-appointed trustee in favor of a creditor-nominated trustee;
- Clear identification of governmental responsibilities for the regulation of trustees;
- Strengthened related party transaction prohibitions;
- Provisions enabling the set aside of fraudulent transactions and to prevent anticipated fraudulent transactions;
- Clear guidelines on public auctions and when private sale of assets will be permitted.

## IMPLEMENTING INSTITUTIONS

There are five Implementing Institutions for Bankruptcy: the Ministry of Justice, the Ministry of Economy, the courts, the trustees (or administrators) and the Central Registry. Together they share the responsibility for effective implementation of bankruptcy law and practice.

**MINISTERIAL RESPONSIBILITIES.** The status quo is about to change with the passage of the new Bankruptcy Law. Currently, authority for various aspects of bankruptcy law and practice has been divided within the government, with various statistical and monitoring services under the Ministry of Economy (MOE) and legal and administrative issues under the Ministry of Justice. The Ministry of Justice has led the bankruptcy process by establishing a system for licensing bankruptcy trustees. This work was done in conjunction with the Macedonian Bankruptcy Association. The MOJ administers the licensing exam.

While on paper, the examination process appears acceptable. Early signs of its application were worrying. When only a small percentage of exam takers passed the initial exam, the commission responsible for setting the exam was replaced rather than upholding the established standards. There are now almost 200 bankruptcy trustees. However, judges view only a handful of trustees as truly competent to assume the task.

The Ministry of Economy pushed the Government to shift responsibility for the trustees from the Ministry of Justice to the Ministry of Economy. With the Ministry of Justice fully engaged in a wholesale restructuring of the judiciary, it did not oppose the shift. The proposed structure under the new law has the Ministry of Economy supervising the performance of a newly established Chamber of Trustees. This supervisory authority can be exercised either ex officio or upon an objection or complaint by interested parties. It has a number of other authorities and responsibilities as follows:

- The Ministry of Economy sets the entrance exam and continuing education exam and issues, suspends and cancels bankruptcy trustee licenses.
- The Chamber must submit the charter, code of conduct and professional standards and any amendments thereto to the Ministry of Economy for approval.
- Each February, the Chamber must submit an annual report on its operations to the Ministry of Economy. That report must also contain the Chamber's plan of operations for the following year.
- The Ministry of Economy has authority to dismiss the Chamber's management board and replace the President of the Chamber under certain conditions.
- The Ministry may also take direct action against bankruptcy trustees although day-to-day disciplinary activities rest with the Chamber.

**COURTS.** A recent survey conducted by the Corporate Governance and Company Law Project (October, 2005) identifies the courts as one of the few Macedonian institutions that has not experienced an increase in perceived trust. In fact, the level of trust is on the decline. A survey completed in September of 2004 showed that 63.9% of respondents from the general public think that the courts are ineffective. 65.6% of people believe that the courts do not treat people equally. Almost 56% of respondents feel that the courts lack independence. Of those respondents who have had experience in the courts, almost 69% reported that the courts were ineffective.

Quality judicial training and retention of judges in particular disciplines remain fundamental objectives yet to be achieved under the Ministry of Justice. Judges are subject to transfer to other disciplines, such as inheritance or family matters, even after establishing themselves as competent commercial/bankruptcy judges. Of the cadre of bankruptcy judges trained in 1999, only one was still working on bankruptcy as of the Fall of 2004. Some of these judges have been rotated completely out of their fields of training. Judicial specialization as a strategic objective is not sufficient because new appointments to bankruptcy and other commercial units may not have any commercial experience or recognized commercial expertise. Judges can come directly from family, misdemeanor or civil practice. Given this practice, it is understandable that the general public and, for that matter, bankruptcy practitioners and other bankruptcy stakeholders, have lost confidence in the bench's ability to adjudicate.

It is not the purpose of this section to discuss the Ministry's judicial reform strategy in detail. However, the Ministry has diagnosed many problems in Macedonia's judicial system and endorsed a comprehensive three year judicial reform plan. Several proposed actions in the reform plan could contribute to future improvement in the efficacy of the judiciary. These include:

- Drafting and adopting legislation on the establishment of a public institution for the training of judges and prosecutors;
- Upgrading the Center for Continuous Education;
- Implementing initial training for judicial candidates;
- Passing constitutional amendments to redefine the system for selection, discipline and responsibility of judges;
- Adopting objective criteria for accountability of judges;
- Establishing a supervisory board composed of judges to oversee judicial performance;
- Passing a law on judicial salaries that will reflect scope of work and responsibilities; and
- Establishing human resource policies that will support an independent judiciary.

The need for commercial specialization has been acknowledged by the Ministry of Justice. The most likely scenario is the creation of commercial divisions in addition to those already established in the larger urban centers and a commitment to training and retention of qualified commercial judges.

A new Law on Litigation Procedure has been enacted. There is an expectation that the changes implemented will help to rectify some of the practical problems affecting bankruptcy cases, especially with respect to delays in proceedings. The new Law on Litigation permits the passage of special litigation procedures in specialized legislation. The draft Bankruptcy Law has taken full advantage of this carve out by prescribing special procedures where appropriate to ensure that litigation will remain within the control of the bankruptcy judge and the bankruptcy council.

In the 2003 CLIR assessment, we noted that the Macedonian Bankruptcy Association expressed a need for introduction of mediation and arbitration into bankruptcy claims in order to lower delays, by-pass the courts, and reduce the strain on courts. A mediation law has been penciled in by the Ministry of Justice as a mid-2006 objective. In fact, a draft law was prepared in 2004 by a small expert group supported by IFC's SEED initiative. Both SEED and CG&CL met with Ministry of Justice and Ministry of Economy officials in the hopes of supporting a comprehensive alternative dispute resolution strategy. MoJ has jurisdiction over mediation; MinEcon has jurisdiction over arbitration. The latter Ministry has supported the passage of a Law on International Arbitration. However, neither Ministry has moved forward with a well-defined strategy to promote domestic mediation and arbitration. It appears that the Macedonian Bankruptcy Association will have to wait until mid-2006 at the earliest before additional steps may be taken at the ministerial level.

**TRUSTEES.** The supply of trustees licensed by the Ministry of Justice far outweighs the demand. Further, the level of competency of the vast majority of currently licensed trustees has been called into question by bankruptcy stakeholders.

While there has been significant training of trustees over the past few years, primarily through the Macedonian Bankruptcy Association and, in part, through the Macedonian Bankruptcy Trustees Association, competency remains an issue.

**CENTRAL REGISTRY.** The MoJ's Judicial Reform Strategy has a stated objective of installing complete IT and software applications in the courts and other institutions including the training and recruitment of technical staff. Reporting and statistics are still problematic, with most court reports poor in quality, not standardized, and, as a result, not very useful. In the past, reporting has not been public or transparent. The Central Registry, as a result of the Law on the One-Stop-Shop System and the Maintenance of Registers of Business and Other Legal Entities, will aid in publicizing key information on bankruptcy proceedings, will act as the portal to access the list of Trustee Chamber members and relevant Chamber proceedings and will be the source of critical information of a credit-rating nature. All bankruptcy notices will be posted on the Central Registry's website. This should allow for ready public access to bankruptcy proceeding information and also aid researchers wishing to compile vital statistics on bankruptcy proceedings.

## SUPPORTING INSTITUTIONS

The Macedonian Bankruptcy Association was established in the late 1990s with assistance from USAID and ABA/CEELI, after a study tour of bankruptcy professionals to the US. The MBkA has been quite successful in leading legal reforms, providing CLE and other training, and providing public information.

The Macedonian Bankruptcy Trustees Association is likely to be dissolved with the passage of the new Bankruptcy Law. The Law requires the establishment of a new Chamber of Trustees. As a condition of licensing, all trustees will have to be members of the Chamber. The Law prescribes the basic structure, authorities and obligations of the Chamber. The Chamber will regulate its organization, management, work, and financing. It will have direct responsibility to regulate the rights and obligations of bankruptcy trustees including the development of a trustee code of conduct, professional standards, conflict of interest policies, continuing education obligations, monitoring of trustee activities and instituting disciplinary procedures and proceedings.

The design of the Chamber and its relationship to the Ministry of Economy has been mapped out in similar fashion to the structure in Canada, where the Canadian Association of Insolvency and Reorganization Professionals (CAIRP) coordinates its activities with the Superintendent of Bankruptcy, a government body. The Chamber will have significant monitoring and regulatory responsibilities but the ultimate word on certain matters (such as the content of the Code of Conduct and Professional Standards) will be subject to Ministry of Economy approval. Although the Ministry of Economy will issue the license to a trustee, expulsion from the Chamber will result in a loss of the license. Therefore, both the Chamber and the Ministry will have significant public authorities and responsibilities.

As was done with the Company Law, the Macedonian Judges Association has been active in the bankruptcy reform discussion and with ongoing education, in part, due to the assistance of USAID through the CG&CL project. MJA has engaged in the public hearing process and will support judicial training on the new law through the CCE. Three former bankruptcy judges were members of the drafting committee charged with rewriting the bankruptcy law. Therefore, there has been both formal and ad hoc input obtained from judges during the consultation and drafting processes.

The Macedonian Bar Association is still viewed by some as an elitist Association that caters to a small number of legal practitioners. The Macedonia Business Lawyers Association (MBLA), a private, voluntary association of in-house counsel, notaries, judges and lawyers, has been by far the more active association dealing with bankruptcy issues. Its last two semi-annual conferences devoted considerable time to bankruptcy issues. With attendance levels ranging between 500 and 600 lawyers and judges, these sessions are perhaps the most effective forum for active discussion and idea exchange.

# COLLATERAL

## OVERVIEW

Collateral Law continues to score well across all dimensions. Moreover, this area has shown continual improvement since 2000. The most obvious changes during this assessment period were in the Supporting Institutions, which also had the greatest need for improvement.

Implementing Institutions have maintained a strong consistent score of 87%, which reflects very high scores for the Pledge Registry (average 98%) combined with consistently low scores for the courts (53%) to create the lower average. As further discussed below, neither institution has changed its scores over the course of the three Assessments. For the Pledge Registry, this is very positive because they have maintained their initial high rating for five years without slipping. For the courts, it means that the woeful performance of 2000 has not gotten any better.

Improvements in the Legal Framework were slight, moving from 91% to 94%. The fact that scores improved at all from their previous high ranking is very significant: the changes were simple refinements rather than systemic overhauls, suggesting that the process of reform has become more mature and refined.

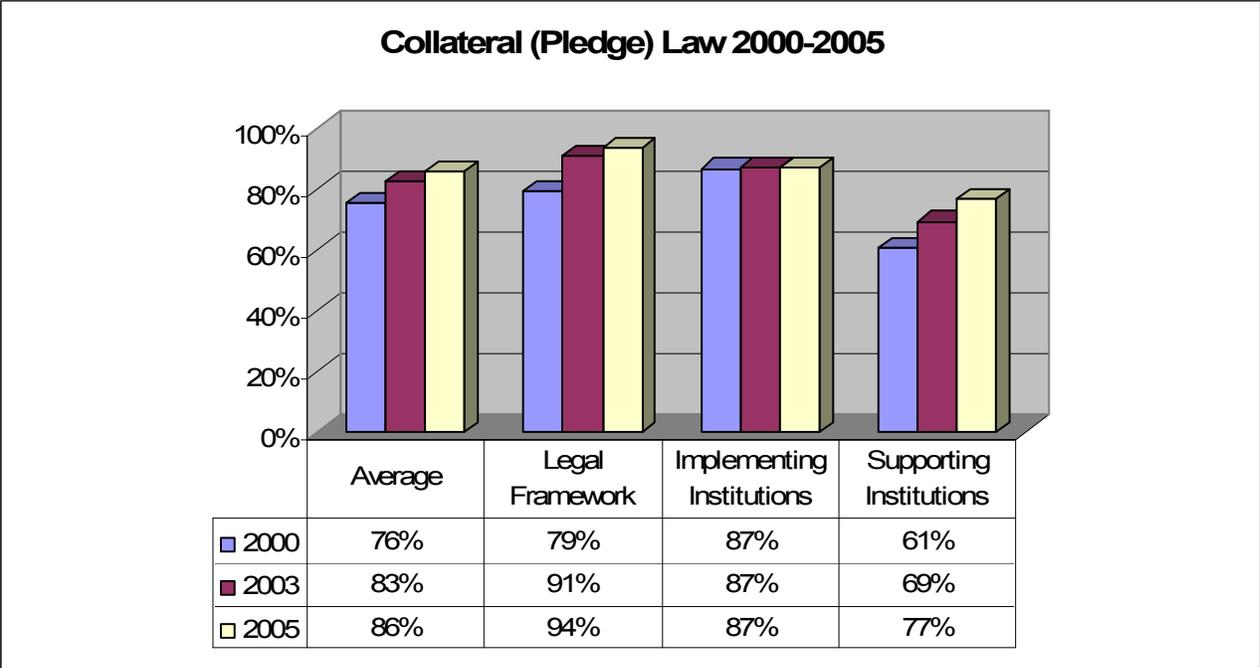
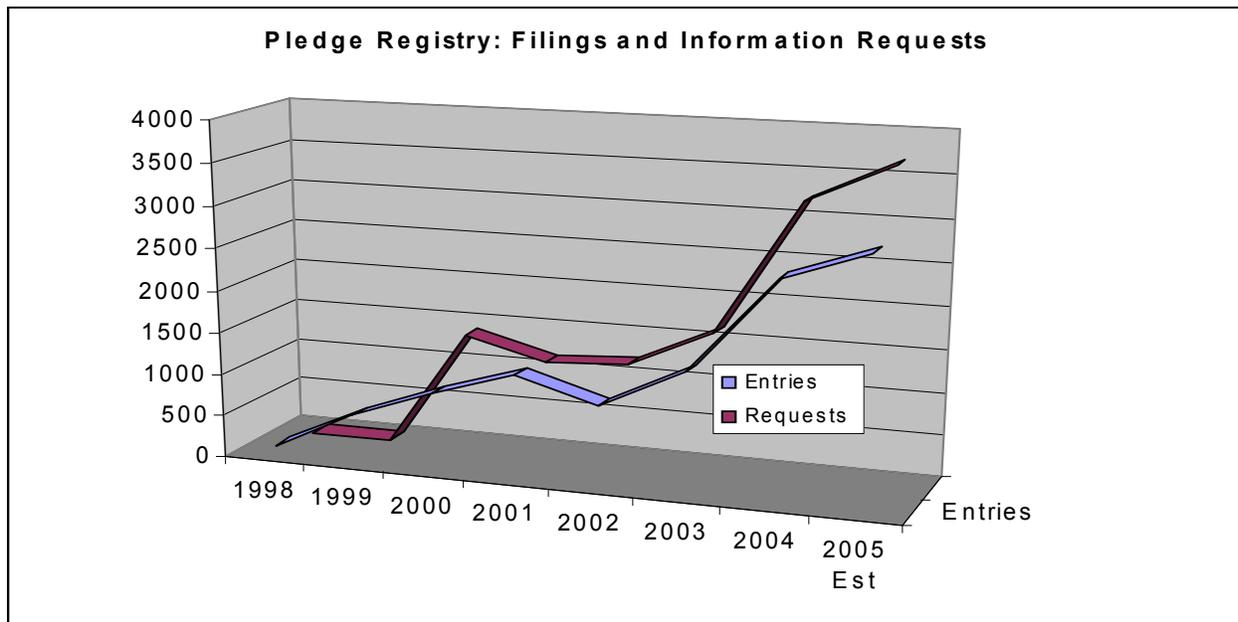


Figure 6 - Collateral Law Comparative Scores

The improvements in indicators are echoed in the statistics on filing, showing that lender confidence in the system is solid. Secured lending against movable property continues to increase, with a solid recovery since the downturn in 2001-02 from the Kosovo conflict. In 2004, there were 2,546 new filings, a 78% increase over the prior year. New registrations are up almost 15% for 2005, with estimates reaching approximately 2,900 for the past year. Approximately 90% of the filings are for vehicle purchases, with only 10% for equipment and other assets. This suggests that secured lending for investments is still underutilized. As further discussed below, this is due in great part to the ongoing failure of the judicial system to ensure enforcement. Even so, the pledge registry system continues to support and enhance credit availability.

Another significant trend is shown in these pledge registry statistics. Lenders are using the registry for credit information prior to making loans. Requests for information have increased by more than 50% per year since 2002, and generally exceed actual filings by more than 30%. In 2005, requests are expected to reach almost 3,700. Macedonia currently has no credit information bureau, so the registry is partly filling that gap by permitting



**Figure 7 - Pledge Registry Filings and Requests**

lenders to check on their borrowers prior to extending credit.

The Collateral Law system in Macedonia is clearly an economic success story. The success is mixed, however, because the underlying system is based on a model that mixes business need and questionably useful government intervention. This hybrid imposes additional costs that depress the rate of growth, especially for lower value loans in which it is difficult for borrowers to absorb these additional costs. Consequently, Macedonia is no longer the best model for countries considering introduction of pledge registries: it has been eclipsed by far more effective and efficient pledge systems in Albania and Bosnia and Herzegovina (BiH). The pledge registry in BiH, for example, opened in January 2005. By September, more than 10,000 loans had been registered. Estimates for the entire year exceed 13,000, more than Macedonia's total filings since opening in 1998. Even after controlling for population and economic health generally, it is clear that the BiH system is more attractive to a broader range of lenders (and substantially cheaper) than the Macedonian system for movable property pledges.

This negative aspect of the analysis should not detract unduly from the tremendous success of the pledge registry as an Implementing Institution. The successful and generally efficient operation of the registry has enabled Macedonia to make an important advance that none of its neighbors have achieved by moving the company registration process out of the courts and into the registry. This move (part of the one-stop-shop reforms

described in Company Law) would not have been thinkable without the registry's proven ability to handle pledge and other registries. Thus, it is an example of the "virtuous cycle" in which one positive reform can generate or support another.

## LEGAL FRAMEWORK

The underlying laws for pledge improved in two ways, neither fully expected in light of the general success of this area. Substantively, the system was improved through legal amendments permitting private enforcement of contracts. Recent changes now permit lenders to use self-help to repossess secured assets if the borrower gives consent through a notarized agreement. In practice, this means that banks are shifting their standardized contracts for secured lending to include borrower consent. It also creates a basis for development of collection services to supplement and replace less effective court proceedings. Both lead to greater efficiency and lower cost. More importantly, the successful use of private enforcement has lowered lending risk, which may have already led to reduced rates for some secured loans.

A second substantive change is significant for the integrity of the system for trading registered securities, though less important for collateral lending *per se*. Prior law permitted lenders to take ownership of pledged assets – including publicly traded shares in companies – in satisfaction of the outstanding debt. The laws regulating publicly traded securities required that all shares be sold or otherwise transferred through the stock exchange. The Collateral Law thus created an unintended exception to the securities trading system, opening an opportunity for abuse and fraud. The recent amendments to the Collateral Law have addressed this by requiring that such assets be sold through the stock exchange, with the lender keeping the proceeds, but not the shares themselves.

Finally, the law was amended to require the registration of leases. Although not particularly popular among the leasing companies (because of increased transaction costs), this change lowers the risk of fraud by lessees who might attempt to use leased property as collateral and clarifies priorities in the event lenders seek to attach leased property in satisfaction of unsecured debts.

These simple yet significant improvements to the legal regime represent more than substantive changes to law. They reflect improvements in the approach to law by stakeholders who identified minor flaws and pressed for change. In the past, most reforms have involved very large-scale amendment, replacement or introduction of entire laws or codes. These are more focused refinements, suggesting a certain maturation process underway in which stakeholders are able to identify, analyze and correct mistakes and problems as they arise, rather than having to wait years for more complex and complete revisions.

Another example of this can be seen in the laws regulating leases. Leasing companies noted that tax authorities had misunderstood the nature of leasing contracts and were attributing depreciation expenses to the wrong parties, substantially increasing tax costs for the leasing companies (and, as a result, the overall cost of leasing). The companies constructively engaged the tax authorities, explained the problem and the solution, and succeeded in having the regulations corrected. While seemingly a minor matter, this successful reform is indicative of significant positive changes taking place in the legislative and regulatory process.

The victory, unfortunately, is not complete. Leasing companies still complain that tax treatment of lease/buy-back operations is creating unjustified and inappropriately high tax rates on these transactions, thus depressing their use and availability. In addition, there are strong and cogent arguments that the existing Leasing Law was not needed and has not actually improved the environment for leasing, which was adequately regulated by the existing Law on Obligations. Indeed, there are nations with vibrant leasing industries that have no specific leasing law at all. On the other hand, Macedonian tradition favors explicit legal permission before stakeholders are fully comfortable with attempting new forms of commerce or contract, and having the law has provided reassurance to many that leases

are fully legal. Some government counterparts would even like to see more detailed regulations for leasing transactions, but this should be resisted.

As noted in the introduction (and in the 2003 Assessment), the very positive scores for Collateral Law should not overlook certain design flaws that are not adequately covered by the CLIR diagnostic scoring methodology. The Macedonian pledge system is a hybrid: it combines essential elements of notice registries (which efficiently ensure lender priority, reduce conflicts and promote payment discipline) with government intervention and protection. In Macedonia, a pledgor must file the entire pledge contract so that the registry can determine whether the pledge details are accurately stated and so that the government (primarily tax authorities) can gain access to financial information regarding the underlying transactions. While both goals are appropriate within the overall commercial and taxation system, they are not necessarily appropriate to combine within the registry. Other systems permit the parties to police each other for accuracy in filings and protect themselves, and government authorities use other avenues for obtaining the information that Macedonia collects through pledges.

There are several significant shortcomings from this hybrid model. First, the cost of scanning large documents and maintaining archives (albeit electronically) for investigation raises the overall cost of registering pledges. This is important in lower value transactions, such as consumer lending or small loans for investments by micro-enterprises. The higher cost eliminates some loans. When combined with another unnecessary provision – that pledges are legal and valid only if registered – this means that the existing system has eliminated an important source of lower-cost credit for the neediest segments of society. It also retards growth in the use of pledges for non-bank financing, such as loans granted by suppliers to their customers.

Second, the current system creates inefficiencies and marginally increases risks. Notice registries, such as those in BiH or Canada, for example, permit lenders to file notices during the pledge negotiation and preparation period to prevent fraud and protect their investment in the pledge creation process. As a result, the risks of fraud are lower and the overall process is easier. Both factors translate into improved pricing for borrowers. Macedonians pay a premium for their system that is not required or needed.

It is unlikely that this will be changed in the long-term, as noted below in the discussion of the Market for Reform. Transaction costs will be lowered as the registry becomes accessible by internet (with responsibility for scanning documents delegated to the parties, possibly at lower cost), which should permit some increase in pledge contracts for lower value financing.

## **IMPLEMENTING INSTITUTIONS**

The primary Implementing Institution for Collateral Law is the Central Registry of the Republic of Macedonia, Pledge Department (the “Pledge Registry” or “Registry”). The courts serve as a secondary Implementing Institution as well.

Scores for the Registry remained very high in 2005. The average score of 87% has been constant since 2000, indicating strong, consistent performance by the personnel and management of the Registry. As noted in the introduction, this performance record was a significant factor in the decision to shift company registration from the courts to the Central Registry: although there are many legal arguments for the change, none is as important as having a trustworthy implementer to handle the work.

These scores reflect very high private sector satisfaction with the Registry and its work. Respondents consistently expressed high regard for implementation at the Registry level. Only two significant complaints were offered. The first has to do with the underlying law that requires scanning of extensive documents and the additional cost this requires. Users felt that the Registry handled the scanning effectively, however. The second was the lack of

internet access to Registry information and filings. Internet-based filing and search are being established, however, and should be completed and available in 2006.

For policy makers and Supporting Institutions, there is one minor complaint. Statistics are not easily available without visiting the Registry and making special requests. Although the staff is very forthcoming and supplied the assessment team with statistics charted above, the Registry does not have readily available information on value, type or time-series statistics that are useful for analyzing and tracking movement developments. Such information is subject to special request. It would be good to see regular publication of this information for broad public dissemination.

It should be noted that the average score for Implementing Institutions combines scores for organization and operations of the Registry with scores for the courts. The average score for the Registry was 98%, while courts received a very disappointing 53%. As a result, the overall score of 87% by itself gives the impression that there is still significant room and need for improvement at the Registry level. There is not (other than internet accessibility) – the only serious problems are in the courts.

The weakness at the court level can be summarized in one word: enforcement. Several stakeholders noted that the risk of non-payment arises directly from the failure of the judicial system to enforce pledge (or other) contracts effectively, efficiently and in a timely manner. Although enforcement itself has improved by the legalized use of self-help and notaries – improvements applauded by users – enforcement by the courts is no better than it was in 2000. The industry is using new enforcement options effectively, but contracts that pre-date the legal changes are still subject to court enforcement, keeping overall risk to secured lenders high.

## **SUPPORTING INSTITUTIONS**

Supporting Institutions for Collateral Law continued to improve substantially. Scores for 2005 rose 8 points to 77% - up from 69% in 2003 and 61% in 2000. This ongoing advancement for the current period is founded on improvements in non-judicial enforcement and private-sector involvement in legal reform.

The improvements reflect implementation of amendments to notary and collateral law over the past two years. In 2003, notaries were empowered (or inducted) as enforcement agents in limited circumstances. While controversial at the time, the changes in practice have been well received. Stakeholders have been generally pleased with the cost and effectiveness of notarial enforcement, and note that the existence of this option has been helpful in improving payment behavior in the market. However, when the debtor is highly resistant to payment, courts are still required.

In addition, the use of notarized consents for private repossession has resulted in the improved enforcement and has stimulated initial growth of collection services. At present, such services tend to be tied to a single customer, but the fact that there are now several providers of repossession services is a substantial improvement since 2003.

Other improvements came in the area of private sector involvement in legal reform. As already noted, the Collateral Law regime was refined over the past two years through specific, limited reforms targeting simple issues. Various private sector actors and organizations were involved in identifying, analyzing and advocating changes. This is an important positive development. Even so, the overall realm of professional and business associations is still weak in this area, with no regular, systematic approach to identifying and analyzing reform needs.

Another weakness is found in training and education. Legal professionals note that changes in law and practice are not effectively disseminated to the legal and business community, nor are they adequately captured in a timely manner in the curriculum of law faculties or business courses. As a result, implementation and adaptation are

much slower than necessary, and new entrants to law and business are not properly prepared for the existing legal environment. Unfortunately, this complaint is true for all areas of law in this Assessment.

## **MARKET FOR REFORM OF COLLATERAL LAW SYSTEM**

The market for reform in Collateral Law is generally satisfied at present. Changes are needed, but there is no significant demand for those changes yet. A move to internet access by the Pledge Registry will meet the principal demand for change at that level.

The only major exception is in the judicial enforcement regime, which is covered in detail elsewhere and need not be repeated here. It is sufficient to note that there is great demand for a reliable system of enforcement, and that efforts are underway to correct the current deficiencies through changes in procedure and creation of private enforcement agents. These reforms do not come into effect until 2006 and will require time to implement.

The minor exception to “equilibrium” in the market for reform is in the area of an improved model for pledge registration. Stakeholders operating in markets that use more efficient pledge registry systems would like to see the current system upgraded through simplification. The existing system is working decently, however, so there is little active demand for change. Reform, if it comes, will need to involve a broader discussion than the simple functional aspects of how much information should be required. The current model is based on an understanding of the role of government as protector of all parties to the pledge transaction. Simpler notice-registry models presume that the parties can take care of themselves and, if not, that the protections can be obtained through market sanctions and judicial intervention. Currently, supporters of the existing system express a strong degree of suspicion of the notice-registry system.

On a practical level, changing the system will require amendments to the existing pledge law regime, with all of the work that entails. It will also require software changes. These are unlikely to be difficult, but they are a cost to be considered.

# COMPANY

## OVERVIEW

Reform of Company Law and its institutions has been a long-term process involving a number of separate and distinct donors and local institutions. The participatory process used in the reforms, including some earlier, misguided approaches, has resulted in vastly improved understanding of the principles and importance of a modern company law regime. Significantly, the investment in participatory drafting and development of the law has led to a general consensus on what the law should look like, and having achieved consensus is now leading to much smoother implementation. Without consensus, reforms must rely on enforcement powers of the state to bring the recalcitrant into line; with consensus, all stakeholders can immediately move to implementation.

It is not surprising, therefore, to see the improved scores for all dimensions of Company Law. Since 2000, the law has improved by 16 points, and is now substantially in compliance with international standards. The Implementing Institutions have also improved dramatically, from 45% (2000) to 62% (2003) to 66% (2005). The current score leaves much room for improvement, but that improvement is currently underway. In addition, Supporting Institutions have moved from 52% to 64% over the period of these assessments, in great part due to the work with Supporting Institutions in the participatory process of drafting the law.

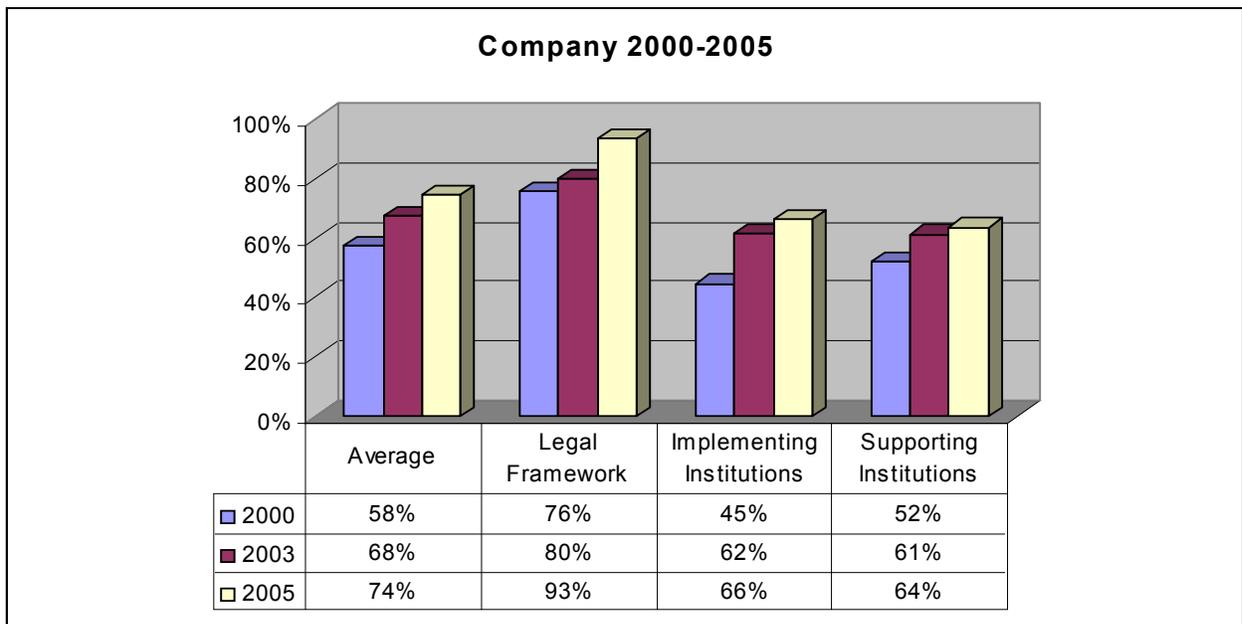


Figure 8 - Company Law Comparative Scores

## LEGAL FRAMEWORK

During the completion of the 2003 CLIR diagnostic, the GOM had been focused on the drafting of a new company law. After more than 596 working days spent by members of the drafting committee and staff of the CG&CL Project on the modernization of the 1996 company law (excluding EU expert days and support staff), the Macedonian 2004 Company Law was passed by Parliament on April 30, 2004 with an effective date of May 8, 2004.

The enactment of the 2004 Company Law was notable not only due to its successful conclusion, but also by virtue of the process used to develop the law. Over the course of the two readings, 27 public hearings were staged by the Ministry of Economy with logistical support from CG&CL.

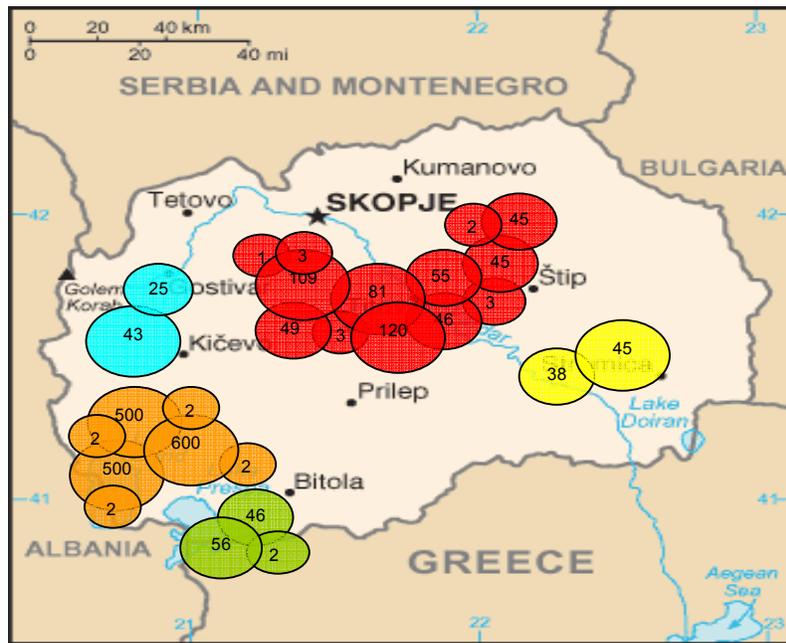


Figure 9 - Public Debates on the 2004 Company Law

The public hearing locations are highlighted in Figure 9. The numbers contained within a circle denote the number of attendees at the hearing.

The 2005 CLIR assessment shows a significant increase in the legal framework score compared with 2003 results (93% versus 80%). The reasons attributable to the increase include:

- Improved aspects of corporation forms and mechanics;
- Increased shareholder protections, especially related to redemption rights arising from fundamental changes in corporate structure and the provision of legal means to enforce shareholder rights; and
- Strengthened creditor rights both under the Company Law and as a result of a new enforcement law.

## THE COMPANY LAW

The Company Law provides for leading edge governance requirements particularly in its applicability to joint stock companies (whether listed or non-listed) with respect to:

- The disclosure of the companies' operational and general financial status;
- Disclosure of executive compensation and non-executive board remuneration;
- Cumulative voting when provided by the charter of the company;
- Limitations on the number of directorships of directors and managers;
- Disclosure and regulation of large transactions and related party transactions;
- Non-competition and conflict of interest measures applicable to directors and managers;
- Establishment of baseline director and managerial standards of care that, if breached, can give rise to personal liability;
- Protection of shareholders during reorganizations (merger, acquisition and division);
- Rights of minority shareholders;
- Shareholders' right to information about the company; and
- Accounting requirements applicable to medium and large-sized joint stock companies that are in line with international financial reporting standards.

In addition to governance improvements, several other aspects of the Law should help to improve the efficiency of the commercial sector and assist in demonstrating that Macedonia's Government is fully aware of and has demonstrated compliance with international commercial law standards. These improvements include:

- Establishment of a National Electronic Commercial Register: A new national, electronic and publicly accessible commercial register is in the process of being established. This registry will eventually accommodate electronic filing and will allow individuals to obtain certified documents electronically. This database will be maintained at the Central Registry;
- Streamlining of the Business Registration Process: A framework is established that reduces the lead time, scope of review and processing time for business registrations;
- Simplified Registration for Small Suppliers: The Law also creates a new category of small scope commercial activity. Those qualifying as small suppliers will be permitted to operate outside the mainstream business registration process. For example, street vendors may register with the local municipality and are exempted from the bookkeeping requirements of the Law;
- Legal Mandate for the One-Stop Shop: The Law mandates the enactment of regulations in support of a one-stop shop. The purpose is to consolidate business filing, licensing and application requirements so that the steps required for a business to become and continue to be operational are minimized. The ultimate goal is to enable a company to deal with all administrative requirements in one place at one time;

- EU Approximation - The law complies with the EU Company Law Directives thereby supporting Macedonia's EU legal approximation objectives;
- OECD Compliance – The Law fully complies with OECD's White Paper on Corporate Governance in Southeastern Europe.

## **SUPPORTING REGULATIONS**

Passing a law is not an end; it is a beginning. The Company Law contains timelines that require Ministerial enactment of specified regulations. For example, the Law requires the Ministry of Economy to enact a by-law covering the one stop shop system within 90 days of the effective date of the law. The Ministry of Justice is obligated to adopt an act within 60 days of the Law's passage that would set out the maintenance of the commercial register, the manner of business registration, prescribed forms, the relationship between the court and the Central Register, the establishment of the one-stop-shop system and any other issues pertinent to the proper maintenance of the Commercial Register. Other regulations, such as the small supplier registration rules, are required to be enacted within 90 days of the effective date of the Law.

**The Business Registration Regulation.** Without these accompanying regulations, the Company Law legal framework is left incomplete with certain key requirements left in limbo. Because responsibility for the enactment of regulation is not confined to one ministry, coordination between ministries became a significant issue. On May 27th, 2004, the Ministry of Justice appointed the working group designated to draft the business registration regulations. Despite the 60 day deadline, the regulation was not adopted until February 1, 2005. This delay left the registration courts without a legally enforceable set of registration rules. Initially, registration procedures were delayed with the expectation that a regulation would soon be forthcoming. Eventually, the registration judges continued registration activities using the previous rules applicable pursuant to the 1996 Company Law. The overall effect of the GOM's inability to act in a timely manner was a significant increase in the average processing time of registration applications – a result quite contrary to the objectives underlying the new law.

The Ministry of Economy is the prime sponsor of the new Law. One might assume that the most responsive ministry with respect to implementation matters would be the Ministry of Economy. Unfortunately, this was not the case. The working group on the one stop shop regulation was officially appointed on July 15, 2004 (shortly before the deadline for submission of the one stop shop regulation). In addition to the working group appointment, the Ministry issued an information regarding the need to amend certain laws to facilitate the implementation of the one stop shop. On July 19, 2004, the Government resolved that the competent Ministries should immediately commence preparation of the necessary legislative and regulatory amendments to facilitate the one stop shop implementation in accordance with the Ministry of Economy regulation. While the information was meant to stimulate activity, the Ministry did little other than issue the information to ensure that the timelines under the Law were satisfied. By the end of 2004, the one stop shop regulation had not been enacted and work had not begun on the small supplier carve out.

**The Small Supplier Regulation.** On July 17, 2005, the Regulation for Small Scale Commercial Activity and the Manner of its Registration was announced in the Official Gazette. The purpose of the small supplier provisions was to have simplified registration and lowered costs for these low earnings traders. Unfortunately, the regulation in its current form fails to accomplish these basic objectives. There are a host of difficulties, but the main drawbacks are as follows:

- The scope of activities covered by the regulation is too limited to capture a significant number of small scale traders;
- Only unemployed individuals are eligible to register as a small supplier. Other threshold requirements are related to the physical premises where work is performed as opposed to thresholds related to business volume or earnings;
- Registration must be renewed annually, presumably for additional fees;
- There are no details as to how and when tax liability and social fund contributions should be calculated. Without specifying a special methodology, calculations will fall under the normal rules and trigger liabilities for which the timing of payment and amounts will be untenable. Such rules applied at these low income levels will discourage registration;
- The registration is to be processed at the municipal level. However, certain decisions are left to the discretion of the Mayor. This could result in disparate rules from one municipality to another; and
- The objective of the small supplier registration was to allow for a local and simplified registration process. It was not intended to impose local registration restrictions so as to restrict the mobility of small scale vendors. The regulation will result in registration requirements for each location. It would be preferable to allow for local registration with national application. The current registration mixes registration issues with zoning and other matters.

The regulation, in its current form, runs contrary to the intent of Article 11 of the Company Law and will most assuredly discourage as opposed to encourage small supplier registration. The regulation should be completely re-written.

## **THE ONE-STOP-SHOP LAW**

The failure to enact the one stop shop regulation on a timely basis turned from a negative to a positive. From the outset, CG&CL had lobbied to have the authority to process registration applications shifted away from the courts to an administrative body. Several hurdles prevented an explicit provision from being enacted in the Company Law.

- Some constitutional experts argued that removal of the registration court authority would require an amendment to the Law on Courts and possibly a constitutional amendment. Any change in the court's jurisdiction requires approval of Parliament by at least a 2/3 majority. The Ministry of Economy did not want to risk failing to pass the law. It sought unanimity from experts on the jurisdictional questions. When it became apparent that unanimity was not possible, an explicit transfer of authority was withdrawn from the table.
- Aside from jurisdictional issues, there were also practical budgetary implications. Company registrations are a source of revenue for the courts. The budgetary impact of its removal had to be addressed;
- If a transfer of authority was to take place, most experts opined that all registration records would have to be transferred to the new authority to maintain the integrity of the commercial registry. This would mean

the transfer of more than 80,000 registration records from the physical files of the three registration courts; and

- Additional financial resources would have to be allocated to purchase the IT equipment and staff the new registration authority.

Shortly before the Company Law was submitted to Parliament in April changes were made to the registration provisions of the Law. These changes removed specific reference to the courts in the registration activities and, instead, referred to an authorized body. This compromise left open the possibility that a shift in registration authority could occur later without the necessity of amending the Company Law.

Over the course of the debate regarding the provisions of the Company Law and thereafter, the obvious choice of successor for registration activities was the Central Registry. It has 30 networked local offices and sufficient equipment and IT expertise to move forward with the file conversion and implementation. During the 2004 deliberations, the Central Registry management became increasingly frustrated at the one stop shop drafting committee impasse. This frustration led to background lobbying. Eventually, resolution of the impasse was escalated to the executive level of the GOM. In January 2005 a Steering Committee chaired by the Vice President, Minco Jordanov, and comprised of representatives from all relevant ministries and agencies (including the Ministries of Finance, Justice and Economy, the Central Registry, the Public Revenue Office, the State Bureau of Statistics, private banks and the Supreme Court) was constituted. The Committee mandated that a study be prepared that specified all tasks necessary to implement the one stop shop system within precise timelines. Specific working groups were established to address legislative drafting, IT development and conversion issues. The Steering Committee endorsed the transfer of registration authority from the courts to the Central Registry. Finally, there was sufficient political weight to push the process forward.

The business registration regulation enacted on February 1, 2005 required all companies who file annual reports to complete an additional data form with the February 28th filing. The form contained basic information on the companies that would then be used as a cross check on physical registration files maintained by the courts. In essence, this was the first step in the transfer of authority and physical data from the courts to the Central Registry. Throughout the spring, summer and fall, Central Registry staff transferred files from the registration courts, scanned and then returned the files to the courts. The conversion process had commenced in earnest.

On September 23, 2005, the Law on One Stop Shop System and the Maintenance of Registers of Business and Other Legal Entities (the One Stop Shop Law) was passed by Parliament. This Law broadened the Central Registry's mandate not only to assume responsibility for business registration but also to maintain all registers maintained by the GOM. With respect to registration, the final version ensured that electronic filing would be accommodated and that the Central Registry would have the legal authority to issue certified copies of documents contained in the commercial register either electronically or physically at the choice of the client. One unique identification number would be assigned to each business registrant. That number is intended to be the identifier used by businesses for all government purposes. Other numbers will continue to be used (for example the tax number by the PRO). These other numbers will be for the internal use of the respective ministries and agencies so that drastic systems changes in these ministries and agencies will not be required for existing information systems. Instead, interfaces will be built to ensure that the unique identifier provided by the business will be cross-linked to the existing numbering systems. If implemented correctly, the internal workings will be invisible to the end user business. The new commercial registration system is slated to go live as of January 1, 2006. Upon completion of the conversion process, the electronic database comprising the commercial register will be the legal authority for all commercial registration purposes.

The assumption of the other registries also has important ramifications for commercial practice. For example, all announcements related to bankruptcy proceedings will now be published on the Central Registry website. In effect, the Central Registry website will have the same legal force as the Official Gazette and most announcements

will have legal effect as of the day following the posting. This means businesses, creditors and other interested parties will be able to obtain timely and accurate information online.

## **CURRENT EXPOSURE**

As will be further explained in the Implementing Institutions section, progress comes at a price. Court registration indicators are worse this year compared with previous years. There are two basic reasons.

1. The system is in transition. The judges were using the old registration rules (pre-Company Law 2004) in 2004 and the first month of 2005. On February 1, 2005, the new registration regulation was enacted under the Company Law. However, this regulation was destined not to be implemented. The legal working group, convened under the One Stop Shop Steering Committee, drafted a new law which was adopted by Parliament on September 23, 2005 and had the effect of nullifying the business registration regulation. In the space of a year, the registration courts were faced with three sets of registration rules, the transfer of their authority over registration to the Central Registry, the mayhem of constant file transfers and a reduction in processing capacity due to the transfer of registration court judges to other departments.
2. Compounding the above problems, the Company Law mandated that Companies must file compliance amendments with the Law by June 30, 2005. As is typically the case, companies delayed filing until the last possible moment. This meant a torrent of applications was received at the deadline in sufficient volume to bury an already deluged system.

The brighter side in all of this is that the Central Registry has progressed well with court file conversions and will be positioned to assume registration responsibilities in the New Year. The new system will accommodate electronic filing (eventually). In the mid-term, there should be significant improvement in the overall efficiency of the registration system and, in particular, in the application processing lead time.

## **IMPLEMENTING INSTITUTIONS**

There has been a modest increase in the CLIR index results comparing the implementing institutions score from 2005 with 2003 (66% versus 62%). The increase is attributable to:

- Improvements in the organization and operation of the company registrar (primarily due to the shift in responsibility from the registration courts to the Central Registry); and
- Improvements in the types of legal remedies and recourse made available under the new Company Law that, in turn, further empower the courts to act when violations arise.

**THE COURTS.** Under the Company Law, the maximum time permitted for a decision on a registration application is eight days. In 2003, prior to the passage of the current law, CG&CL surveyed the three registration courts with the objective of determining the average processing time for various types of registration applications filed between September 2002 and August 2003. Since the files were not stored electronically, representative cases were selected by a manual review of the court files. Surprisingly, the average timeframe for initial registration of LLCs was 7.6 days, below the future benchmark of 8 days. There were relatively few new JSC registration applications. The 2003 JSC registration application processing time varied considerably within a small sample with an overall average of 27.4 days. There was substantially greater delay in the processing of amendments compared with initial registrations.

The above survey was replicated in 2005 for the comparable 2004/2005 period. The overall average processing time had lengthened considerably to 22 days for LLCs and 44 days for JSCs. These average times may be skewed. Several applications were filed and not completed at the time the survey results were compiled. These incomplete applications generally related to Company Law compliance amendments filed at or near the June 30, 2005 deadline. These incomplete applications were dropped from the survey sample used to calculate the above averages. If included, the reported average times would increase significantly.

The Courts will continue to play a significant role under the Company Law, but not in the registration process. With the passage of the One Stop Shop Law, registration responsibility will shift to the Central Registry as of January 1, 2006. However, the courts will remain the central arbiter to enforce shareholder collective rights, breaches of directors and officers' duties, shareholder rights to information and the many shareholder remedies expressly provided in the Law.

As has been discussed in the contracts and bankruptcy sections of this report, the overall effectiveness of the law will, in part, depend on the skill level, integrity and autonomy of judges assigned to commercial divisions of the courts and the effectiveness of decision enforcement measures. A recent survey conducted by the Corporate Governance and Company Law Project (October, 2005) identifies the courts as one of the few Macedonian institutions that has not experienced an increase in perceived trust. In fact, the level of trust is on the decline. A survey completed in September of 2004 showed that 63.9% of respondents from the general public think that the courts are ineffective. 65.6% of people believe that the courts do not treat people equally. Almost 56% of respondents feel that the courts lack independence. Of those respondents who have had experience in the courts, almost 69% reported that the courts were ineffective.

The Justice Ministry's Judicial Reform Strategy contains several proposed actions including upgrading of continuous education, establishment of a judicial supervisory board, introduction of new judicial and prosecutorial training institutions, restructuring of judiciary human resource planning, passage of a new Law on Execution and Security, introduction of a new enforcement service and the introduction of a new court budget regime. Some measures have already been implemented (e.g. passage of the Law on Execution and Security and the Law on Court Budget). However, the court reorganization has yet to be implemented. Critical aspects of the court reorganization and the accompanying human resource planning will be to establish dedicated commercial courts or divisions and to commit to placement and longstanding retention of qualified judges to adjudicate commercial cases. The Ministry of Justice has indicated its willingness to move toward dedicated commercial divisions and to restrict depletion of commercially trained judges. These contemplated changes remain outstanding at the time of this CLIR assessment.

**THE CENTRAL REGISTRY.** With the passage of the One Stop Shop Law, responsibility for the processing of business registrations passed to the Central Registry with effect from January 1, 2006. The Central Registry (CR) has 30 local offices. It has direct data connections with all thirty offices with frame relay and ISDN lines as backup. The Registry maintains connections with all major state authorities for purposes of data exchange including the courts. The One Stop Shop Law not only expands the jurisdiction of the CR in the area of business

registration. The CR is assigned the responsibility to administer all government mandated registries. With the assistance of aid from the Norwegian Government, the CR is expanding its hardware and network capacity so that it can assume control and maintenance of the commercial register by January 1, 2006 and assume control of other legal registries by September 30, 2006.

The shift of commercial registry responsibility to the Central Registry is not a one-to-one transfer of responsibility from the courts to the CR. It means a substantial upgrading of government provided business services. The main benefits can be listed as follows:

- Companies will be assigned a unique business number which will serve as the primary reference number for all government/business interaction;
- Other filing requirements (i.e. with the Statistics Bureau, Customs, the Public Revenue Office, and the social funds) will be subsumed in the registration process and automated so that the system fulfills the commitment that businesses need only to “stop once” to achieve their business and government registration objectives;
- The CR has pledged to reduce the cost of registration to reflect the streamlining and efficiency of services;
- Registration activities will be processed at any CR office regardless of the registered business address of the business;
- The legally valid commercial register will be the electronic commercial register maintained by the CR, not the hardcopy court files;
- Certified services will be available both electronically and manually;
- Once adequate digital signature methodology has been implemented, full scale electronic filing will be permitted; and
- The commercial register serves as a public information source and therefore will be open to public query.

Once fully operational, the commercial register should significantly improve the business climate and, with proper implementation, the CR could be viewed as a regional leader in the provision of such services.

**CENTRAL DEPOSITORY.** For joint stock companies, shares are recorded in the Central Depository in a dematerialized form. The Central Depository compiles the shareholders’ record for purposes of providing notice to shareholders and prepares voting lists for the companies’ general meetings of shareholders. In the past, the Depository faced challenges to the compilation of such lists by certain shareholders. These shareholders were recorded as having their rights restricted pursuant to shareholder agreements. Under a typical shareholder agreement, the shareholder’s representative (usually a member of management) had the right to attend and cast votes at the general meeting on the shareholder’s behalf. The disenfranchised shareholder wishing to re-assert his right to attend and vote, attempted to have the Depository retract the voting and other restrictions unilaterally. However, the Depository ruled that it could not render a decision that would affect the relations between parties to a contract. The Depository’s decision (or lack of one) was based on court rulings that defined these agreements as contracts.

In a 2003 CG&CL survey, one quarter of Macedonian joint stock companies, mostly non-listed companies, indicated that they had signed agreements with their shareholders in 2003. The main reasons companies chose to

sign shareholder agreements were that they would provide for “more efficient work” and “better share management.” The main reasons why companies chose not to sign shareholder agreements were that there was no need to sign these (36%) or because shares were held by relatively few people (11%). The majority of companies (52%) indicated that they would be likely to seek a renewal of the shareholder agreements if the new company law allowed this. In signing the agreements, the shareholders gave to management the right to vote during Annual Meetings of Shareholders in 71% of the companies where agreements were signed. Other rights given to management included the right to appoint members of the board of directors (4.9%) and the right to transfer (sell or assign) their shares (6.8%).

From the above data, one can conclude that shareholder agreements would continue to be used as a management tool to restrict shareholder rights in the absence of a legal intervention. The Company Law provides such an intervention, at least with respect to restricting future agreements, activities and proxies. Article 321 specifies that any agreement or other legal activity entered into by a shareholder that infringes on the rights and interests of other shareholders is null and void, unless all shareholders provide their consent to such agreement or legal activity. Article 392 restricts who may represent a shareholder at the general meeting to specifically exclude managers (the prime culprits in past schemes) and directors of the company and related entities as well as close family members of such managers and directors and the legally authorized representatives of such parties. Under the Company Law, the proxy is only applicable for one meeting. Therefore, agreements entered into in future that purport to limit rights over an extended period of time will be considered void.

## SUPPORTING INSTITUTIONS

The overall scores for supporting institutions have been static comparing the 2005 CLIR to the 2003 results (62% to 61%, respectively). However, this masks specific improvements in targeted areas. In particular, improvements are visible in:

- The gathering of data on company registrations, liquidations, and other statistics of interest to policy makers and the private sector;
- Incorporation of international financial reporting and valuation standards as part of the overall company law reform process;
- Media reporting on matters related to the company law; and
- Active participation of company representatives on corporate governance issues.

However, the gains in scoring on the above issues are offset by the overall dissatisfaction with the current business registration process. If one can assume that this dissatisfaction will dissipate upon the Central Registry implementation of the commercial register, there should be a significant upward trend in this section.

**THE MBLA.** One of the prime supporting organizations on company law matters is the Macedonian Business Lawyers Association (MBLA). It has devoted considerable time both to the discussion of company law and bankruptcy reform, having made these primary topics in several of its conferences. These conferences attract business law practitioners, judges, notaries and law professors. Enrollment usually ranges from 500 to 600 attendees. The MBLA has positioned itself as the most effective voice to promote dialogue and policy

development in commercial law amongst legal practitioners. In addition to the semi-annual conference events, the Association publishes a monthly magazine and numerous special purpose publications. It embarked on a dedicated program of continuing member education on the Company Law following its passage.

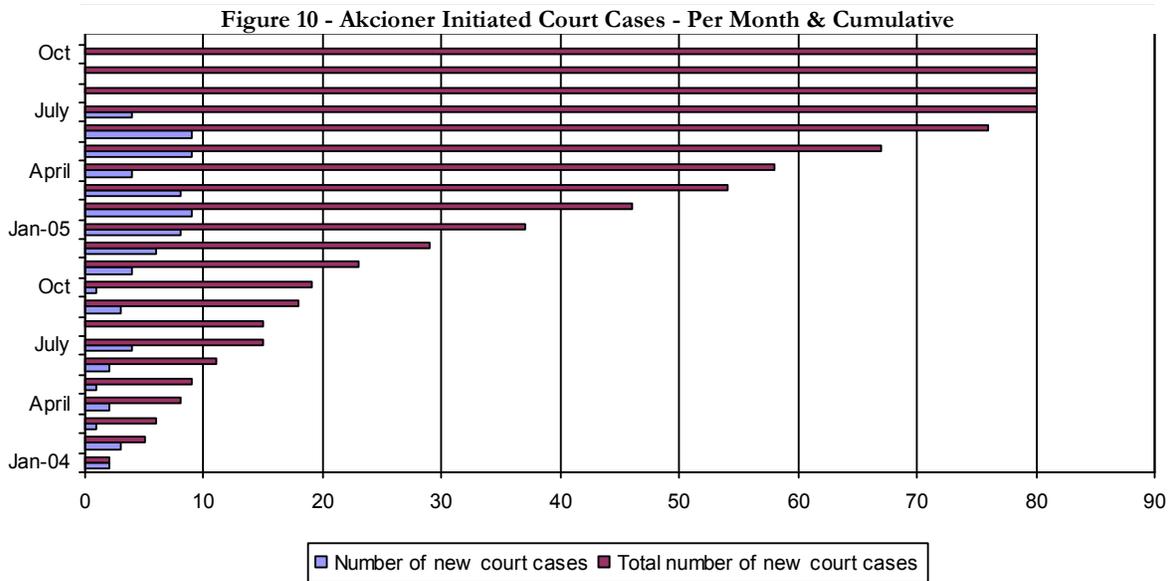
**AKCIONER.** Akcioner is a non-governmental organization (NGO) created in 2001 with the express purpose of promoting and protecting the rights of minority shareholders as guaranteed by the 2004 company law and other national legislation. In seeking ways to advocate against policies, laws, and business practices that result in the violation of shareholder rights, Akcioner organizes its efforts around the following five activity areas, which represent the core of its mission as a shareholder association:

- Education of shareholders about the protection of their rights;
- Legal aid and legal counseling (advocacy clinic for shareholder rights);
- Representation and lobbying institutions in Macedonia;
- Organizing shareholders for collective actions; and
- Mediation between companies and shareholders.

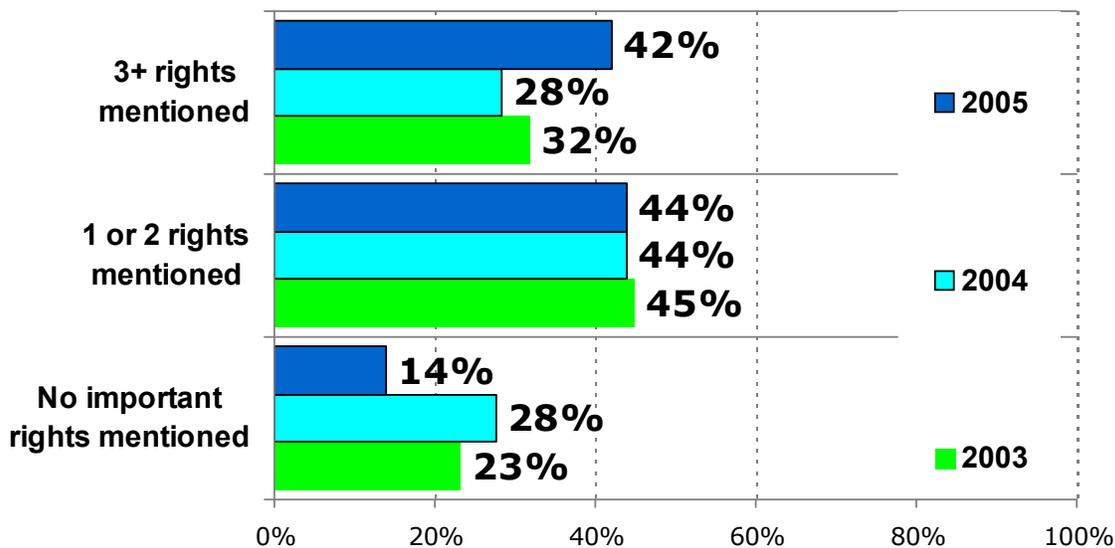
The members of Akcioner's management bodies are shareholders of Macedonian companies. Akcioner has also developed a network of regional coordinators in almost all major cities in Macedonia. In addition, shareholder representatives in major Macedonian joint stock companies are included in the NGO's national network. Akcioner is also a member of Euroshareholders.

As part of Akcioner's educational program, the NGO has been publishing a newsletter for retail shareholders with support of the CG&CL Project and the Center for International Private Enterprise (CIPE). In 2005, Akcioner organized its first international conference of shareholder rights in Bitola in close cooperation with the Project and Euroshareholders.

Akcioner's traditional constituency is largely comprised of impoverished employee-shareholders, for whom even a modest membership fee is difficult to contribute. The average household income of retail shareholders is 200 Euros per month. The difficult financial situation of retail shareholders makes it extremely difficult for the NGO to become financially sustainable. It continues to rely on support of donor agencies such as CIPE and USAID. Despite ongoing questions of sustainability, Akcioner has made impressive advances. It has staged multiple town hall meetings throughout the country to discuss issues such as shareholder democracy, shareholder agreements and the new Company Law. However, the most impressive statistics and the activity that garners the most media coverage are the legal actions that have been undertaken by Akcioner. The following Figure shows the total and newly initiated cases supported by Akcioner.



A major obstacle to the work of Akcioner continues to be the bureaucratic and cumbersome nature of the court system. Frequently, Akcioner has been denied access to company registration records maintained by the court system. Corruption and conflicts of interest worsen the legal environment in which it operates. Despite this, Akcioner has filed charges in more than 80 court cases. While the majority of these cases are still pending, Akcioner has recorded victories and, as a result, is being viewed more seriously by the media and current and potential members.



**Figure 11 - Number of Rights Mentioned**

The efforts of Akcioner, combined with the public relations and public education campaigns sponsored by CG&CL, have served to improve shareholder awareness of their rights. CG&CL conducts an annual shareholder attitude survey. The 2005 results show that there has been a marked percentage increase in the number of shareholders who are able to identify three important shareholder rights (42% of

shareholders surveyed in 2005 versus 28% in 2004). This has important implications for increased shareholder activism.

**CORPORATE GOVERNANCE COUNCIL (CGC).** In May 2003, the project established a Corporate Governance Advisory Committee (now referred to as the Corporate Governance Council). The Council consists of representatives of the MBLA, the Central Securities Depository, the private sector, MSE, MSEC and project staff of CG&CL and the USAID funded Macedonia Financial Sector Project. The first task of the Council was the development of the corporate governance survey to assess the corporate governance practices of Macedonia's Joint Stock Companies.

The Council operates informally under the umbrella of the National Entrepreneurship and Competitiveness Council (NECC). Its explicit mission is to encourage effective, transparent and widespread implementation of the Company Law in Macedonia as a means to increase enterprise attractiveness to investors, to ensure fair treatment of all shareholders and stakeholders, and to accelerate sustainable economic growth of Macedonia. Since 2005, CGC has also been working actively to promote corporate social responsibility (CSR) among Macedonia's businesses in cooperation with the UNDP. As well, the Macedonian Stock Exchange, a member of the CGC, is developing a new corporate governance code for listed companies.

Thanks largely to its influential membership, the Macedonia Corporate Governance CGC plays a visible role in sponsoring or organizing high profile events, such as round table discussions, televised debates, press conferences, and workshops. CGC's target audience is Macedonia's business community – executives, entrepreneurs and other business leaders – and members of government and relevant NGOs, all of whom must be included in the drive for sustainable and long-term improvements to the country's business environment. To date, the Macedonia Corporate Governance Council has provided leadership in the areas of corporate governance and corporate social responsibility through sponsorship of the following types of events:

- Public debates on the company law;
- Kapital Conference “Status of Investors Under the New Company Law” – May 2004;
- International OECD Conference on Corporate Governance “Transparency and Disclosure: Implementation and Enforcement” – June 2004;
- Shareholder Awareness Survey – December 2004 presented with the Minister of Economy;
- Publication of 24 Company Law guides;
- Organization of the UNDP/USAID/CG&CL - Corporate Social Responsibility Conference – May 2005;
- Shareholder Awareness Survey – November 2005.

The Council was established as a platform for discussion and coordination among its members and the CG&CL Project. It has not been established to be a separate legal entity or to be financially sustainable although it has the potential to be an independent, financially sustainable organization.

**THE PILOT ENTERPRISE PROGRAM.** The Pilot Enterprise Program is an initiative of the CG&CL Project. Consequently, it should not be listed as a supporting institution. However, the underlying benefits of the program relate directly to institutional development and, as such, bear mentioning. The program was designed as a “train the trainers” effort. The Project put out to tender an RFP designed to attract local law firms. Staff at the winning law firms underwent training on corporate governance and company law issues and then conducted

workshops with a select group of Macedonian joint stock companies. The design of the program accomplished several objectives:

- It increased the institutional capacity of local law firms in the field of commercial law; and
- It provided an avenue for hands-on training of managerial staff at joint stock companies on corporate governance and Company Law compliance issues. In so doing, it provided a forum to stress international corporate governance standards and the resulting benefits.

The program ran from September 2004 through June 2005. Eleven companies participated. Each company underwent a needs assessment. By mutual agreement, a training plan and curricula were established. 127 sessions were held covering topics such as “How to Prepare a Model Company Charter” and “Principles Underlying Corporate Social Responsibility”. Over 97% of attendees surveyed ranked the program as good or very good (30% good; 67% very good). The success of the program lends support for the establishment of a larger program as part of follow-on USAID activities. As stated above, the overriding benefits to the program are the increase in capacity in the provision of legal consulting services and direct implementation of corporate governance and Company Law requirements by Macedonian JSCs.

**EXPANSION OF UNDERGRADUATE AND POST-GRADUATE COMMERCIAL LAW PROGRAMS.** The Law Faculty at Cyril and Methodius University in Skopje has revised its commercial law curriculum. In 2004, it introduced a graduate level commercial law program and undergraduate electives that embody international practice in various areas of commercial law. The South East European University also added a corporate governance elective to its undergraduate program with the first class having been completed in the Spring 2005 term. In addition, a corporate governance elective was taught as part of the Dutch Government-sponsored Winter University program during the January 2005 session. The Winter University program provides courses meeting international standards. Graduates of the courses can use the credits attained in their university undergraduate programs to satisfy elective credit requirements.

# COMPETITION

## OVERVIEW

Healthy competition ensures that consumers pay the lowest possible price coupled with the highest quality of the goods and services which they consume. Competition not only reduces particular prices of specific goods and services - it also tends to have a deflationary effect by reducing the general price level. By improving efficiency in production of goods and services, a well-crafted competition regime also improves the competitiveness of a country in the international marketplace. Paradoxically, the poorer the country, the more it is in need of competition to reduce prices for inputs and services while increasing efficiency and thus competitiveness. Protection from competition leads to inefficiency and higher prices.

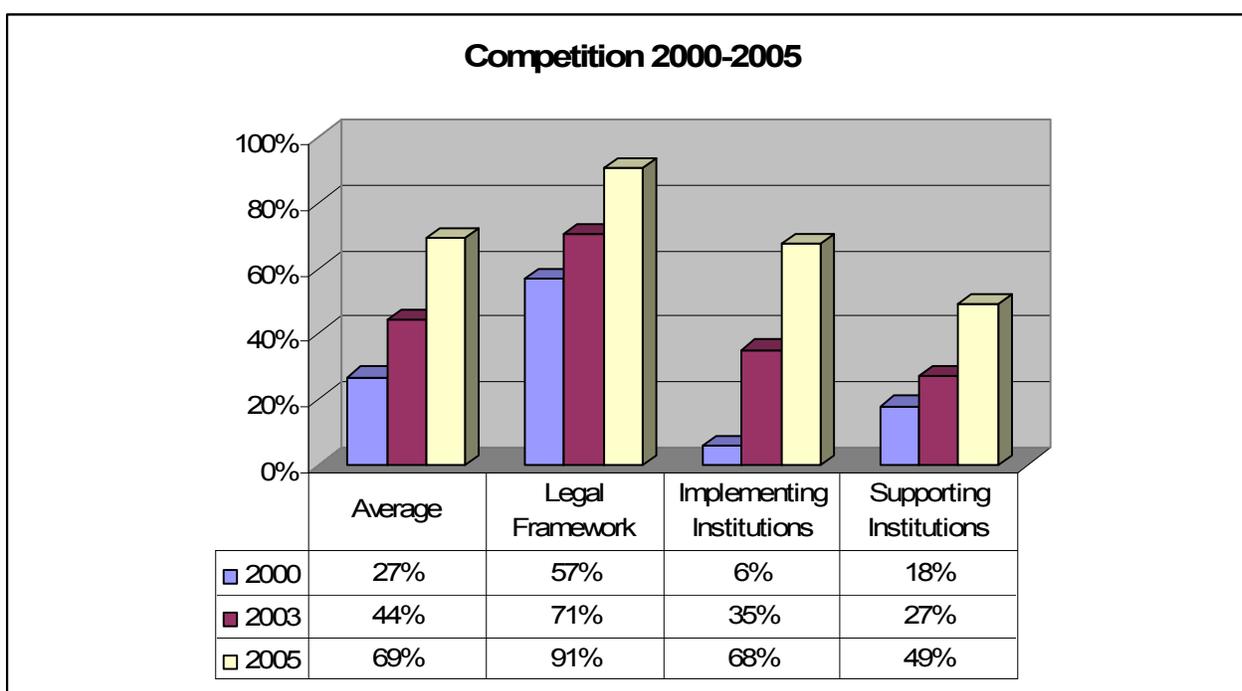


Figure 12 - Competition Comparative Scores

Macedonia is now clearly moving forward in this area that has lagged far behind all others since the first assessment in 2000. Competition law is now substantially in conformity with international standards, moving it 20 points since the 2003 Assessment to a score of 91% today. Unlike 2000, when the score of 6% for Implementing Institutions evidenced the lack of any meaningful authority for implementation of a competition regime, today there is a potentially viable Implementing Institution in place, with necessary regulations and – hopefully – funding to maintain it. Supporting Institutions are still quite weak, but have also improved dramatically, from a mere 18% in 2000 to 49% today.

## LEGAL FRAMEWORK

The most recent legislation affecting the competition regime is the Law on Protection of Competition, adopted on January 11, 2005. It entered into force on January 25, 2005 (Official Gazette of the Republic of Macedonia No. 04/05). The preamble to the law makes it clear that the drafters understood the importance of competition and an independent, accountable enforcement agency to ensure that free competition is protected equally for all competitors, and that enforcement is not subject to inappropriate influence.

In 2000, Macedonia could be described as lacking any reasonable system for protecting competition, as reflected in the score of only 57%. Although improved between 2000 and 2003, the regime lacked certain fundamental requirements, and also lacked the regulations necessary for implementation. 2005 scores of 91% establish a substantial move forward, not only to meet international standards, but also to provide more effectively for an enforcement regime. It maintains earlier improvements, while incorporating European standards effectively.

**GENERAL PROHIBITIONS.** The new law prohibits all agreements concluded among undertakings, decisions of associations of undertakings and concerted practice, which have as their objective or effect the prevention, restriction or distortion of competition, particularly those which:

- Directly or indirectly fix purchase or selling prices or some other trading conditions;
- Limit or control production, marketing, technical development or investments;
- Divide the market or the supply sources;
- Apply diverse conditions to identical or similar legal matters with different trading partners, thereby placing them at a competitive disadvantage;
- Make the conclusion of agreements conditional by forcing the other parties involved to accept supplementary obligations, which, by their nature or according to commercial usage, have no connection with the subject of such agreements.

The law applies these same prohibitions to entities that dominate the market, but further prohibits abuse of a market dominant position through practices such as:

- Refusal to trade or encouraging and demanding other undertakings not to purchase or sell goods or services to a certain undertaking, with an intention to harm that undertaking in a dishonest manner;
- Refusal to allow access to its own networks or other infrastructure facilities to another undertaking ready to provide adequate remuneration.

**PROTECTION FROM CONCENTRATION.** The new competition regime recognizes that various concentrations such as mergers and acquisitions are a legitimate form of business activity and can enhance overall market functions and efficiency. At the same time, excessive concentration can lead to market dominance and anti-competitive behavior. The Commission for Protection of Competition is therefore given the authority to determine whether any such concentration would lead to excessive concentration, and can prohibit mergers and

acquisitions. To ensure Commission oversight, entities contemplating mergers and acquisitions must first obtain Commission approval before moving forward.

The new law arguably permits revocation of agreements leading to market dominance through privatization. This has not been clearly established in law, regulation or practice and should be more fully defined to avoid unnecessary and anti-competitive privatization arrangements. However, the prohibitions against various practices that might be used to undermine competitive privatizations (such as bid rigging) do provide potential protection from insider sales and “crony capitalism,” if applied.

**EXPANDED RESTRICTIONS AND PROTECTIONS.** Earlier versions of competition law failed to address several areas of critical importance, but the new law has rectified this. The law has more clearly confronted problems of price fixing among competitors, which is expressly prohibited. Of equal importance, this prohibition applies to government entities as well, thus prohibiting bid-rigging in government procurements, a frequent source of both corruption and anti-competitive activity.

The law also allows for a balance in accepted restrictions such as franchises and intellectual property rights. These are expressly exempted from the prohibitions against restrictions, thus providing the necessary framework for expansion of investment in these areas.

Sanctions include denial or revocation of contracts that would lead to (or have led to) excessive concentration of markets. In addition, the Commission has been given authority to assess significant fines against enterprises (up to 10% of annual turnover) and even individuals. The law does not provide for jail terms, only misdemeanor offenses. Presumably, any activity rising to the level of criminal behavior will be addressed through criminal statutes on fraud and other economic crimes.

## IMPLEMENTING INSTITUTION

Previous attempts by Macedonia to create a viable authority for policing violations of competition law failed. Under the new law, the former Monopoly Authority (under the Ministry of Economy) has been replaced by the Commission for Protection of Competition. The Commission is an independent legal entity of the state with a mandate and the authority to perform its tasks independently of government influence or interference. Its members are appointed directly by the Assembly of the Republic of Macedonia, and can only be replaced by the Assembly.

To promote independence, the budget for the Commission is separately allotted in the national budget, and thus is not directly tied to any particular ministry. At present, the overall budget of Macedonia is rather low, so that actual financial support of the Commission is not yet sufficient for the tasks ahead. Over the next few years, the Commission will most certainly need support from donors, especially in training and technical assistance.

To further promote independence, the five Commission members (Commissioners) may not participate in politics as an elected representative, be an active member of a political party, or be a member of the board of any enterprise. These prohibitions are designed to reduce any potential conflict of interests with bodies that might come before or otherwise attempt to influence the Commission.

In addition to the five Commission members, the Commission has the authority and (hopefully) budget to contract with various investigators, analysts and other experts. At present, the Commission has been kept rather small, with only 11 full-time staff permitted (in addition to the five commissioners). There are plans to expand staffing by 8 more positions, for a total of 19 staff and 5 Commissioners.

In previous assessment years, procedures for bringing complaints about anti-competitive behavior were either missing or inadequate. This has been rectified. The 2005 law sets forth procedures for both ex officio investigations and for filings by interested parties. The Commission has investigative authority and can hold hearings, compel production of documents, seize evidence and otherwise ensure proper investigation and analysis of alleged violations of the law. Upon finding a violation, the Commission is authorized to assess and collect sanctions.

Full implementation of these authorities, however, must await constitutional revisions that are currently being prepared and proposed. Under the existing constitution, only the courts have the authority to authorize sanctions of the sort foreseen by the new law. Until now, the Commission has had to rely on the courts to hear complaints and award damages, which has been extremely unsatisfactory due to the extensive problems within the judiciary. (See *Contracts: Implementing Institutions* for further discussion of the courts.) Theoretically, the courts could delegate their powers to the Commission, but legal experts have deemed this approach inadequate for Macedonia, and are amending the constitution for greater clarity and flexibility.

In the meantime, the Commission's mandate includes public education on issues of competition and review of proposed legislation to ensure compliance with an EU-compliant competition regime. Over the medium term, the Commission is likely to need substantial technical assistance in both of these tasks. Moreover, the law governing legislative process must be amended to ensure that the Commission receives the opportunity to comment on legislation: today, the Assembly has no requirement for vetting of laws, but does so only voluntarily. Accordingly, the Commission is not in a position to fulfill this important task.

The new law provides greater regulation than any of its legislative predecessors. Even so, regulation is not complete. Additional internal regulations and guidelines are needed to supply the Commission and its expert staff with tools needed to effectively promote an open competition regime. Experience in this area is quite limited for Macedonia, and human resource capacity is likewise limited. The Commission will need to rely on outside assistance – both through donors and through its own relationships with competition authorities from other countries. Although there are improvements in the scores, this Implementing Institution is far from self-sufficient. Substantial assistance is still needed.

## **SUPPORTING INSTITUTIONS**

Supporting Institutions have improved in the past five years, moving 31 points from 18% in 2000 to 49% today. However, this growth is not at all sufficient and is the lowest score for Supporting Institutions in the entire assessment. A great deal of work will be needed with government, private sector business and the NGO sector before Macedonia's competition regime will become fully functional.

One of the more positive developments will have long-term benefits. The Law Faculty of Cyril and Methodius in Skopje has developed new curricula and courses on competition. These new materials are being presented at both graduate and undergraduate levels, ensuring that law students of today will be better prepared in this field.

This development has critical importance for the bar, which, on the whole, is inadequately prepared to support developments in this field. The Macedonia Bar Association does not have any sort of committees or other method of tracking or advancing developments in this field. The Macedonian Business Lawyers Association (MBLA) is currently better able to participate in much needed debate and dialogue, but would benefit from input by foreign experts in this rather new area of law.

The Organization for Protection of Consumers has been growing stronger over the past few years. It can and should play a fundamental watchdog role in monitoring prices and practices to ensure that competition is underway. It could also serve as a useful vehicle for consumer and public education on the benefits of

competition. GTZ is working on competition law and policy; hopefully their efforts can be absorbed by this and other organizations.

The International Council of Investors (ICI) has become increasingly active in tracking and reporting on competition issues. Through its annual report on constraints to investment, the ICI publishes a wide-ranging analysis of issues affecting trade and investment in Macedonia. This includes competition issues.

As noted elsewhere, the appearance of two independent think tanks in the last two years has increased the overall capacity of Macedonia to analyze competition issues. However, these organizations are responsive – they may have capacity, but they need to be contracted to do the analyses needed. Donors would do well to advance capacity development by using these and other organizations to prepare research papers and studies on the economic implications of Macedonia’s changing environment for competition.

The National Entrepreneurship and Competitiveness Council (NECC) also has potential for advancing an improved competition regime. There is some confusion in the public mind over their role, however. Competition and competitiveness are not the same thing. The first deals with rules of the game between the players within a given market. The second focuses on comparative and competitive advantages between nations and regions. Macedonia’s competitiveness can be improved, however, by improving the environment for competition. When competition is protected, prices on inputs (goods and services) will fall, making it more attractive for production of exports.

## **MARKET FOR AND IMPROVED COMPETITION REGIME**

Demand for reform is complex. For Macedonia, as elsewhere, the most noticeable result of introducing free market competition is normally an increase in business failures, as old, uncompetitive businesses are undercut by more efficient producers. Although prices may fall, these are not perceived as quickly or as forcefully as the plight of the newly unemployed. Economic theory assures us that the market will eventually shift toward more efficient allocation of resources, but this shift may not result in the re-employment of the newly unemployed, especially those older employees with few useful skills for today’s market. Thus the social dislocation – especially in the absence of a reliable social safety net – tends to reinforce the arguments of those who oppose improved competition regimes and seek greater phasing in of new laws and approaches.

The international business community, on the other hand, is a strong proponent of implementing European-standard competition laws. Foreign investors have even noted that there is a strong tendency among local competitors to maintain barriers to competition. These foreign investors are generally more efficient and can often provide higher quality goods and services at lower prices. Clearly, this benefits all consumers, even if it does result in a short-term increase in unemployment. Competitive investors also employ local workers, but they may employ fewer than the enterprises they replace, leaving a temporary net increase in unemployment.

This conflict between consumer benefit and labor dislocation is often used effectively by vested interests to argue for maintaining various protections. In Macedonia, the “oligarchs” of industry and commerce are known for opposing improvements that would affect their short-term prospects. They continue to wield significant power in slowing or avoiding reforms, and competition is no exception. Careful attention should be given to improved public education and more focused education of policy makers so that these vested interests do not hold the greater good of the country hostage to their narrow but powerful interests.

# CONTRACT

## OVERVIEW

The laws regulating contract in Macedonia have historically been rather strong. The foundation was built on the Obligations Law of former Yugoslavia, which, all in all, was quite good. Upgrades in the past few years have helped to fill gaps brought by modernization and refine legislation as practice and theory came into conflict.

Unfortunately, the strength of underlying legislation has been counterbalanced by the weakness of the judiciary called on to enforce commercial obligations. This is not surprising: the system inherited from Yugoslavia was not designed to operate in a market-oriented, commercial economy. The extensive changes in law and commercial relationships soon made the old form of judicial support not only antiquated but also highly ineffective. Early reforms focused on doing a better job with the wrong system. Recent reforms are more radical: the old system has been replaced with one designed for today's reality.

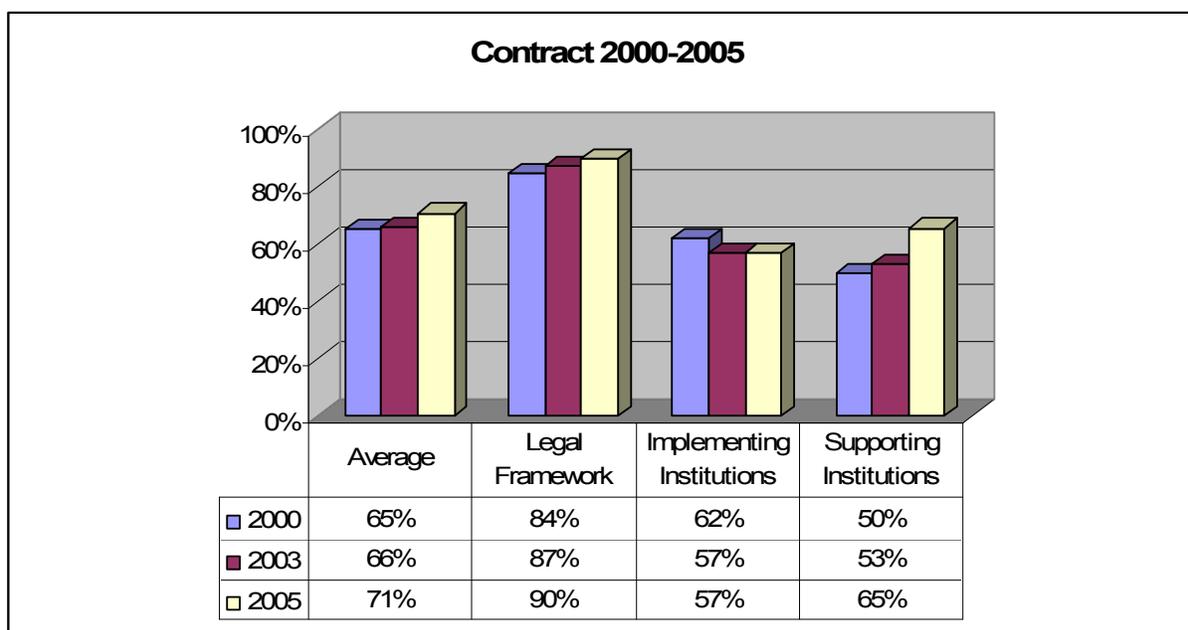


Figure 13 – Contract Comparative Scores

Perhaps because of the weakness in the courts, Supporting Institutions have been slower than expected to develop the architecture necessary for a mature system. Legal associations – and the legal profession generally – are still weak in providing high quality services in the area of contract law (but with notable exceptions). In a world governed by relationships and negotiations, with responsibility for “truth” and thus understanding placed on the judge instead of the parties, demand for clear, internationally recognizable contract standards was suppressed. Today, lawyers face the prospect of malpractice for failure to represent their clients adequately, and part of the representation will soon be understood as proper drafting of enforceable commercial agreements. In turn, the changes in the judicial system can be expected to change the dynamics of the private sector as well with regard to contract issues.

## LEGAL FRAMEWORK

There have been few substantive changes in the underlying obligations law since the last assessment. Improvements responsible for upgraded scores – from 87% in 2003 to 90% today – lie in two areas only. First, law and practice have become clearer in the area of permitting parties to choose the forum for litigation and the law that would cover the litigation. Second, there were minor improvements in the definition and understanding of notary law and practice.

In short, Contract laws, as written, support the ongoing development of modern contract practice. There are no serious impediments or weaknesses in this area. Macedonia would do well to become a party to the Convention on the International Sale of Goods (CISG) eventually, and to improve language within the Law on Obligations to broaden the acceptance of trade usage and industry standards in commercial contracts. Otherwise, there are no significant gaps in the indicators for Contract.

Laws relating to the judiciary – the Implementing Institution for Contracts – have been dramatically revised, as discussed below. It should be noted that stakeholders in the legal community were generally satisfied with their ability to provide input on the new laws. However, some indicated that they had been left out of the procedure, suggesting that the communication and feedback mechanisms for such legal reform projects are still substandard.

The greatest importance at this time is development of practice within the existing law, through the improvement of Implementing Institution performance and the development of Supporting Institutions to press for greater contract standardization. As these two developments occur, users will identify and can address any other minor reforms needed in the law itself.

## IMPLEMENTING INSTITUTIONS

A revolution is underway in the courts, and it is greatly needed. Consistently low since the first assessment in 2000, the courts are the only Implementing Institution that has shown no improvement over time. That is about to change.

**BACKGROUND.** All former Yugoslav republics inherited a judicial system designed for a different world. Under the old Yugoslav legal and economic model, commercial contracts were not particularly relevant. Most economic activity was with or through the state, and thus most decisions relating to economic disputes were as much political as commercial. Judges had a very different role, primarily as an arm of the executive, in ensuring resolution according to policy as well as law. With the collapse of the command model of government, creation of an independent judiciary, and introduction of commercial contracts (and their accompanying disputes), the courts of the region have all but collapsed under ever increasing backlogs and untenable processing times.

The result of this breakdown for investors has been increased risk that obligations could not be enforced, and increased costs of attempting to enforce. In a competitive regional and international market, these costs and risks have made Macedonia highly unattractive for both domestic and foreign investment. It has also retarded the development of credit. Higher costs and risks lead to higher interest rates and collateral requirements, which in turn increase the probability of default by decreasing the capacity of businesses to repay their loans and adjust to market changes while remaining prosperous. In addition, many suppliers of goods and services have been unwilling to extend credit at all, preferring cash in advance. Although understandable, this approach also lessens accountability of suppliers who do not have to answer to customer complaints regarding quality, which can only be resolved through lawsuits as customers have no leverage to negotiate based on outstanding balances. In short,

the crisis in the courts has extensive negative multiplier impacts. Underperforming courts have been shown elsewhere to increase interest rates, lower credit, increase default, and lower investment.

To address these problems, several of the former Yugoslav republics have tried to speed up case processing through better administration, including computerization, but have failed to undertake the fundamental changes to the system that will be required for conversion to support commercial contracts and economic growth. Instead, they are trying to do the wrong things faster instead of accepting that the basic structure and system need to be overhauled. Croatia is a good example, having made only cosmetic changes to processes without addressing the underlying assumptions that continue to lead to inefficiencies.

Macedonia has now faced its past and replaced its fundamentally flawed judicial system with a radical set of changes through two new laws: the heavily amended Law on Litigation Procedure (LLP, effective 28 December 2005) and the Law on Enforcement Procedure (LEP, effective 6 May 2006). These reforms arise from the National Strategy on Judicial Reform of 2004, which is being pursued to improve the independence and efficiency of judicial operations. These legal changes introduce far-reaching changes in practice, which – if followed – will dramatically improve the ability of the judiciary and its Supporting Institutions to ensure the enforcement of commercial obligations according to their terms, thus creating a basis for investment and economic growth in Macedonia.

**THE LAW ON LITIGATION PROCEDURE (LLP).** When the LLP comes into effect at the end of 2005, it will introduce not only new procedures, but new concepts. Most important is the elimination of the “material truth” standard, which has formerly placed the burden of establishing the facts, law and “truth” of a matter asserted on the judge, not the parties. Under the older, inquisitorial judicial model, a judge could accept and request additional evidence until satisfied with the submissions, with no obligation of the parties for timeliness in providing necessary evidence or arguments. As a result, Macedonian judges, like the judges in all neighboring countries, would permit introduction of “found” evidence several years into trial, or even on appeal. Lawyers regularly abused the system to create endless delays on even the most straightforward disputes.

The LLP addresses these and other problems through a number of practical and theoretical changes:

- **Role of the Judge.** The judge will become the “referee” for the parties, with no investigative role in seeking additional evidence.
- **Burden of Proof.** The parties must now either provide evidence in a timely manner or have it excluded from the trial. It can no longer be “found” at some opportune moment in the future. In fact, after the hearing on the evidence, no new evidence is permitted at all.
- **Burden of Responsibility.** Deadlines for submission of pleadings and evidence have been shortened, and failure to meet a deadline without prior excuse can result in a default judgment or exclusion of the pleadings and evidence. The lawyers are therefore professionally responsible for timeliness, subject to malpractice claims if they simply miss deadlines in order to delay proceedings.
- **Finality of Judgment.** Once issued, a judgment is enforceable without delay for appeal, objection or any other delaying tactics. Although this is not new (similar provisions existed previously, but were seldom used), this approach is now combined with a completely new approach to litigation.
- **Reduction of Appellate Delays and Inefficiencies.** Under prior law, the appellate court could vacate a decision with no meaningful instructions to the lower court on how to correct insufficiencies. As a result, litigants exploited the system to create a game of “appellate ping-pong” with cases being shifted back and forth between levels over the course of years. The new law limits the number of appeals, shortens the deadlines for appeals, and creates a new framework for shifting appellate practice of remand and instructions.

- **Reduction of Bases for Refusal.** Another popular delaying tactic in the past has been challenge of the competency of the judge to hear the case. Wide-ranging and even unfounded challenges were accepted or at least heard, causing extensive delays. The law now limits the basis for recusal to clear conflicts of interest.
- **Improved Representation.** The LLP now requires the use of attorneys or in-house counsel in commercial law suits to improve the quality of pleadings and practice.
- **Improved Process.** Ineffective service of papers has been a plague throughout the region. Macedonia has now shifted the burden of providing appropriate addresses for service of process to the parties. If process is unsuccessful by delivery, it can be “nailed” to the bulletin board of the courthouse in order to eliminate hiding by defendants and bribery of process servers. This will reduce costs and delays for the courts and plaintiffs.

The courts are also being reorganized for efficiency. Currently, all cases – regardless of size – are processed through the same general civil divisions. The new law provides for creation of a specialized commercial division for cases with a value in excess of 500,000 dinars, and for a small claims court as well. Both should improve the timing and effectiveness of the courts in dealing with commercial disputes.

**LAW ON ENFORCEMENT PROCEDURE (LEP).** Rather than reform the consistently underperforming enforcement division of the civil courts, Macedonia has decided to replace it altogether. The new LEP (effective in May 2006) will remove enforcement from the courts and transfer it to private enforcement agents (PEAs). These licensed agents will execute judgments through attachment and liquidation of assets. In addition, PEAs will have the authority to enforce trustworthy documents.

To ensure efficiency, the PEAs are given the right to appraise property for seizure and determine the means of enforcement. Appeals against PEA actions are strictly limited in scope and timing, with very short deadlines. The enforcement plan is left up to the parties, except to the extent provided for in the judgment. Only the plaintiff can request a delay in the enforcement – the debtor has no such right. In other words, the PEAs have a wide range of discretion in determining how best to enforce decisions and trustworthy documents with little if any interference from or delay by the debtors.

The PEA Law is controversial, but primarily for reasons of theory and bias toward debtors. One of the principal opponents characterized the new system as “legalized extortion” to get debtors to pay their just and legal obligations. Indeed, this mindset poses the greatest threat to reform, arising from some ideological belief that debtors have a right of non-payment that overrides their obligation to pay. Unfortunately, this theory is propounded by some of the most influential drafters in the country, who are likely to continue attacks on the new law and attempt to undermine it prior to passage. If they succeed, they will cost Macedonia millions in lost investment, interest rates, and unemployment, as they appear to have not even a rudimentary knowledge of the economic consequences of misplaced incentives in commercial transactions.

There are some legitimate concerns about the PEA system, however, although most arise from a lack of familiarity with modern enforcement and concerns over such a new approach. Much additional work will be needed to complete the framework, monitor implementation, and refine the process over time. For example:

- **Regulation of PEAs.** The law establishes that PEAs must hold a law degree or pass the PEA exam. The exam, governing bodies (a chamber of bailiffs) and regulations have not yet been established. These are underway, however, and are expected to be completed before the law comes into effect.

- Protections against Abuse. Proponents of the law attempted to place various protections against abuse by PEAs in the LLP, but opponents of the PEA system refused to permit this in their attempts to stop the approach. Such protections are now being drafted in a separate law.

**OTHER LEGAL DEVELOPMENTS.** Although not directly captured by the assessment, it should be noted that Macedonia has adopted a new procurement law since the last assessment, with donor assistance. The role of the state in the economy is still very large (too large, in fact), so that proper regulation of procurement in accordance with international standards is essential in improving the implementation of commercial contracts generally. This law, prepared with assistance from the World Bank, will also help to reduce corruption in government contracting, if properly enforced.

Mediation is also moving forward. Revisions to the LLP now permit the use of mediation at any point in the trial, and permit the judge to recommend mediation prior to continuing a trial. Currently, less than 2% of cases are settled in Macedonian courts. There are a number of reasons for this, least of which was the lack of proper laws on alternative dispute resolution. ADR has been consistently undermined in two ways. First and foremost, the crisis in judicial enforcement meant that there were few if any negative consequences for delaying a plaintiff's claim. ADR is attractive as a cheaper, more efficient form of dispute resolution in order for both parties to avoid the costs of litigation. A defendant may not have any incentive to use ADR if delay is more profitable, and a plaintiff will not use ADR if the decision or award cannot be enforced without a court action. Second, arbitration has been offered by the Chamber of Economy, which has been ineffective and thus unattractive. With improvements in the courts and the Chamber underway, the outlook for ADR is positive.

Throughout the period of CLIR Assessments in Macedonia, courts have not only scored poorly, but they have also undermined the scores in a number of areas assessed because of their important role as secondary supporting institutions. Drafters are currently preparing changes to the constitution of Macedonia that would permit delegation of adjudicative and enforcement authority to other entities. For example, competition and tax authorities currently rely – to their detriment – on the enforcement power of the courts. Under the new changes, these authorities will be granted their own enforcement powers. This reform will lighten the burden on the courts and permit them to focus more fully on commercial matters without the distraction of these administrative cases. At the same time, various authorities will be empowered to pursue enforcement more vigorously and effectively.

**COURT ADMINISTRATION.** Donor support for upgrading court administration is strong, but has been delayed while the judicial system was being reformed. Finalization of the LLP and LEP changes allow work to move forward more rapidly on court management, computerization and software development to support the procedural changes. Experience elsewhere suggests that actual installation and implementation will take several years before the new systems can be applied effectively. Consequently, it is likely that an assessment 2-3 years from now will find a vastly improved court administration.

**CONCERNS.** Macedonia has undertaken profound structural, procedural and ideological reforms. Although the reform process included a large stakeholder group, there is still very limited knowledge about the changes and no experience with them. There is a great need for training and education of the entire legal profession, but Macedonia does not have sufficient resources of its own to achieve this.

Bosnia and Herzegovina (BiH) adopted similar reforms approximately three years ago, including introduction of adversarial litigation approaches in which the parties are responsible for production of evidence and meeting deadlines. Throughout that time, donors have provided extensive technical assistance to a wide variety of stakeholders to ensure success. Today, the changes are beginning to take hold, with judges beginning to apply the law and lawyers beginning to adjust their practices to comply with the new rules. Many judges are still reluctant to

apply the law as written, with the result that numerous unnecessary delays still burden the courts. General understanding of the procedural changes is still limited, although growing. In other words, it has taken approximately three years for BiH to turn the corner on these reforms and establish a critical mass for effective future change – provided that there is ongoing donor support for a few more years.

Macedonia is less complex than BiH, but some of the changes are more extensive (such as the creation of new divisions for small and large claims, something only now being considered in BiH). Based on experiences elsewhere, strong donor support will be needed for at least 3-5 years to ensure success and to keep from wasting the investments made to date. There is strong political will in some ministries (namely the Ministry of Justice) to stay on course, but the country clearly does not have sufficient resources for the challenge ahead. This must be addressed by donors.

## SUPPORTING INSTITUTIONS

Supporting Institutions continue to provide a mixture of successes and failures, but the successes are significant. During the past two years, scores for Contract's Supporting Institutions have risen from 53% in 2003 to 65% today. Weaknesses tend to continue in bar association and education indicators, both of which bear further scrutiny. Successes are more varied.

Notaries continue to improve their scores as user satisfaction increases. According to stakeholders, changes adopted in 2003 are permitting better enforcement (other than in real estate, which is beset by cadastre and registration problems) at satisfactory costs. Part of this satisfaction comes through the recent introduction of self-help remedies through notarized contracts in which debtors permit creditors to engage in private repossession or other collection activities without court intermediation. As a consequence, there are now effective enforcement options available that do not incur the unnecessary delays of the court system.

Some have characterized this appearance of alternative enforcement mechanisms as a failure of the court system. In fact, the crisis in the judiciary has accelerated adoption of these self-help and quasi-judicial approaches, but they should have been a deliberate part of the overall reform strategy. All countries need a range of tools for resolving and enforcing commercial obligations, including self-help, credit reporting, and pledge registries. Self-help has been conspicuously absent until recently; credit reporting still is. The World Bank recently conducted a feasibility study for private credit information bureaus and determined that the market will only support a public bureau. They are now preparing to assist with its creation. This will be a tremendous improvement for the overall contract framework by attaching negative and positive consequences to contract compliance, while also improving the ability of commercial actors to assess, manage, and lower their risks.

Lawyers' associations were mixed in their results over this period. Although the Macedonian Bar Association did offer some training on the new laws, all but one respondent interviewed for this assessment expressed strong disappointment overall with the MBA, consistent with all other periods. Stakeholders expect the MBA to provide more and better services, but are consistently disappointed. This suggests that it might be time to reconsider the role of the MBA and the other potential mechanisms for training and services.

Bar associations in Europe tend to be first licensing organizations, then service providers. North American approaches tend to separate the functions. That is, the bar in Europe is frequently a mandatory organization for all lawyers, which licenses and monitors the profession, and may also provide various training and other services. In the North American model, the mandatory licensing organization (the bar) will monitor the profession, while voluntary organizations (bar associations) provide training and other services.

In former Yugoslavia, the bar association was both a form of control and support for lawyers, but the support functions tended more in the area of fees and working conditions, not necessarily training. Today, few of the

former Yugoslav republics have respected mandatory bar associations; most are seen as an overburdensome tax on the profession benefiting only the bar officials. Unfortunately, Macedonia suffers from this undesirable situation.

It would be useful to reconsider the role of the bar in Macedonia. The Macedonian Business Lawyers Association (MBLA) continues to do a respectable job of providing education, information and legal materials to the legal community, and is a voluntary association. The MBA, on the other hand, consistently fails to meet expectations. It might be worthwhile for legal reformers to consider whether the MBA should have its scope more narrowly defined for licensing and performance monitoring, with a consequent reduction in fees. Training could then be given primarily through the much more effective voluntary associations such as the MBLA.

However handled, training has become a critical issue for Macedonian lawyers. The changes in the judiciary are so fundamental that it is accurate to say that no one has ever used them. All licensed lawyers were trained under a different system, and no one has yet been trained under the new one. For the reforms to be successful, those using the newly reformed courts must learn anew how to use them. While donors (through organizations such as the MBLA) are organizing some courses for the bar, it is not yet enough, and all such education is voluntary. It is virtually inconceivable that such voluntary education will suffice to retrain the entirety of Macedonia's legal stakeholders. Reformers should seriously consider the imposition of mandatory continuing legal education (CLE) requirements. There is very strong support for mandatory CLE among lawyers, with one caveat: courses should be provided on a competitive basis. That is, no single institution should be permitted monopoly power over the provision of these services, otherwise the courses will not be properly geared to the needs of the users. It would be far better to permit the law school, MBLA, MBA and other professional organizations to compete in providing the necessary programs.

Judicial education must also be increased. Various stakeholders expressed dissatisfaction with the performance of the Republic Judicial Council and the Judges Association in meeting the training needs of the judiciary. At present, the great majority of courses offered is sponsored, developed, and/or conducted by donors. Local organizations do not yet have capacity to offer this on their own.

The USAID Court Modernization Project will train all trial judges and create a cadre of trainers to continue training for judges through appropriate counterparts. Their work could also be very useful to the law faculty, which is slowly beginning to upgrade their curriculum. Without a complete replacement of existing courses on civil procedure, Macedonia will produce badly undereducated lawyers, who must then relearn civil procedure after graduation. Many of the courses currently offered by the law faculty have not been amended to capture changes in the law over the past few years, and thus represent wasted opportunities for improving the knowledge of practitioners. It is imperative that the curriculum be reformed immediately to capture the changes in procedural law for this entirely new judicial system in order to ensure an effective transition.

Media reporting on judicial reform is perceived to be somewhat better today than in earlier assessments. Journalists are often distrusted, however, because their understanding of the legal system is poor and because they tend to focus more heavily on scandals and negatives than improvements or important but mundane issues. (During public presentations of this report, for example, media tended to emphasize negative comments about the court system, while neglecting the deliberate emphasis on changes underway that will dramatically improve the courts.) More attention to media – including increased training and education of reporters – will be needed to create public awareness and improve public support for the changes underway.

## MARKET FOR REFORM

Demand for reform in Contract has focused almost exclusively on the judiciary, which is appropriate given the well developed legal framework currently in place. This demand, however, has tended to be unfocused. All stakeholders knew that changes were needed, but five years ago this was expressed through attempts at improving efficiency, without recognizing that the entire system needed to be overhauled. With the overhaul, underway, there will be increased demand for improvements in results. This should be used to drive reform at every level – judicial performance, continuing legal education, law faculty curriculum, media coverage, and ongoing government support for the reforms.

The Macedonian government does not have sufficient resources of its own to see these changes through. First, it has limited financial resources. Second, it has limited human resources with capacity and time to oversee the long-term reforms underway. Third, the government itself is being reorganized, upgraded and professionalized in some areas, and cannot be expected to absorb its own internal reforms effectively while attempting to monitor and direct the very challenging long-term process of changing the judiciary. Long-term donor support is still needed to supply and uphold the necessary reforms.

Unfortunately, there are also some interests arrayed against reform of the courts. As previously noted, some of the drafters and other influential members of the legal community do not understand what is at stake in these reforms. These advocates of less effective contract enforcement, in order to protect debtors, do not recognize that excessive protection of debtors undermines the economic foundation of the country for attracting and maintaining domestic and foreign investors. If Macedonia wishes to have a system of credit, then creditors must be protected, not debtors. Otherwise, the economy will continue to suffer from uncompetitive interest rates, restrictive lending practices, and overcollateralization of loans that tie up capital and reduce the flexibility of businesses in meeting market challenges.

Finally, it should be noted that vested interests and even some government entities may wish to slow the process of reform to protect themselves from repayment of significant debts. Public education, watchdog journalism, and consistent investment in the judiciary and legal profession will be needed to counterbalance any attempts at slowing or undermining these essential reforms.

# FOREIGN DIRECT INVESTMENTS

## OVERVIEW

Foreign investment in the Macedonian economy is at a crucial crossroads. In recent years, investment has been badly affected by uncertainties arising from the Kosovo conflict. Although political risks have dropped and can now be managed through political risk insurance, these are not the only issues. Investors have been concerned with the economic costs and risks of the dysfunctional court system and breakdowns in bankruptcy practices by unregulated trustees in the past few years. Privatization, which often provides appealing opportunities for foreign and domestic investors, has not been handled with consistent transparency, resulting in excessive insider deals. Availability of land with clear title is still problematic.

FDI inflows indicate that recovery is underway from the Kosovo conflict over the past several years. The larger investments of 2000 and 2001 were attributable to privatization and investment in banking and telecommunications, respectively. Although the country continues to receive investment in industry and trade, the rates of investment currently are inadequate for the Macedonia's economic growth needs, due in great part to the constraints already named.

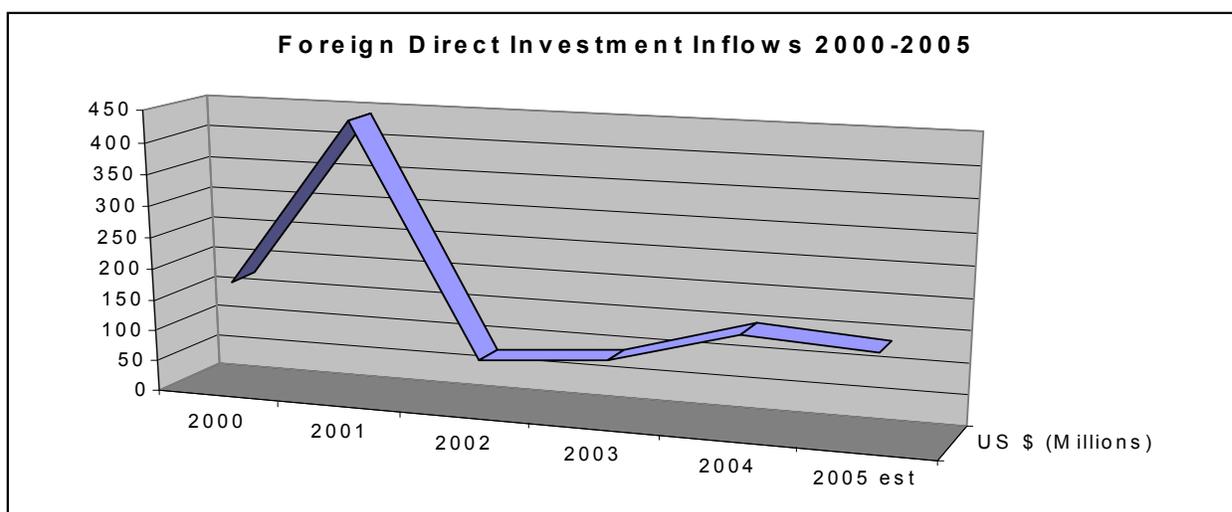


Figure 14 - FDI Investment Inflows

Yet there are improvements in the overall legislative and regulatory environment. Foreign investors tend to be generally pleased with the legal framework, which continues to improve. Trade reforms have led to one of the freest trade regimes in the region, increasing attractiveness for investment in import and export oriented opportunities. In the past year, an investment promotion agency – MacInvest – has at last been established with a director who enjoys a positive reputation among the investment community. Supporting institutions – especially private sector associations – continue to grow in number and effectiveness, increasing the capacity of stakeholders to seek and advocate long-term, sustainable changes.

These gains alone will not lead to increased investment, but do prepare the groundwork to support increased investment when other constraints are addressed. Among these, judicial reform is perhaps the single most important factor in attracting and increasing FDI in Macedonia.

## LEGAL FRAMEWORK

The legal framework for FDI has consistently scored well for Macedonia. In general, the investment regime has tended to recognize the special needs of foreign investors and provide protections. At the same time, the laws have protected investment in general, not favoring foreign investment over local investment or otherwise creating disparities based on the national source of investment funded. This healthy approach places Macedonia's investment laws ahead of countries that discriminate against local capital in misguided reliance on foreign capital as the primary solution to investment ills. These gains are also captured in the World Bank's Doing Business 2006, in which Macedonia ranks 30th in the world for its protection of investors.

The one-point improvement to 94% since 2003 is attributable to several offsetting changes in the legal environment. First, Macedonia has steadily expanded the potential market size through bilateral and regional trade agreements. By lowering trade barriers, reformers have given potential exporters and importers a more attractive trading area than the relatively small, low-income Macedonian market. This is particularly attractive to investors wanting to set-up headquarters or significant export subsidiaries in Macedonia. Second, laws have been clarified on issues of expropriation, bringing Macedonia fully up to international standards.

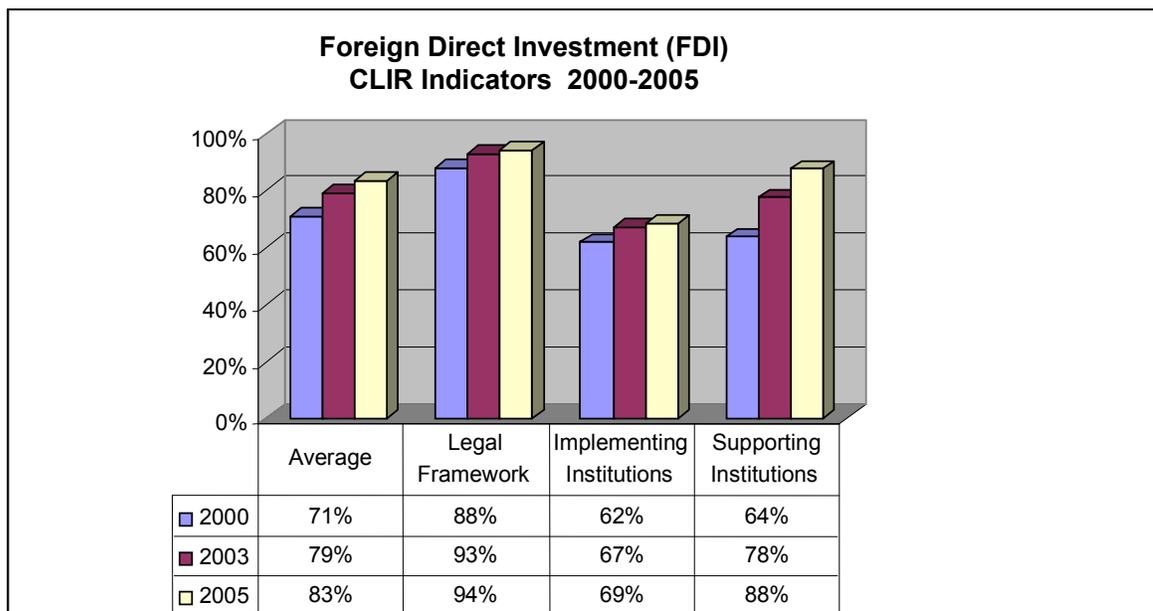


Figure 15 - FDI Comparative Scores

On the negative side, there was an offsetting decrease in scores for Macedonia's approach to local participation in foreign investment. Although the law does not require a foreigner to have a local partner, experience over the past few years has uncovered significant discrimination or other risks for foreign investors who do not have local partners. This de facto situation downgrades the de jure guarantee of non-discriminatory treatment.

Several other issues not expressly captured by the assessment methodology are also worth noting. First, many foreign investors continue to be concerned by the excessive rigidity of labor. In fact, Macedonia was 123rd internationally in the World Bank's Doing Business 2006 rankings, making this the weakest area of the Macedonia's business and investment climate. Although recent reforms to the labor laws brought some improvements, foreign investors unanimously agree that the reforms did not go far enough. The labor issue, while not expressly covered through the CLIR indicators, is extremely important to understand from an investor standpoint. At the simplest level, labor represents a cost of doing business. For Macedonia, the basic cost of

salaries is relatively low and regionally competitive. But there are other costs as well as risks created by the labor regime. For Macedonia, the cost of hiring and firing workers is far out of line with other countries in the region and with Northern European standards. As a result, wage competitiveness is offset by tax, pension, and bureaucratic costs.

Rigid labor laws also increase risks for employers. If it is difficult to terminate workers when business and economic conditions change, then it may be impossible for a company to compete while carrying the excess costs of unneeded employees, and can even lead to bankruptcy. For example, a business might provide services for which the demand in the summer is triple the demand in the winter. Logically, the company might then wish to triple its labor force for the summer months. If, however, it is costly or unreasonably difficult to terminate those workers, the company will forego increased business and revenues to avoid being saddled with the extra costs during the lean months. Macedonia has made some progress in this regard by providing for seasonal labor contracts, but much more work is needed. It seems counterintuitive, but greater freedom in firing actually increases hiring (and wages) because employers can better manage their risks to meet business needs.

Second, another concern only briefly addressed through the CLIR methodology is the ability of investors to obtain land. Poor access to land is considered one of the greatest constraints to foreign investors according to several associations of investors. Legally, a foreign company can own land through a Macedonian subsidiary or can lease outright, but much productive and desirable land is either (i) still under state control or (ii) lacks adequate title assurance because of long-standing problems in the land registry and cadastral records. Investors (both foreign and domestic) also complain that sales or grants of state-owned land are neither transparent nor public. This approach to privatizing land seems similar to privatization of state-owned enterprises in which the process was fraught with accusations of insider deals and poor accountability.

Finally, it should be noted Macedonia has attained its 94% score for FDI legal framework without an integrated foreign investment code. There has been some discussion of drafting an FDI code for Macedonia. Such codes are popular among government officials, but investors simply do not care. Instead, investors care that the substantive laws and practices of a legal system contain various safeguards, whether through a single code or spread across a wide range of laws. The high scores in this assessment indicate that Macedonia has already achieved the substance desired by investors. The cost of allocating scarce resources to create a more formal presentation of these laws will result in no measurable benefits; drafting a foreign investment code is therefore not recommended.

## IMPLEMENTING INSTITUTIONS

In January 2005, the Government of Macedonia established the Agency for Foreign Investments (MacInvest) to promote foreign investment and service investors. This organization is governed by seven directors from both the public and private sector and replaces the Investment Promotion Agency foreseen in the 2003 Assessment, but which never became fully functional.

The MacInvest staff enjoys respect from the investor community, but investors are concerned about the levels of funding and staffing being sufficient for the task at hand. MacInvest has already prepared substantial information brochures and CDs for investors, laying out the general benefits and restrictions, and has an active, well-designed website ([www.macinvest.org.mk](http://www.macinvest.org.mk)). The quality and availability of these materials are good, and the creation of the materials evidences an encouraging degree of commitment to the mandate of MacInvest. It is too early to tell, however, whether MacInvest is properly oriented in its investment promotion strategies.

In many transitional countries, investment promotion agencies lack sophisticated understanding of investor wants and needs and often limit their external promotion activities to booths and brochures at investment fairs abroad, or occasional trade missions. The director of MacInvest appears to understand the need for focused research to

promote areas in which Macedonia has interesting and competitive investment opportunities. The organization is currently working with municipalities around the country to enable them to promote investment as well.

Scores for Implementing Institutions rose in this assessment period only marginally (2 points – from 69% to 71%) because the previous assessment assumed establishment and implementation of the Investment Promotion Agency for purposes of scoring. It is too early to judge improvements in the performance of MacInvest. The increase comes because Macedonia continues to solidify an approach in which incentives are approved or disapproved, not investments, thus reducing control of state or quasi-state authorities over investment strategies and decisions.

Courts also serve as an Implementing Institution because of their substantial role in enforcing laws affecting foreign investment. As noted elsewhere in this report, the judiciary continues to receive very low ratings for performance. This situation should change with the installation and implementation of a dramatically improved system for resolving commercial disputes.

## **SUPPORTING INSTITUTIONS**

Scores for Supporting Institutions improved dramatically since 2003, moving from 78% to 88%. This ten-point jump is attributable to ongoing improvements in several areas.

First, the Customs Administration continues to improve its performance, continuing the trend started prior to the last assessment. The current and previous Directors General have been dedicated to reducing and controlling corruption and inefficiencies. Moreover, the current Director General comes from a business background and has publicly committed the Administration to business-friendly reform. The private sector continues to express strong support and appreciation for the changes.

Improvements in customs have highlighted the need for further improvements at the border. In popular thinking, all delays at the border are due to problems with customs. However, customs inspectors continue to implement and utilize random checks and profiling, and now inspect fewer than 20% of shipments. The major delays for cross-border shipments come from a combination of delays with immigration, phytosanitary inspection, and customs brokers, plus the substantially improved customs procedures.

Phytosanitary inspections continue to be a source of dissatisfaction for importers. Inspection hours do not mirror business needs for transport, thus causing shippers to frequently incur increased expenses while waiting overnight or over weekends at borders. These inspection services are in need of improvement if Macedonia hopes to attract increased investment in regional shipping services or to improve competitiveness of its importing and exporting industries.

Another ongoing improvement is in the area of private sector associations. The International Council of Investors has become increasingly important as a voice for investors in advocating policy and legal reforms. The ICI now produces an annual policy report – the “White Bible” – with important economic and legal analysis for use in discussing the reform agenda with government officials. The recently created European Business Association is playing a similar role and enjoys the strong support of European embassies. Many Macedonians feel that the government listens more carefully to foreign investors than local investors on reform issues (with some exceptions highlighted in the next section), so that these and other international organizations increasingly have influence on the reform agenda for investment issues.

The appearance of new think tanks, elaborated in the opening chapters of this report, is also a sign of positive change. Their research and analysis can and do provide reformers with support for reform initiatives, such as cost/benefit analyses for tax reforms.

Specialized services have also shown improvements during the past two years. Education, although in need of deep, ongoing reform, has been supplemented and improved by the presence of private educational institutions that offer business courses based on international business practices, with improved pedagogical techniques. Debt collection and credit information have made marginal advances as well. Several foreign firms now employ in-house or dependent collection services for unpaid bills, while many banks and other companies are using the Pledge Registry as a basic credit information service. Insurance for a variety of investor needs has improved markedly since the last assessment, with investors generally satisfied that they can meet their requirements locally.

Intellectual and industrial property rights – an area deserving of more intensive, specialized assessment – continue to be problematic, although with some improvements. The Business Software Association (BSA) has proven to be a strong player in pressuring for enforcement and reform of laws. BSA has been successful on a number of occasions in pressuring the Trade Inspection Office to conduct investigations and even raids on counterfeiters. Unfortunately, Trade Inspectors have shown little interest in pursuing this area of their mandate unless actively pressured. Fortunately, the police and the Ministry of Culture are supportive of IPR enforcement activities, with the Ministry an effective advocate at times for IPR owners. Likewise, customs officials have exercised their authority to hold and delay imports of allegedly counterfeit goods at the borders.

Weaknesses in the judiciary undermine enforcement of IPR, thus increasing risks for investors with rights to protect. The Trade Inspection Office has limited powers of seizure and enforcement, but can bring misdemeanor actions in court. Courts, however, are performing very poorly in urgent matters, with excessive delays when immediate actions are needed. Specialists in this area recommend the development of specialized procedures and practices for IP matters to improve enforcement.

Registration of trademarks and copyrights is also problematic. The Industrial Property Office is beset by backlogs, and is currently processing applications from 2002. Although legislative amendments of July 2003 provided for automatic registration if an application has not been rejected within 90 days, such automatic approvals are still not actually registered. The office has also been cited for mishandling registrations, including inappropriate cancellation of existing registrations. More training and capacity building is needed.

In a different area, foreign investors continue to enjoy an unfair advantage in terms of finance. With access to foreign sources of credit, they can frequently obtain much better terms than local competitors who are limited to local financing, which is more expensive due to costs and risks of lending in Macedonian. This temporary benefit will disappear as conditions improve in the local lending market. It is not considered particularly important to the foreign investors, who would actually prefer to have a more stable business environment with commercially reasonable lending available locally.

## **MARKET FOR REFORM IN THE FDI REGIME**

There is strong ongoing demand for reform of the courts, tax regime, property rights, labor and other areas from the FDI community. Although they speak as foreign investors, they also speak for many domestic investors because most of the challenges they address are constraints on all investment, not just foreign investment. Foreign investor associations thus play a crucial role for all investment.

There is resistance, however, to some of the requests for change. Foreign investors note that there are strong vested interests with established political connections that regularly lobby for anti-competitive protections. Foreign investors also report impressions that the Macedonian Chamber of Economy takes a protectionist stance in resisting policies and laws that permit foreign investors to compete evenly with domestic investors.

Macedonia's desire to enter the European Union provides substantial impetus for reform. This bodes well for foreign (and domestic) investors because the attempts by vested interests to protect their markets or otherwise

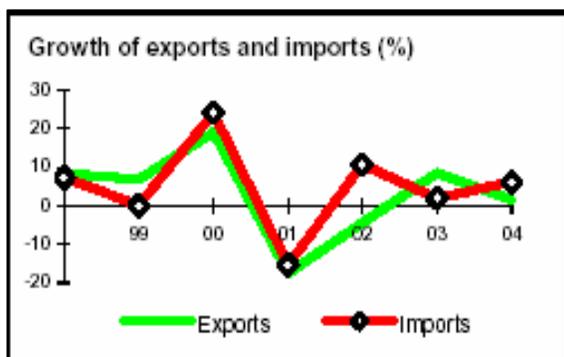
undermine the competitive successes of foreign investors result in practices and policies not in keeping with European standards, and thus not defensible as the country attempts to approximate those standards. Ongoing advocacy by investor organizations, supported by solid economic and legal analysis from local think tanks, can be expected to positively influence the rate and direction of reform over the short and long term.

# TRADE

## OVERVIEW

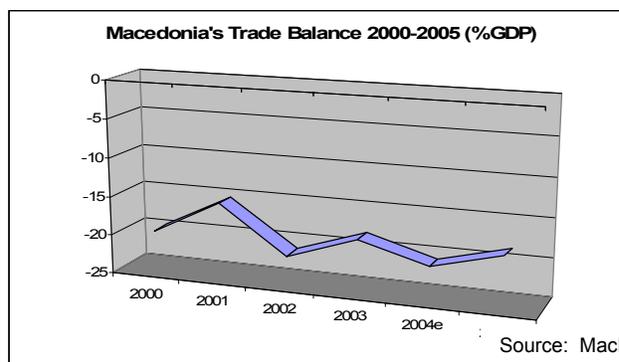
As with other areas in this assessment, trade demonstrates a disparity between the level of reforms and the level of benefits accrued from those reforms. Macedonia has pursued a very aggressive program of compliance with WTO standards and reduction of trade barriers through bi-lateral and multilateral treaties and agreements. This investment in the future, however, has not yet paid off in near term economic benefits.

Macedonia continues to run a trade deficit, averaging around 19% of GDP since 2000. The deficit is expected to drop from 20.8% to 18.5% this year – a notable improvement – but export levels are still too low to support the economic growth needed for the country.



Source: World Bank 2005

Figure 16 - Growth of Exports and Imports



Source: MacInvest 2005

Figure 17 - Macedonia's Comparative Trade Balance

Macedonia's legal and regulatory environment for trade has shown steady improvement over the past five years. The average scores have climbed from 65% in 2000 to 77% in 2003 to 81% in 2005. The greatest improvements have been in the Legal Framework, which now holds a score of 90%. Lower scores in Implementing and Supporting Institutions show the need for additional improvements at the implementation level, but there has been continuous growth in each area nonetheless.

These scores indicate that the foundation for improved trade is in place. Building on that foundation will take ongoing commitment from both the government and the private sector, independently and together, if the Macedonian economy is to benefit.

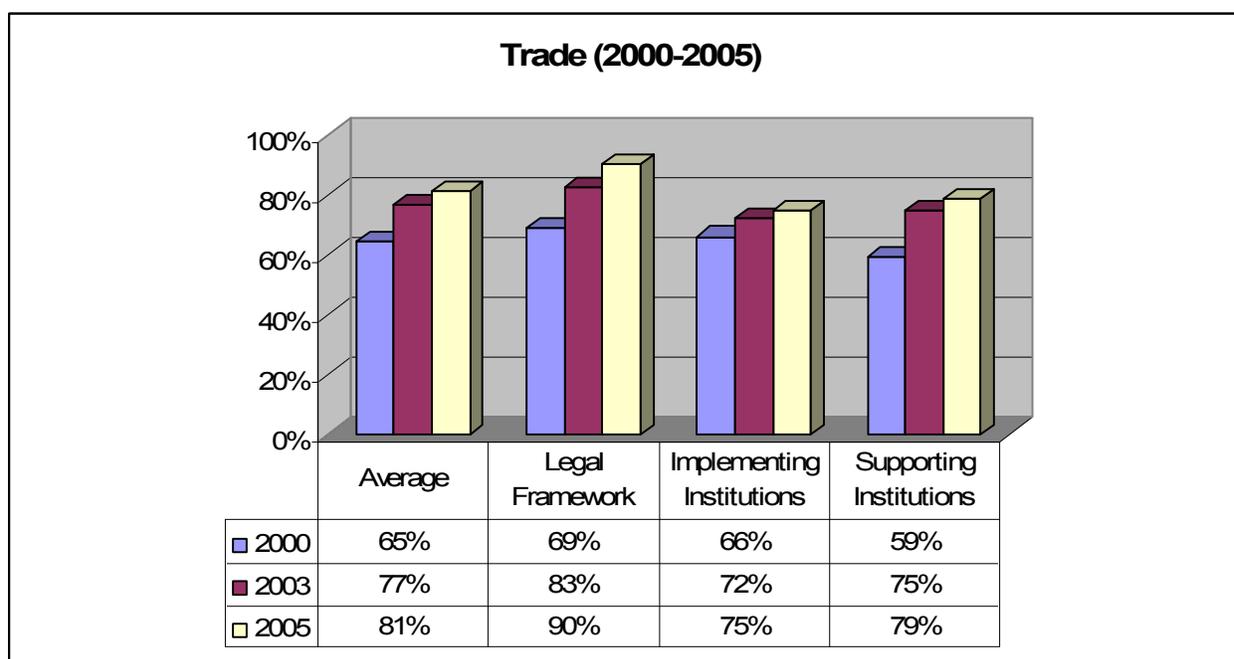
## LEGAL FRAMEWORK

Improvements to the scores for trade law came from several sources. First, Macedonia has upgraded its regime for handling non-tariff barriers by filling several gaps highlighted in the 2003 CLIR Assessment. In the past two years,

the government has adopted countervailing duty and safeguard provisions, with regulations and a committee responsible for addressing subsidized imports. There are still no anti-dumping provisions, due to perceived complexity of the issues and limits on current capacity. Even so, these changes provide Macedonian trade authorities and businesses with important tools for combating unfair trade.

Macedonia is also leading the region in bilateral trade agreements, having signed treaties with all neighboring countries and important trading partners. Import and export licensing has been simplified, with permission granted more or less automatically when a company registers and obtains a customs number. Customs legislation is now in 100% compliance with EU standards for the smooth flow of goods, due to improvements in legislation in 2005. Moreover, Macedonia has adopted the Istanbul Convention on Trade Facilitation and is working to ratify and adopt the simplified Kyoto protocols.

International standards remain a challenge for Macedonian exporters as a practical matter, but the legal regime has improved. All existing ISO standards are in substantial compliance with EU requirements, but not enough of the ISO standards have been adopted. Even for those standards in place, however, there is little understanding by the private sector of how to comply for export to the EU. The door is in place, but few are walking through it.



**Figure 18 - Trade Comparative Scores**

To improve export competitiveness, trade professionals are also advocating clarification and adoption of appropriate cumulative rules of origin for exports to the EU. Currently, Macedonia does not have diagonal accumulation rules in place for certificates of origin. Several associations are advocating changes.

Successes on the legislative front come from strong political commitment to compliance with WTO requirements, coupled with strong donor support and technical assistance. USAID's WTO Compliance Activity has been instrumental in identifying and tackling various needed reforms over the past five years, and figured prominently in earlier assessments as well. The EU is providing substantial support as well, especially in the area of customs and training.

## IMPLEMENTING INSTITUTIONS

The primary Implementing Institution for Trade Law has been the Ministry of Economy. Since the last assessment, the MOE has defined and delegated the functions more effectively by establishing a Trade Commission that coordinates the various ministries and agencies with responsibility for various aspects of trade, while also setting policies and, to some extent, priorities.

This is a marked improvement over prior approaches. It is too early to comment on the abilities of the Trade Commission in fulfilling its role, however, but initial reports are positive. Commission experts are meeting monthly to examine and pursue reform needs, and a ministerial committee meets quarterly, thus replacing ad hoc coordination with regularly scheduled meetings that permit better coordination and strategic management between ministries. The Commission has not yet had the occasion to enforce any countervailing duties or other enforcement actions, and it is expected that training and assistance will be needed when such opportunities begin.

Donor assistance to trade authorities and other ministries with overlapping functions has been instrumental in assisting these bodies to draft and promote new laws and regulations. Due to the quantity of reforms sought within a limited timeframe, legislative process has not generally included sufficient public participation by interested stakeholders. This is not surprising given the circumstances, but the Trade Commission will do well to improve its capacity for public participation in the future to ensure compliance.

The Commission also faces the challenge of increased adoption and use of ISO standards. Efforts are underway to upgrade all former Yugoslav standards to European levels. Implementation, however, is a two-sided equation: the private sector has generally not actively sought to prepare for entry into the European market, so that exports are suffering. Government agencies have a limited role in and capacity for training the private sector in this area. Unfortunately, it seems that lost revenues from rejected exports may be the primary stimulus for change.

To the extent that courts are involved in trade issues, their scores continue to be low. As discussed elsewhere, fundamental reforms are underway in the judiciary and should improve performance significantly over the next 2-3 years.

## SUPPORTING INSTITUTIONS

Improvements in scores for Trade's Supporting Institutions are due to ongoing growth and maturation of a variety of public and private sector organizations. Supporting Institutions have moved up four points, from 75% in 2003 to 79% today. Moreover, this is a dramatic 20 point improvement since 2000, when much weaker institutions scored a disappointing 59%. This consistent progress suggests that sustainable development of a number of organizations is now underway.

The Customs Administration is characterized as a Supporting Institution for purposes of the diagnostic. As noted in the chapter on Foreign Direct Investment, Customs is considered a success story by the business community for its accomplishments in reducing corruption and inefficiency in customs services. Ongoing improvements in providing customer-oriented services and reducing inspection times through better risk profiling have contributed to business confidence and have established momentum for ongoing reform.

Since the first assessment, Customs has introduced a computerized ASYCUDA system which is now networked and operating effectively. Private sector representatives, such as the Macedonian Chamber of Economy, are now

seeking to have greater access to ASYCUDA information for purposes of tracking and promoting trade more effectively.

The Directorate General of Customs plans to develop e-customs capacity over the next few years, with help from EU and other donor organizations. To support this and other strategic interests in trade facilitation generally, the DG has increased its cooperation and development initiatives with neighboring states to ensure that improvements on the Macedonian side of the border are not diluted by weaknesses of the adjoining countries. Customs is therefore pursuing greater use of integrated border management with Greece, Bulgaria and Albania.

The Customs service has also made improvements regarding protection of intellectual property rights through seizure of questionable trademarked goods at the border. Several associations, most notably the Business Software Association, are seeking ongoing improvements in this regard, while individual businesses are seeking to register their copyright and trademark rights with Customs to ensure easier clearance and the capacity to seek seizure of counterfeit goods. As noted in the chapter on Foreign Direct Investment, this advance is not well supported by the courts: imports can be delayed only temporarily, subject to urgent court proceedings, but the courts cannot generally handle the claims in a timely manner.

Tax authorities continue to lag behind other government institutions in their developments. Importers complain that they must pay import duties immediately, without regard to cash flow issues that constrain their ability to pay until they sell the imported goods. In addition, authorities have been very slow in issuing VAT refunds when imported inputs are re-exported.

Scores also improved due to the emergence of think tanks, particularly the Council for Economic Analysis. CEA provided a cost/benefit analysis that was instrumental in bringing about tariff reductions, in what may be the first instance of government policy being changed based on clear economic analysis. (The policymaking system has tended to depend more on ideology and assumption, with few if any laws backed by economic impact studies.) In addition, private sector business associations are playing an increasing role in advocating change and are developing healthy relationships with the Customs Administration and other government agencies to improve the trade environment.

In addition, there has been some positive movement in the provision of private sector training in trade-related areas. The Macedonian Chamber of Economy has offered a number of courses to both customs service personnel and private sector businesspeople in trade facilitation. Overall training and advisory services for the private sector are still weak, however. During the course of trade talks and the opening of the market over the past five years, Macedonian exporters and producers have generally failed to make necessary adjustments to upgrade their products according to ISO standards. As a result, they have missed opportunities to prepare for the current trade regime and are lagging behind. Much work is needed in the area of public education to improve understanding of the need for ISO compliance, accompanied by specialized training in how to achieve that compliance.

## **MARKET FOR REFORM ON TRADE**

Demand for trade reform has been driven primarily by political commitment to first join and then comply with the WTO. Given the generally poor understanding of trade issues, it is not inappropriate to assume that much of this commitment was also connected to pressure from donors, but this should not be overestimated. In the end, government commitment to the goals coupled with strong donor support for the process has resulted in substantial improvements over the past five years.

Among the general population, there is still a poor understanding of the benefits of a more open trade regime and much sentimental longing for the better days of the Yugoslav era when markets were protected and directed by government. This is not surprising in light of the economic dislocation since independence, but it is also not

helpful. There is little public support for improved trademark and copyright protections, with one enforcement officer even being quoted as asking why Macedonia should be protecting foreigners by enforcing these laws against counterfeiting Macedonians. What he – and others – do not understand is the positive impact on Macedonian entrepreneurs and investors when the IPR system protects all rights holders. Without such understanding, change will continue to be slow.

The lack of success in improving ISO standards also suggests poor understanding of the need and benefits of the new trade environment, but it also points to the very deep gap in knowledge about marketing. Today, Macedonia's number one export market is its neighbor, Serbia and Montenegro, which still accepts imports below EU standards. Growth opportunities, however, are greatest in the EU market, but most producers do not understand the concept of adapting their products to that market demand instead of finding demand for lower quality products already being produced. As Serbia and Montenegro moves closer to EU membership (with consequent emphasis on ISO compliance), Macedonian producers must make the adjustment.

# APPENDIX 1

## CLIR COMPARATIVE SCORES - MACEDONIA



## Macedonia's CLIR Progress 2000-2005

	2000	2003	2005
<b>BANKRUPTCY</b>	<b>62%</b>	<b>64%</b>	<b>70%</b>
Legal Framework	87%	89%	95%
Implementing Institutions	57%	58%	59%
Supporting Institutions	42%	44%	58%
<b>COLLATERAL</b>	<b>76%</b>	<b>83%</b>	<b>86%</b>
Legal Framework	79%	91%	94%
Implementing Institutions	87%	87%	87%
Supporting Institutions	61%	69%	77%
<b>COMPANY</b>	<b>58%</b>	<b>68%</b>	<b>74%</b>
Legal Framework	76%	80%	93%
Implementing Institutions	45%	62%	66%
Supporting Institutions	52%	61%	64%
<b>COMPETITION</b>	<b>27%</b>	<b>44%</b>	<b>69%</b>
Legal Framework	57%	71%	91%
Implementing Institutions	6%	35%	68%
Supporting Institutions	18%	27%	49%
<b>CONTRACT</b>	<b>65%</b>	<b>66%</b>	<b>71%</b>
Legal Framework	84%	87%	90%
Implementing Institutions	62%	57%	57%
Supporting Institutions	50%	53%	65%
<b>FDI</b>	<b>71%</b>	<b>80%</b>	<b>84%</b>
Legal Framework	88%	93%	94%
Implementing Institutions	62%	69%	71%
Supporting Institutions	64%	78%	88%
<b>TRADE</b>	<b>65%</b>	<b>77%</b>	<b>81%</b>
Legal Framework	69%	83%	90%
Implementing Institutions	66%	72%	75%
Supporting Institutions	59%	75%	79%
<b>AVERAGE</b>	<b>61%</b>	<b>70%</b>	<b>77%</b>
Legal Framework	79%	86%	92%
Implementing Institutions	55%	65%	69%
Supporting Institutions	49%	58%	68%

# APPENDIX 2

## CLIR COMPARATIVE SCORES – EUROPE AND EURASIA

	Albania		Armenia		Azerbaijan		Bulgaria		MACEDONIA			Poland		Romania		Serbia		Ukraine		Kazakhstan	
	2000	2001	2001	2002	2002	2001	2000	2003	2005	1999	1999	2001	1999	1999	2001	1999	1999	1999	1999	1999	
<b>BANKRUPTCY</b>	<b>42%</b>	<b>57%</b>	<b>44%</b>	<b>44%</b>	<b>34%</b>	<b>62%</b>	<b>68%</b>	<b>70%</b>	<b>79%</b>	<b>80%</b>	<b>79%</b>	<b>58%</b>	<b>47%</b>	<b>39%</b>	<b>53%</b>						
Legal Framework	90%	89%	67%	67%	67%	87%	89%	95%	80%	80%	59%	61%	41%	60%							
Implementing Institutions	21%	42%	44%	25%	25%	57%	58%	59%	80%	80%	62%	41%	45%	51%							
Supporting Institutions	16%	41%	21%	10%	10%	42%	44%	58%	76%	76%	52%	39%	33%	49%							
<b>COLLATERAL</b>	<b>77%</b>	<b>23%</b>	<b>54%</b>	<b>70%</b>	<b>70%</b>	<b>76%</b>	<b>83%</b>	<b>86%</b>	<b>78%</b>	<b>31%</b>	<b>24%</b>	<b>55%</b>	<b>37%</b>								
Legal Framework	91%	29%	75%	91%	91%	79%	91%	94%	90%	44%	40%	76%	56%								
Implementing Institutions	80%	11%	50%	73%	73%	87%	87%	87%	79%	13%	13%	56%	23%								
Supporting Institutions	58%	30%	36%	48%	48%	61%	70%	77%	65%	35%	19%	31%	31%								
<b>COMPANY</b>	<b>50%</b>	<b>70%</b>	<b>46%</b>	<b>76%</b>	<b>76%</b>	<b>58%</b>	<b>68%</b>	<b>74%</b>	<b>76%</b>	<b>66%</b>	<b>65%</b>	<b>44%</b>	<b>59%</b>								
Legal Framework	75%	90%	56%	87%	87%	76%	80%	93%	70%	53%	80%	39%	53%								
Implementing Institutions	54%	69%	46%	68%	68%	45%	62%	66%	76%	73%	57%	52%	67%								
Supporting Institutions	21%	51%	35%	72%	72%	52%	61%	64%	82%	70%	59%	42%	58%								
<b>COMPETITION</b>	<b>n/a</b>	<b>40%</b>	<b>35%</b>	<b>63%</b>	<b>63%</b>	<b>27%</b>	<b>44%</b>	<b>69%</b>	<b>80%</b>	<b>60%</b>	<b>26%</b>	<b>44%</b>	<b>58%</b>								
Legal Framework		66%	71%	93%	93%	57%	71%	91%	82%	66%	40%	55%	64%								
Implementing Institutions		22%	22%	37%	37%	6%	35%	68%	81%	62%	15%	42%	64%								
Supporting Institutions		33%	13%	59%	59%	18%	27%	49%	76%	51%	23%	37%	46%								
<b>CONTRACT</b>	<b>56%</b>	<b>51%</b>	<b>48%</b>	<b>77%</b>	<b>77%</b>	<b>65%</b>	<b>66%</b>	<b>71%</b>	<b>82%</b>	<b>71%</b>	<b>67%</b>	<b>50%</b>	<b>65%</b>								
Legal Framework	84%	90%	81%	93%	93%	84%	87%	90%	83%	74%	86%	50%	73%								
Implementing Institutions	51%	41%	39%	61%	61%	62%	57%	57%	83%	73%	63%	49%	66%								
Supporting Institutions	35%	22%	25%	77%	77%	50%	53%	65%	79%	66%	54%	50%	54%								
<b>FDI</b>	<b>n/a</b>	<b>44%</b>	<b>29%</b>	<b>70%</b>	<b>70%</b>	<b>71%</b>	<b>84%</b>	<b>83%</b>	<b>78%</b>	<b>64%</b>	<b>n/a</b>	<b>45%</b>	<b>67%</b>								
Legal Framework		73%	52%	77%	77%	88%	93%	94%	87%	96%		89%	83%								
Implementing Institutions		15%	12%	81%	81%	62%	82%	69%	82%	58%		18%	68%								
Supporting Institutions		44%	22%	52%	52%	64%	78%	88%	66%	38%		28%	50%								
<b>TRADE</b>	<b>n/a</b>	<b>44%</b>	<b>27%</b>	<b>40%</b>	<b>40%</b>	<b>69%</b>	<b>80%</b>	<b>81%</b>	<b>71%</b>	<b>61%</b>	<b>n/a</b>	<b>37%</b>	<b>57%</b>								
Legal Framework		73%	29%	68%	68%	81%	93%	90%	93%	90%		56%	79%								
Implementing Institutions		21%	23%	25%	25%	66%	72%	75%	71%	53%		34%	61%								
Supporting Institutions		37%	28%	28%	28%	59%	75%	79%	49%	40%		19%	32%								
<b>AVERAGE</b>	<b>56%</b>	<b>49%</b>	<b>41%</b>	<b>62%</b>	<b>62%</b>	<b>61%</b>	<b>70%</b>	<b>76%</b>	<b>78%</b>	<b>59%</b>	<b>46%</b>	<b>45%</b>	<b>57%</b>								
Legal Framework	85%	73%	62%	82%	82%	79%	86%	92%	84%	69%	62%	58%	67%								
Implementing Institutions	52%	32%	34%	53%	53%	55%	65%	69%	79%	56%	38%	42%	57%								
Supporting Institutions	33%	37%	26%	49%	49%	49%	58%	68%	70%	50%	39%	34%	46%								