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A graphic of a globe showing the continents of Europe and Africa, set against a dark background. The globe is illuminated from the left, creating a bright glow on the left side of the continents. The globe is positioned in the lower right quadrant of the central orange section of the cover.

ISSN 1857-5250  
UDK 33

Price: 300 MKD (5 EUR)

**Volume 10**  
Issue 2  
1-68 pages

Skopje, Macedonia  
December 2015



# CEA Journal of Economics

ISSN 1857-5269  
UDK 33  
Volume 10, Issue 2  
Skopje, December 2015  
International Journal  
Published since 2006

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CEA Journal of Economics  
Volume 10, Issue 2  
1 - 68 pages  
Skopje, Macedonia  
December, 2015

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UDC 330.368(497.7)

## INCOME INEQUALITY IN MACEDONIA: MECHANISMS AND SOLUTIONS

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### Abstract

*The rising income inequalities are one of the most important structural reasons of the global economic crisis. We focus on the income inequality in the country with highest Gini coefficient in Europe – Republic of Macedonia. We argue that there are two main drivers of income inequality in the country: installed neo-liberalism and political patronage system. Neo-liberalism is used as a tool to remove the legislative protection of the workers, to maintain the wages on the miserable low level and to block the redistribution of income from the elites towards the others in the society. The completely opposite system of political patronage and populism is used as a tool of governance. It is based on state related benefits targeted to different groups of citizens and designed to be distributed in small portions and in turns in order to gradually increase the serfdom of the majority of the population from the elites. As a result, the country currently has the highest income inequality in Europe, accompanied by increase of poverty. The article concludes with suggestion of five directions for policy reforms.*

**Key Words:** income inequality, neo-liberalism, political patronage, economic policy.

JEL Classification Index: B20, H10, I30.

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### 1. Introduction

The most important structural reason of the global economic crisis, along the deregulation of financial markets, is the increasing income inequality. We focus on the income inequality in the country with highest Gini coefficient in Europe: 43,6 in 2010 (World Bank, 2014). The goal of this paper is to describe the main mechanisms of income inequality and to propose possible directions for policy reforms. The main mechanisms of inequality are the two opposite forces: neo-liberalism and political patronage. The neoliberalism is synonym for the free market, while populism is based on state intervention. Moreover, they are usually masked by the

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26) We would like to thank the participants of the 6th joint IOS/APB/EACES Summer Academy on Central and Eastern Europe "Poverty, Social Exclusion, and Income Inequality Dynamics in Central and Eastern Europe" (Tutzing, June 4–6, 2014), for their comments that have led to improvements in the paper.

policy makers: implementation of the neo-liberal agenda is presented as an improvement of the market environment and populism as a Keynesian policy.

We argue that any given reform will fail to improve the situation in the country if it does not directly target income inequality and its mechanisms, because in every other case the political elites will find ways to distort the reforms and to direct them to serve their own interests. The paper proposes five pillars of policy actions. The first is a necessary condition for the success of any other reform. It should limit the power of the political elites to control everything. It consists of a free and independent media, judiciary and civil society organizations. The second pillar should be to put an end to populism and political patronage and to implement a new development strategy based on SME's, long-term investments and wage growth. The third pillar should be the dismantling of neo-liberalism and to create social welfare state. The fourth pillar should be raised in order to secure internal stability of the country. It should provide two things: (i) multi-ethnic parties, which should replaced ethnic tension in society with the new one – between the classes, and (ii) to put the end of building the country on two different tracks, Macedonian and Albanian, and to start building a common Macedonian nation as a multitude of Macedonians, Albanians, Turks, Serbs, Vlachs, Bulgarians, Bosniaks, Roma and any other population that live in the country. The fifth pillar should provide external political security and economic future of the country by integration in NATO and EU. It is not sufficient to ensure the future of the country alone if the previous four pillars are not built in parallel. However, without this pillar, it is also true that there is no future for the country.

The structure of the paper is as follows: Section 2 provides facts about income inequality in Macedonia; Section 3 analyses the two mechanisms of inequality: neo-liberal ideology and political patronage. The policy recommendations are provided in the last section.

## 2. Facts about income inequality in Macedonia

The income inequality is significantly increased in Macedonia. Figure 2 presents income distribution among different groups of population in years 1998 and 2010. The source of data is World Bank (2014). The first year for which the World Bank has published data for the income distribution in Macedonia is 1998, while the last one is 2010. The income share held by the richest 20% of the population increased from 37% in 1998 to 49% in 2010. So in 2010, the income share held by the richest 20% of population is almost equal to the income share held by the remaining 80% of the population. Moreover, this process takes place on the backs of the lowest 20%, the second 20% (lower middle class) and the third 20% of the population (central middle class). The aggregate share of income of these three groups decreased from 40% in 1998 to 27% in 2010.

**Figure 2**

The income distribution in Macedonia 1998 and 2010.

Source: World Bank (2014).

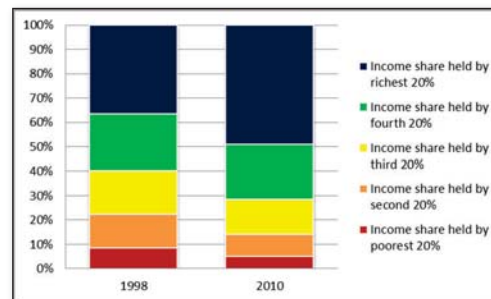
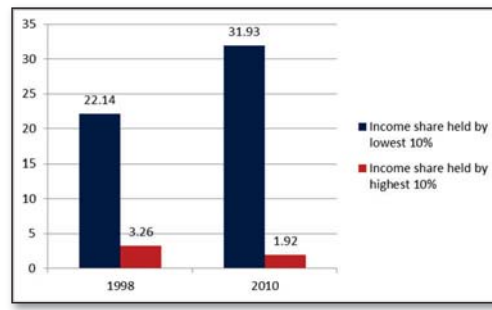


Figure 3 focus only on the income share held by the richest 10% and by the poorest 10% of the Macedonian population. The income share held by the richest 10% increased from 22% to 32% in the period 1998-2010, while the income share held by the poorest 10% of population decreased from 3.26% to 1.92% in the same period. So, in 2010, the relative proportion of the income held by the poorest 10% of population is 16 times smaller than the one held by the richest 10% of the population.

Two theses can be used in defense of the rising income inequalities in Macedonia. The first thesis is that increasing income inequality occurs in many other countries and therefore increasing inequality in Macedonia merely follows this trend, and the second thesis is that poor people should not complain because although they receive a smaller piece of the pie (i.e. income) now compared with the past, the pie is growing so much (thanks to the rich people), so their piece is actually bigger. However, both theses are incorrect in the Macedonian context.

**Figure 3**

The income share held by richest 10% and poorest 10% of the population in Macedonia, 1998 and 2010.



Source: World Bank (2014).

It is true that the income inequality increases in many other countries and that the raising income inequality in the developed countries is one of the main factors for the Global financial crisis. However, the problem of Macedonia is that it has biggest income inequality in the South-Eastern Europe (SEE) region. The GINI index values for the countries from SEE region are presented in the table 1. The data source is the World Bank (2014). Selected years for every country are chosen, because the database does not contain data for every year for each country. The first and last year of every country corresponds with the first and last available data. The GINI index increased significantly in Albania (from 29.1 in 1997 to 34.5 in 2008), Bosnia and Herzegovina (from 28.0 in 2001 to 36.2 in 2007), Macedonia (from 28.1 in 1998 to 43.6 in 2010) and Croatia (from 26.8 in 1998 to 33.7 in 2009), while it decreased in Serbia (from 32.7 in 2002 to 29.6 in 2010) and Montenegro (from 30.1 in 2005 to 28.6 in 2010). The GINI index of Bulgaria and Romania had trend of increase before EU membership, which is substituted with trend of decrease in the period of EU membership.

Macedonia has the highest value of the GINI index in the most recent period. The value of 43.6 in 2010 is significantly higher than the GINI values of all other SEE: Albania (34.5 in 2008), Bosnia and Herzegovina (36.2 in 2007), Bulgaria (28.2 in 2007), Croatia (33.7 in 2009), Montenegro (28.6 in 2010), Romania (27.4 in 2011) and Serbia (29.6 in 2010). The Macedonian income inequality is seriously becoming similar to those of Latin American countries. Additionally, it should be expected that the income inequality in Macedonia is raised even more after 2010 as result of the Global crisis.

The second thesis that income share held by the poor people is actually bigger in absolute terms, despite it decrease in relative terms is not correct for Macedonia because the average growth rate of the economy since the beginning of transition is low. The reduction in the relative share of income for the majority of the population is accompanied by increase of the poverty in the country. The percentage of people living below the poverty line increased from 21% in 1998 to 31% in 2010. So, in a twelve year period, the rise in income inequality pushed half of the lower middle class (the second 20% of the population) into poverty.

**Table 1.** GINI index in SEE countries, different years based on available data

Albania	1997	2002	2004	2008
GINI	29.1	28.2	31.1	34.5
Bosnia and Herzegovina	2001	2004	2007	
GINI	28.0	35.8	36.2	
Bulgaria	1992	1997	2001	2007
Gini index	30.7	26.4	34.3	28.2
Croatia	1998	2002	2005	2009
GINI	26.8	31.1	29	33.7
Macedonia	1998	2002	2005	2010
GINI	28.1	38.8	39.1	43.6
Montenegro	2005	2010		
GINI	30.1	28.6		
Romania	1992	1998	2002	2011
GINI	25.5	29.4	31.5	27.4
Serbia	2002	2005	2010	
GINI	32.7	33.4	29.6	

Source: World Bank (2014).

Note: Kosovo is not included as the data is not available.

### 3. Two mechanisms of inequality

There are two main mechanisms, or drivers, of inequality in Macedonia. The first is the implementation of neo-liberal ideology in selected areas of the economy and the second is populism and the system of political patronage.

#### 3.1. Neo-liberal ideology in the economy

Macedonia is not a special case. Neo-liberalism, earlier or later, was introduced in all transition countries in Europe. For example, Slovenian economist Mencinger writes about the introduction of neo-liberalism in the former communist countries that joined the European Union (EU): "New member states (NMS), or at least their governments, have been much more attracted by the American market model and neo-liberalism than the "old" EU states ever were. The EU showed very little interest in promoting the social market model in transition countries. The vacuum created by the collapse of socialism was filled by American advisers promoting a pure "shareholder value" type of capitalism; they were immediately followed by many domestic "Marxists" who quickly turned into 'Hayekians' (Mencinger, 2012)."

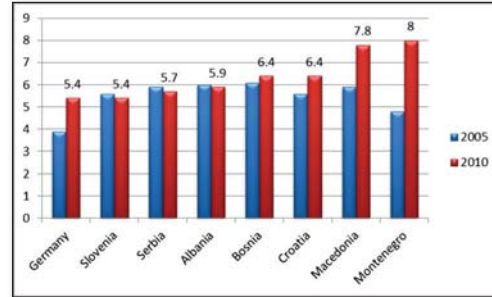
Neo-liberal ideology can easily be recognized in Macedonia, at least, in the four key elements: increased flexibility of the labor market, the destruction of the power of trade unions, the existence of flat taxation and the glorification of foreign direct investments (FDI).

The first element: the increased flexibility of labor markets. Labor rights are continuously cut and year-by-year labor legislation increasingly favours the employers. This thesis can be confirmed by the index of labor market regulation, which is published by Economic Freedom of the World (2014). Figure 4 compares the indices of labor market regulation in 2005 and 2010 in selected SEE countries, taking Slovenia and Germany

as benchmarks. The range of the index is from 1 to 10, where 1 means that the labor market is strongly regulated and 7 or more means that the system is flexible. The figure presents two striking facts related with Macedonia: (i) In 2010, Macedonia have index value above 7 which means that there is no existence of labor market regulation as in Germany, Slovenia or neighboring Serbia; and (ii) the index for Macedonia is increased from 5.9 to 7.8 in the period 2005-2010, what is an indicator for the deterioration of labor market legislation in the country. In addition, it should be noted that all SEE countries have higher index values than Germany (the economic leader of Europe) and Slovenia (the best developed former communist country).

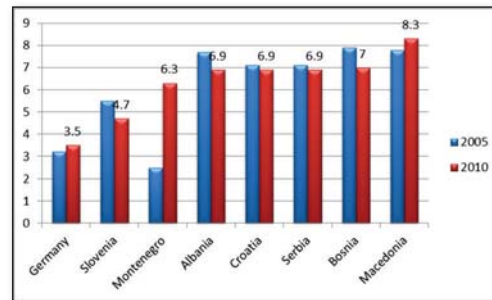
The second element: the destruction of the power of the trade union movement. Figure 5 presents the collective wage bargaining index in the SEE region. Germany and Slovenia are shown again as benchmarks. The index values range from 1 to 10, where 1 means that wages in the country are fixed through the collective bargaining process and 7 or above that wage fixing does not depend on this process, but on an individual enterprises. This figure presents the same story as figure 4. In 2010, Macedonia have the highest value of the index among all observed countries and it is higher than 7, which is indication of not functioning of collective wage bargaining process in the country. In addition, again all SEE countries have index values significantly higher than Germany and Slovenia.

**Figure 4.**  
Index of labor market regulation, selected SEE countries and Slovenia and Germany as comparator countries, 2005 and 2010



Source: *Economic Freedom of the World (2014)*.

**Figure 5.**  
Index of collective wage bargaining, selected SEE countries and Slovenia and Germany as comparator countries, 2005 and 2010



Source: *Economic Freedom of the World (2014)*.

The third element: existence of flat taxation. The inclusion of Macedonia in the race of the Central and Eastern European countries (CEE) towards low and flat taxes started in 2007 – a decade later than in CEE (Estonia, Lithuania and Latvia introduced flat taxation in 1995). Macedonia was first country from SEE that introduced flat taxation. In January 2007, Macedonia introduced a 12% flat personal income tax and corporate profit tax, which later on, in 2008, was cut to 10%, which is the current value.

Despite the fact that flat taxation does improve tax collection because of its simplicity (“one tax bracket fits all”) and low level, it does not contribute to correcting the inequalities of income distribution. On the contrary, it does the opposite - it favours the flow of income towards the rich inside and outside the country. Moreover, the existence of the flat taxes, together with low property taxes in the country, slants the tax systems in general completely in favour of the rich. As a result, state budget in Macedonia is largely filled with indirect taxes (value added tax), where the poor pay a higher percentage of their disposable income than the wealthy.



The fourth element: the glorification of FDI. In Macedonia, the policy makers present FDI as a 'holy grail' for the economy and the basis for economic development, although the empirical literature gives mixed views about the positive effects of FDI in transition countries (Carkovic and Levine, 2002; Blomstrom and Kokko, 2003). Moreover, in order to attract FDI Macedonia offer different types of privileges - from tax exemptions to direct financial support for big multinational companies, which put foreign investors in a more favourable position than domestic investors. Therefore Mencinger (2012) argues that this process can be seen as a replacement of the so-called muddy privatization at the beginning of transition with a new way of selling the productive assets of the economy, now directed at foreigners, who have been allowed a significant or in some sectors dominant market share (telecommunications, banking, electricity, etc.).

Other elements of the implementation of neo-liberal ideology can be seen in the destruction of the public health system and its replacement with private hospitals, and the high positioning of some countries in the rankings for doing business.

What were the proclaimed goals of the introduction of neo-liberal measures? The increased flexibility of the labor market, along with the reduction of social contribution rates was intended to reduce administrative barriers and salary burdens in order to increase the number of new jobs in the economy. The low and flat taxes were intended to make the economies havens for investment. FDI was supposed to inject new capital and to bring new technologies, knowledge and skills, which would increase productivity and accelerate economic growth. However, these goals were never achieved. The unemployment rate is constantly around 30% in Macedonia, with long-term unemployment rate of 82.6%, which is more than double the long-term unemployment rate of the EU average (IMF, 2013). The economic growth is not satisfactory which result in living standard that remained at one third of the EU level for the last decade.

The key question is who wins and who loses from the introduction of neoliberal measures? The winners are the rich groups in society and all the rest are the losers. The flexibility of the labor markets and the destruction of collective bargaining have removed the protection the workers had and keep wages at a miserably low level. This makes profits bigger while flat taxation does not allow for redistribution of income from the elites towards the rest of society. Of course, everything would have been different if a significant number of new jobs had been created or if increased productivity had pushed up wages and living standards.

Last, but not the least, those who implement neo-liberalism in the country and who should believe in it, have not in fact given neo-liberal ideas a chance to work. Neo-liberalism was implemented at the same time with "the second mechanism – populism and political patronage", which glorifies state power, increases public spending and encourages the growth of public debt, all of which are strongly criticized by the 'father' of the neo-liberalism - Hayek (Hayek, 1944). But, why did this mix happen? It is not the result of a belief in neo-liberal ideas. Maybe it is to do with income and wealth distribution? And, of course, in a situation where unemployment is huge, wages are low and living standards are bad – the elites should offer something to the people. The "second mechanism" is a tool for governance.

### **3.2. Populism and political patronage**

Acemoglu and Robinson (2012) argue that the problem lies not in capitalism but in institutions. Countries are poor not because of geography, not because of history, not because of natural resources, but because of their institutions. Populism and political patronage are a form of abused institutions. They existed in SEE region long before the transition. Pappas (2013) argues that the political patronage which started to occur in the 1980s in Greece, is the main reason for the Greek crisis: "In the view of many, political patronage is the main cause of the Greek crisis... since society had been divided into two irreconcilable parts represented by parties regularly alternating in power, all citizens could reasonably expect to gain from patronage once their own party won elections." However, Greece is just one piece of the mosaic. Ferrera (1996) used the concept of clientelism in order to explain the particularities of the Southern European welfare model (Italy, Spain, Portugal and Greece): the persistence of clientelism and the formation – in some cases – of fairly elaborate patronage machines for the selective distribution of cash subsidies.

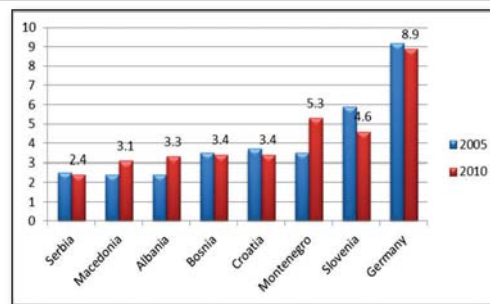
Macedonian system of populism and political patronage, in general, is no different from the case explained by Pappas (2013). The Macedonian specific is that society is divided not into two parts as in Greece, but into four, represented by two main Macedonian and two main Albanian political parties where as a rule one main Macedonian and one main Albanian political party have formed a government. However, the key is that everybody expected to gain from the abuse of state resources when their political party won the election. Therefore, more than twenty years after the start of transition the political parties have not succeeded in forming a real ideology – left or right. Usually they shift around and their policies are more closely connected with the oligarchies than with ordinary citizens.

The system of political patronage works through three types of state related benefits. The first type is real incomes such as salaries and social transfers, which are used as the main tool for creating a voting machinery for the ruling parties. Their main goal is to increase the dependence of the largest part of the population from the ruling parties. Examples of this type of state benefits are: hiring employees based on party membership, receiving a salary administration without having to go to work or at least a greater commitment of party activities, increase of pensions before elections, welfare transfers for people who do not qualify, and the like. As a result, the country has an exaggerated state and public administration, with low wages, rather than an efficient administration with higher wages.

The second type of state benefits occurs in different forms, but the two most commonly used ones are: agricultural subsidies and the awarding of public tenders. The role of subsidies in agriculture is similar to the state benefits from the first type - creating dependency. Thus, it is not important that subsidies in agriculture drastically increased in the period from 2006 to 2012, while the majority of average crop yields are on the same level as in 2006, and the trade deficit of the country with food products increased by over 300%. The awarding of public tenders has direct influence to the distribution of income, where the basic "unwritten" criteria is the closeness to the political elite.

**Figure 6.**

Index of judiciary independence in the selected SEE countries and Slovenia and Germany as comparator countries, 2005 and 2010

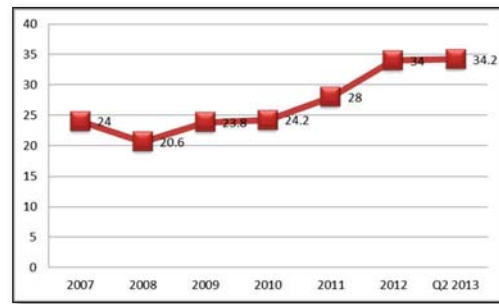


Source: *Economic Freedom of the World* (2014).

The third type of government benefits applies to protection upon the violation of laws, tax evasion, building without permit and protection in the courts. Taxes are not equally paid throughout the country. The recent process of legalization of the large number of informal settlements in the country represents the granting of a new kind of state benefits to those who built without permission. The courts are not independent. The index of judicial independence for Macedonia is 3.1 in 2010 (the index can take a value from 1 to 10, where 1 means that the judiciary is strongly influenced by members of government, citizens or firms, and a value of 7 or above means that the judiciary is completely independent). Figure 6 shows that the situation is the opposite in Germany where the judiciary in the country is entirely independent (8.9).

In these ways, the country who proclaimed that is based on social cohesion and solidarity have in reality a system which gradually increases the serfdom of the majority of the population in relation to the elites. Therefore the state benefits in the political patronage system are designed to be distributed in small portions and in turns, rather than in one go.

**Figure 7.**  
Total debt of the central government in Macedonia  
(as a percentage of GDP), 2007 - 2013



Source: Ministry of Finance (2013).

The system of political patronage and populism is financed by increased borrowing. There is a strong increase of public debt from 2008 until today. The external debt of the central government is increased by 80% in the period from 2008 to 2013 (from 921 million euro in 2008 to 1662 million euro in the second quarter of 2013) The domestic debt of the central government increased by 127% during the same period (465 million euro in 2008 to 1065 million euro in the second quarter of 2013). Figure 7 presents the total debt of the central government as a percentage of GDP. It increased from 20.6% of the GDP in 2008 to 34.2% of the GDP in the second quarter of 2013. In addition, in the recent years government stop to publish data about the level of the public debt, which incorporates the debts of public enterprises, municipalities and the central bank, despite the central government debt. However, it is clear how these stories end. Neighbor country Greece is a prime example.

#### 4. The possible directions for policy reforms

The many reforms in Macedonia in the past two decades have not significantly improved living standard and have not solved unemployment and poverty, because there were no reforms which targeted directly the income inequality and its main mechanisms. Moreover, the laundry-list approach (simply to go for whatever reforms seems to be feasible, practical and politically doable) used in the region is faulty in its economic logic because of the existence of the principle of second-best, which means that any given reform taken on its own can be guaranteed to be welfare promoting, in the presence of multitudes of economic distortions. Therefore, Hausmann et al. (2008) argue that the right approach is to focus on the reforms that alleviate the most binding constraints. This paper proposes five pillars of reforms for Macedonia, where three of them directly target the damned triangle: income inequality, neo-liberalism and populism and political patronage, and the rest are necessary for internal and external stability of the country.

The first pillar is a necessary condition for the success of any other reform. It consists of free and independent media, the judiciary and civil organizations, in order to limit the power of ruling political parties to control everything. Without these, the elites always will find a way to distort reform and direct it to serve their own interests. In some cases they will make gains for themselves directly, for example with corrupted investment in infrastructure, or in some cases indirectly, for example with more money on social transfers to more voters. The reforms of this pillar are conditioned by two levels. On the first level is the readiness of ruling political parties in the country to implement democracy and the rule of law. On the second level is the will and strength of the EU to implement democracy and the rule of law in the country as part of the integration process.

The second pillar is about putting an end to populism and political patronage and implementing a new development strategy. The first logical step in the destruction of populism and political patronage is a significant increase in transparency in public spending. The new development strategy for the country should be based on small and medium-sized enterprises (SME's), long-term investments and wage growth. These three priorities are the complete opposite of the present development priorities of the country: FDI, short-term investments and low wages and poor workers protection.

SMEs should take the primacy of FDI and to represent the key driver of the Macedonian economy. There are many regions in Europe that have managed to achieve significant growth thanks to SMEs. Therefore successful Western European practices should be used, side by side with increased government support for SMEs. In addition, the recent crisis shows that SMEs were a very important stabilizer of the effects of the recession in the EU in comparison with large companies, because they had a significantly lower number of dismissals (Gunila, 2013).

The investment strategy of the populists is aimed only at winning the next election. Macedonia needs serious investments in energy infrastructure in order to provide for the future of the economy. However, due to weak economic power of country two approaches should be used: (i) joint projects with other SEE countries; and (ii) replacement of the ad hoc approach with the political consensus on the important infrastructure projects in the next 20 years.

Low wages and the removal of protection for workers lead to nowhere. They simply make Macedonia a loser in the big game between the countries. If wages do not grow and the difference from those in developed countries is not decreased, the rate of emigration from the country will continue, and the people will be forced to work the worst jobs in order to provide a living for their families. What can be done to drive up wages? Wage growth is determined by labor productivity, which depends on technological progress, education of the workforce, laws, income distribution and social structures. FDI has not brought significant technological progress, but SMEs could, especially if they are placed in a fair market environment. Macedonia should not be satisfied with the present educational system. It is time the country to adopt the complete educational model from some successful Western European country. Fair distribution of income is the goal of the third pillar. There is no doubt that more satisfied workers are more productive.

The third pillar is the dismantling of neo-liberalism and replacing it with social justice. The first steps in developing a social welfare state in the Western Balkans should be: progressive taxation, a progressive scale for the payment of key public goods, a fair minimum wage, youth guarantee, effective active measures for employment, social protection based on minimum income, increased child protection and care, real integration of people with special needs and more care for the most vulnerable citizens.

The fourth pillar should ensure internal stability of the country. It would not exist if Macedonia is not a multi-ethnic society. The ethnic tensions are continually used in masking the unfair income distribution and they are always served by the policy makers instead of a better standard of living. The country need to replace the ethnic tension in the society with the new one - between the classes. The only way for this to happen is political parties to become multiethnic and the Macedonian nation to start to build as the multitude of Macedonians, Albanians, Turks, Serbs, Vlachs, Bulgarians, Bosniaks, Roma and any other population that live in the country.

The fifth pillar presents integration of the country in NATO and EU. It should ensure the external political security and economic future of the country. It is wrong to think that the membership in NATO and EU is sufficient condition for insurance of the country future. The Greece is the best example for this. Therefore Macedonia needs to build the previous four pillars. However, it is also true that without membership in NATO and EU there is no future for the country, especially when all the countries from the region progress on this path.

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