

INSTITUTIONS' CAPACITY FOR GOVERNANCE AND ITS IMPACT ON THE GROWTH PERSPECTIVES IN REPUBLIC OF MACEDONIA

Milena Ristovska
University "Ss. Cyril and Methodius", TURKEY

Abstract

The theory and practice have confirmed the importance of good governance and quality institutions for the economic growth. The issue of building well-functioning market economy and institutions supporting it is a rather pressing issue in Macedonia whose long term persistence of negative growth rates is largely due to the weaknesses of the institutional framework.

This paper presents the functioning of the current institutional framework in Macedonia that significantly influences the growth dynamics and also gives some guidelines for reforms in selected areas of great importance for the growth (judicial system, public administration, protection of the property rights and e-governance).

Key words: *institutions, governance, growth dynamics.*

1. Institutions' Capacity For Governance

For the past two decades, the issues of the quality of institutions, the development of institutions that promote economic growth and the good governance have been the central topic in the debates regarding the conceptualization and implementation of development strategies and policies on both national and global level. Even though up until recently neglected, if not completely ignored in the economic growth models, recently the institutions (their quality and governance capacity) have been increasingly pointed out as one of the main reasons for the differences among the growth rates of different national economies. This fact has been confirmed by the empirical analysis of the positive correlation between the institutions' governance capacity and the economic growth of the national economies.

Institutions themselves represent a complex and multidimensional phenomenon that is defined from different angles and sometimes in a rather broad manner. Generally, the institutions cover: 1) the legal framework that provides the formal rules and limitations within which the individuals and the economic agents function and also defines and provides stimuli for establishment of mutual relationships between these agents; 2) voluntary and cooperative arrangements among the private agents that influence the

nature and the organization of the exchange among them and 3) cultural values and beliefs that influence the economic behavior.⁹

The governance is a process in which the institutions (on every level) make decisions, determine who to involve in the process of decision-taking and implementation of decisions and also determine who is to be accountable and responsible for the effects of the implementation of these decisions which affect numerous different actors. Alternatively, the governance with the economic growth and development is a process of application of the 'rules of the game' and cooperation for efficient allocation of resources, as well as coordination or control of the economic activity or the processes in the society, in general.

The institutions' capacity for governance is the ability for decision-making and for implementation of decisions i.e. it is a capacity for achievement of the goal function despite the anomalies, disruptions that occur inside and outside the institutions as system. This ability is a result of the interaction among the human capital, organizational resources and the social capital that exist in every institution and of the continuing process of learning for adaptation and survival. The institutions' capacity for governance is determined by the:

- *capacity of the individuals within the institutions*: their skills and knowledge; understanding for the problems, the opportunities and the viewpoints of others; ability to generate creative ideas; willingness to take initiatives, to experiment and learn from mistakes; ability to establish and maintain professional and personal networks through which communication and cooperation take place; ability to assess the broader implications from their actions etc;
- *capacity of the institution itself*: ability of the institutions to quickly react to the changes in the environment which asks for information, their processing into concrete ideas for action, cooperation within the institution, as well as with its environment and adaptation of the strategies. Effective institutions have well-networked communication among their members, close (similar) understanding of things and cooperative links in the mutual solving of the complex problems. The information flow from the upper to the lower levels of hierarchy, but also vice versa, as well as across sectors and organizational departments. There is constant experimentation and learning by mistakes;
- *capacity of the institution to cooperate within a broader environment*: ability to establish partnerships for achievement of the goals which are a reflection of the care for the collective wellbeing in the broader surrounding.¹⁰

⁹ World Bank, 2002, *World Development Report 2002: Building Institutions for Markets*, Oxford University Press, p. 4.

¹⁰ Innes, Judith E., David E. Booher, 2003, *The Impact of Collaborative Planning on Governance Capacity*, Institute of Urban and Regional Development, University of California, Berkeley, p. 9 – 18.

2. National Level Governance With The Economic Growth

National level governance could be defined as practicing the political, economic and administrative authority to manage the issues that are of national interest. It is a system of complex mechanisms, processes, relationships, connections and institutions through which the individuals and the social groups express their interests, practice their rights and fulfill their relationships, but also overcome their mutual differences. This governance could not be reduced to the realization of the classical functions of redistribution, command and control. The institutional capacity of the state authorities and their specific characteristics are a significant, but not the sole factor that determines the success of the reforms which aim at attaining economic growth and development. Nowadays, the government and numerous social and economic actors play an active role of intermediaries, negotiators and practitioners which implement the programs and achieve the goals in a complex process of governance that also involves learning.

The governance framework should also include the informal institutions (culture, customs, tradition, values) that shape the individual behavior and the subjective perceptions. The development strategies and the reform policies should be compatible with the characteristics of the culture and the effective governance should take into account the system of beliefs, values that exist in the society.

Integrating this perspective for defining the system of governance on national level, the national level governance is process of exercising the capacity of the formal and informal institutional environment (in which the individuals, social groups, civil society organizations and the state organs in charge of conceptualization and implementation of the policies are in constant interaction with each others) to impose and implement public policies and to improve the coordination in the private sector.¹¹ The main functions and goals of this governance structure are: 1) proper management (distribution and allocation) of the public resources; 2) establishment and maintenance of a surrounding that is conducive for proper functioning and development of the private sector and 3) establishment of productive partnership between the public and the private sector that should not be reduced to narrow, closed circles of influence and privileges. The success of the realization of these functions largely depends on the respect of the basic principles of good governance – accountability, involvement of all the relevant actors, stability, credibility and transparency.

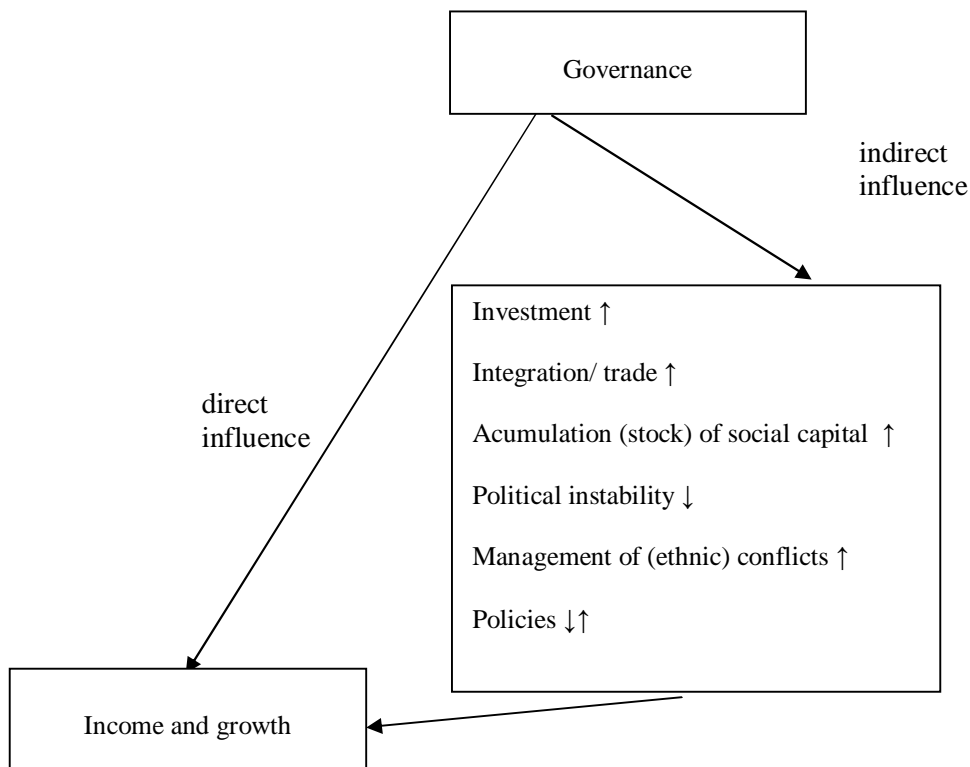
3. The Impact Of Governance On Economic Growth

The theory and practice have confirmed the positive impact the quality governance has on the national income and the growth rates of the economy, as well as on the increase of the

¹¹ Ahrens, Joachim, *Governance, Conditionality and Transformation in Post-socialist Countries* in Hoen, Herman W. (ed.), 2001, *Good Governance in Central and Eastern Europe: The Puzzle of Capitalism by Design*, Edward Elgar Publishing Inc, p. 55 – 61.

investments, their productivity, the management of ethnic diversity and conflict, the quality of development policies and the growth of the social capital stock.

Picture no. 1: The influence of the quality of governance and the functioning of institutions on the economic growth



There are numerous attempts in theory and practice for quantification of the exact influence of governance and institutions on the economic growth of different national economies. These studies almost identically show that the economies with high quality institutions (for an example, measured by the index of economic freedom in the world) achieve both higher growth of the level of investments and higher growth of their productivity. Provided the initial income, the geographic/location conditions and human capital are constant, the assessed impact of the one- percentage-point growth of the private investments as portion of the GDP on the long term growth is 74% higher in countries whose index of economic freedom has a value that is higher than 7 compared to the countries whose index value is lower than 5. Similarly, on average, the private investments have proved to be 25% more productive in countries where the value of the index of economic freedom is above the mean compared to the countries whose value of the same index is below the mean. Ceteris paribus, the higher initial rang according to the index of economic freedom and the improvement of the rank position in a longer period of time have a strong positive influence on the relative share of private investment in the

GDP. It is these investments that have proved to be the main drivers of the development.¹²

4. Growth Dynamics In The Republic Of Macedonia

In 1991 after declaring its independence, Republic of Macedonia started building market economy and democratic society. This was in fact a rather complex and multidimensional process of establishing new institutions, system of values and policies that were completely different from the ones in the previous socio-market system. The main processes that underpinned this system transformation were: liberalization of the prices, internal and foreign trade, stabilization, privatization, reform of the tax system and banking system, establishment of social security institutions etc. The aim of the transformation was to build a well-functioning free market economy with viable private sector that could cope up with the new standards and demands that the market competition imposes on him.

The beginning of this transition was marked with extremely high rates of inflation, stagnant and even decreasing rates of growth and pauperization in the social sphere. This condition was partly 'inherited' from the previous system, but mostly the adverse development trends were a result of: the decreased national market due to the breakup of Yugoslavia, the interrupted trade relations with the former trading partners, the inability of the economic subjects to adapt to the new, changed conditions on the market, their inability to cope with the challenges of the competition on the liberalized market, then the underdeveloped or (somewhere) practically nonexistent institutional base for efficient functioning of the markets, the slow realization of the reforms and the restrictive monetary and fiscal policy which disable the positive influence of the increased demand upon the supply and hence, upon the growth. In this sense, the policies and the reforms made the most negative influence on the growth perspectives – slow pace of reforms, lack of political will to implement the needed changes because of fear from social riots, lack of synchronization and postponement of the reforms etc.

The analysis of the macroeconomic indicators from the period 1991 – 1996 points to a dramatic decrease of the industrial production. The companies were working with outdated technologies and not adjusted to the new conditions on the market which was drastically smaller than the one in the previous system and offered no possibility for a guaranteed placement of the produced goods. The loss of the markets and the lack of state help (in form of socialization of the losses) was a serious problem for them. This period was also marked by high inflation rates which necessitated restrictive monetary and fiscal policies aimed at stabilization of the economy which in the long run of things, had little, if any positive effects on the development and growth. There is a deficit in the foreign

¹² Gwartney, James D., Randall G. Holcombe, Robert A. Lawson, 2006, 'Institutions and the Impact of Investment on Growth', *KYKLOS Vol. 59-2006-No.2*, Blackwell Publishing Ltd., p. 270, 271.

trade and due to the high political risk, insufficient stability of the economic and political system and the lack of information for the investment possibilities abroad, there is a low inflow of foreign direct investments. Because of these reasons the companies did not make any significant restructuring of the production, organization and technology. There was also negative exterior influence such as the blockade on Yugoslavia and the embargo imposed on Macedonia by Greece.

The first positive growth rates were registered in 1996. During the period 1996 – 2001 there were some development effects from the liberalization and the stabilization of the economy. The growth of the total factor productivity is the main source of the growth rates in this period (the growth of the total factor productivity accounts for 41% of the average growth rates in this period). The growth of the engaged physical capital accounts for only 14% of the average growth rates and 45% of them result from the employment growth. This points out to an intensive growth model – the productivity growth is higher than the growth of the stock of the production factors.

The private business sector is the driver of the growth and after the completion of the privatization it realized major projects and underwent significant production, technological and managerial restructuring. Numerous bilateral trade agreements were signed during this period and these agreements significantly increased the market for export of our domestic products, but there were no significant positive changes in the structure of our exports and the competitiveness of our products. The competitiveness of our products was based on the price and not on the qualitative changes in the structure. The reasons for this lie in the inappropriate model of specialization of the production structure based on certain specific natural advantages.

But, the rate of unemployment is still very high during this period of time – 37% of the active population. This unemployment is a result of the huge number of laid-off and bankruptcy of numerous companies, as well as of the discrepancy between the needs of the labor market and the qualification structure of the active population – segmentation and profound distortions on the labor market. Closely related to this is the problem of expanded shadow economy – between 35 and 40% of the GDP.

The trend of positive growth rates was interrupted in 2001 with the outbreak of the ethnic conflict on the territory of our country which imposed serious distortions in our economy along with the tensions in Kosovo in 1999. A slight growth was registered in 2002 after which there is a trend of positive growth rates accompanied by macroeconomic stability. These development results come from the efficiency of the implemented structural reforms which proved to be very important for the improvement of the business climate in the country. The most significant reforms include:

- measures for improvement of the regulatory framework. This reform means change in the existing legal framework that regulates the registration of new businesses and the work of the newly established companies, as well as change in the functioning of the existing institutions that support the market operations

of the companies – completion of the real estate cadastre and improved functioning of the financial markets. The exact changes that constitute this reform are: passing and enactment of new laws on registration of business and other regulations that significantly lower the time and the costs necessary for starting a business, elimination of some burdensome regulations for running a business and changes in the system of licenses and controls, reform of the taxation system (lower and flat tax rates of the income tax and expanded tax base) etc. other significant changes in this sphere are the actions for implementation of the standards and codes of corporate governance and the accounting and audit standards, as well as actions for increased capacity of the National bank for supervision and regulation of the banking sector.

- measures for improvement of the investment climate and attraction of foreign direct investments. In 2007 the Government published a new investment programme which is supported by a strong marketing campaign for promotion of the investment opportunities in the country that should enable entrance of well-known foreign companies and trade marks. Their operations in the country should contribute to the increase of the employment, transfer of advanced technology and know how, acceptance of new organizational and managerial skills etc.
- reform of the judicial system that was launched in December 2004 with the aim of building a efficient, effective and just enforcement of the creditor, contractual and property rights. The strategy is implemented in cooperation with the World Bank and its focal points are: decrease of the duration and the costs of the contract enforcement and of the bankruptcy procedures, proper implementation of the law on bankruptcy and misdemeanor, decrease of the backlog and postponement of the trials, efficient enforcement of the judicial decisions, improvement of the regulatory framework for bankruptcy and increase of the speed, transparency and justification of the administrative decisions.
- reform of the rigid and stagnant labor market that causes high rate of unemployment and large scale informal sector. The aim of the new Law on work relations is to eliminate the burdensome characteristics of the former law and to initiate growth, investments, transfer of labor force from the informal towards the formal sector and strengthening of the rights of the employees. The reform is realized with active measures for employment and in coordination with other economic policies.
- decentralization i.e. transfer of finance and jurisdictions from central to local level.

Indicator	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP (in millions denars)	920	11791	59161	13603	169521	176477	186019	194979	209010	236389	233841	243970	251486	265257	286619	303305
GDP per capita (US\$)	2 134	1 053	1 141	1 500	1 917	1 971	1 663	1 790	1 837	1 793	1 718	1 885	2 316	2 653	2 850	n.a.
GDP per capita PPP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4 300	4 500	4 800	5 100	5 000	5 100	5 300	5 600	6 000	6 400
Real BDP growth rate	-7,0	-8,0	-9,1	-1,8	-1,2	1,2	1,4	3,4	4,3	4,5	-4,5	0,9	2,8	4,1	4,0	4,0
Inflation	n.a.	n.a.	362,0	128,0	15,7	2,3	2,6	-0,1	-0,7	5,8	5,5	1,8	1,2	-0,4	0,5	3,2
Export (F.O.B) (in US\$ billions)	n.a.	n.a.	1,06	1,08	1,20	1,15	1,20	1,31	1,19	1,32	1,16	1,112	1,362	1,672	2,041	2,401
Import (C.I.F.) (in US\$ billions)	n.a.	n.a.	1,01	1,27	1,42	1,46	1,59	1,91	1,78	2,08	1,68	1,916	2,211	2,785	3,097	3,763
Trade balance	n.a.	n.a.	0,05	-0,19	-0,22	-0,31	-0,39	-0,60	-0,59	-0,76	-0,52	-0,804	-0,849	-1,113	-1,056	-1,362
Growth rate of the productivity of the labor force in the industry	-9,6	-10,0	-10,4	-4,9	3,1	9,2	8,2	-0,2	0,7	10,9	-10,6	13,5	12,4	4,7	15,5	n.p.
Investicii vo osnovni sredstva (% of GDP)	19,3	16,4	3,1	1,6	4,0	6,0	7,2	22,3	19,7	21,4	14,8	16,6	16,7	18,8	20,0	n.p.
Net foreign direct investments (in US\$ millions)	n.a.	0,0	0,0	24,0	13,0	12,0	18,0	118,0	32,0	176,0	439,0	77,0	94,0	156,0	97,0	300,0
Value added by sectors																
Agriculture	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	12,8	13,2	12,9	12	11,8	12,4	13,4	13,2	12,8	n.p.
Industry	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	28,4	27,1	26,5	26,9	26,1	24,2	24,4	22,7	23,1	n.p.
Construction	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,2	6,7	6,1	6,8	6,0	6,0	6,3	6,5	6,6	n.p.
Services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	52,7	52,9	54,5	54,2	56,1	57,5	56,0	57,7	57,6	n.p.
Industrial production index (2000 = 100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	94,9	99,2	96,6	100,0	96,6	91,8	96,1	94,0	100,6	104,2
Rate of unemployment	19,2	27,8	28,3	31,4	37,7	31,9	36,0	34,5	32,4	32,2	30,5	31,9	36,7	37,2	37,3	36,0
External debt (% of GDP)	n.p.	n.p.	45,5	37,2	32,3	26,5	30,3	40,1	41,5	39,9	41,0	43,1	44,9	44,6	38,8	36,7

Source: EBRD, *Transition Reports 1999 – 2006*; Commission of the European Communities, 2007, *Commission Staff Working Document, The Former Yugoslav Republic of Macedonia 2007: Progress Report*, COM (2007) 663 final; Ministry of finance of Republic of Macedonia, Bulletin (different editions).

5. The Impact Of Institutions On The Economic Growth

The development results registered in Republic of Macedonia from 1991 till present which can be described as unsatisfactory, are largely a result of the low quality of the functioning of the institutions i.e. the problems in their work, the failure to coordinate themselves and the slow pace of reform. More precisely, the problems related to the governance that jeopardized the success of the transitional reforms and the prospects for higher growth rates are a result of:

- the relatively weak capacity of the state institutions to implement the laws, to collect the taxes, to resist the pressures of interest groups and to implement coherent market-oriented reforms. The problem lies in the insufficient credibility and commitment of the institutions to implement the planned reforms. Despite the huge importance of the market-supporting institutions, little has been done in the area of protection of the property rights, the rights of the creditors and the contract rights which in return provides weak incentives for entrepreneurial and innovation activity. Even though there is a low risk of expropriation, there is a general concern about the high political risk and instability in the country that deter the potential foreign investors and that make the domestic economic agents more careful when thinking of taking up a new venture. One could also add up the serious pressures from the powerful interest groups of companies that not only manage to make favorable concessions for themselves, but also cause serious distortions of the free market competition;
- the lack of consistent political leadership, strong correlation between the economic and political cycles and strong dependency of the economy from the politics. There is a tendency of the newly elected political elites to change the political priorities which most usually comes down to annulations of the previously accomplished results;
- the insufficient coordination among the institutions in charge of close spheres. This results in doubling of the efforts for realization of same goals and same projects, insufficient cooperation and inability to overcome the conflicts between the bearers of public functions;
- the resistance to further reforms by those that benefit from the previous setting of the relations, who gained political power or are interested in partial reforms that will preserve their favorable position. The biggest obstacles come from the economic subjects that already have a well established position in the previous system and now when the circumstances have changed, tend to influence the measures of the macroeconomic policies;
- the failures of the institutions due to contradictions in the existing laws, inconsistent implementation of the laws and their insufficient transparency. The improper implementation of the laws is a huge problem whose solving needs a strengthening of the institutional capacity;

- the relatively weak local government and ill-defined relations between the central and the local government. This problem is due to be overcome with the decentralization and the transfer of finance and competences on local level;
- the high level of corruption in the public offices due to the high level of bureaucracy interference and regulation of the economy;
- conflict between the formal and informal institutions that causes the problem of hysteresis;
- the underdeveloped civil society and lack of tradition of consultations and transparent and equal cooperation with the interest groups and other stakeholders when drafting and passing new laws and policies etc.

6. Domains For Improvement Of The Institutions' Governance Capacity

The most problematic parts of the institutional framework that fail to fully support the economic growth of the economy are the poorly functioning system of property rights, the slow and over-dimensioned public administration and the judicial system. One could also point to the poor interconnectedness of the public institutions. So, without any intention to be completely comprehensive in the analysis, the following could be done in order to improve the quality of institutional functioning:

- Improvement of the protection of the property rights – The general assessment is that despite the well defined legal framework for protection of the property rights in Macedonia, there is a fundamental problem of their protection and enforcement. So, the following should be done in order to secure a well-functioning system of property rights:
 - increase of the efficiency of the work of the institutions in charge of protection of the property (especially the real estate cadastre);
 - strengthening of the capacity of the mechanisms for implementation of the laws on competition and property rights;
 - development of secondary legislation necessary for efficient implementation of the new Law on industrial property and the Law for protection of the competition;
 - development of the skills and qualifications of the employees in the institutions for protection of the property rights etc.¹³
- Modernization of the public administration – The most problematic points in this sphere of the institutional network are:
 - the mismanagement of the accomplishments that brings to inadequate incentives for proper functioning;

¹³ According to the Annual report of the European agency for reconstruction for Macedonia for 2004, http://www.eur.europa.eu/macedonia/main/mac-annual_programme_2004_legislation_internal_market.htm

- the recruitment and promotional systems that do not reflect the real situation in the country and base mostly on the formal education while at the same time do not attract and promote qualified staff that continually learns and acquires new skills and knowledge;
- too big interference of the politics and inability to make an objective assessment of the results of the public servants individually or the entire public administration;
- lack of mission and lack of focus on the achievement of the organizational goals, as well as insufficient respect for the broader public whose needs should be met with the provision of the public goods and services.

The reform should focus on:

- the reform of the public services which basically comes down to quantitative and qualitative changes in the structure of the human resources employed there;
 - obtaining increased efficiency and responsiveness of the system for policy creation;
 - the reform of the government apparatus – the rules, the institutions and the structure of the administration that are needed for the implementation of the government policies, including new modalities for the public administration.
 - the reform of the system of public revenues and expenditures etc.¹⁴
- Modernization of the court system – the inefficient judicial system in Macedonia is the reason for poor protection of property and contractual rights and hence, for low investment and innovation activity, so the focus should be put on:
 - decreasing the backlog of unsolved cases;
 - decreasing the time and cost of court procedures;
 - better transparency of the court decisions and their full implementation;
 - computerization of the court services etc.
 - electronic interconnectedness of the public institutions – Establishment of e-governance system that should provide:
 - decreased operating costs and increased efficiency;
 - higher quality of the public services provided for the end users – the citizens and the businesses;
 - transparency, decreased corruption and bigger accountability;
 - increased capacity of the government;

¹⁴ Support for Improvement in Governance and Management (SIGMA), 2004, *Public Administration Reform Assessment: Republic of Macedonia*, European Union and OECD.

- networks of communities and horizontal and vertical integration of the government agencies, as well as involvement of the public;
- Core quality decision-making process due to the constant communication and interaction among the different government agencies and the public in general;
- synergetic effects from the use of ICT in other sectors of society.

7. Conclusion

The cross-country and cross-sectional studies of the development in longer time periods show that the cases of success of different national economies are not a result only of the endowment of natural resources, the more rapid rates of technology progress and the high rates of physical and human capital accumulation, but are, more importantly, heavily dependent on the well functioning of the institutional network that supports the system of markets in any national economy. This network includes not only the formal institutions that channel the information, define and enforce the property and contractual rights and increase the market competition, but it also includes the informal institutions (the beliefs, norms, values) that shape the individuals' behavior.

The different subsystems of this institutional network interact with each other and through their coordination and cooperation the governance with the economic growth and development is realized on national level. The goals of this governance process are: efficient distribution and allocation of the scarce resources, decrease or complete elimination of the risks and costs of the business, implementation of the development policies and development of the private sector. The government agencies, the judicial institutions, the legislature, the regulatory bodies, the civil society organization, the business entities and the citizens make, take and implement decisions that define the expectations, grant authority and verify the results from the realization of the common interests and goals for a more dynamic economic growth and social prosperity.

Unfortunately, the institutional factor proved to be of little positive significance for the economic growth in Republic Macedonia. The institutions were slow and reluctant to reform, inefficient in the implementation of the development policy, they failed to coordinate and cooperate and in that way, actually imposed obstacles to the growth. That is why the institutional reform is the much needed transformation that should positively affect the growth prospects and in the long run should provide increased transparency, accountability and responsiveness to the public needs.

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