

**VYSOKÁ ŠKOLA EKONOMIE A MANAGEMENTU**

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# VYSOKÁ ŠKOLA EKONOMIE A MANAGEMENTU

Nárožní 2600/9a, 158 00 Praha 5

## NÁZEV DIPLOMOVÉ PRÁCE

Public Finance in the Republic of Macedonia – Government Budget and Public Debt

## TERMÍN UKONČENÍ STUDIA A OBHAJOBA (MĚSÍC/ROK)

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I hereby declare that I wrote the thesis on above mentioned subject by myself, and that the literary and other types of sources I used in the thesis are cited.

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**VYSOKÁ ŠKOLA EKONOMIE A MANAGEMENTU**

**PUBLIC FINANCE IN THE  
REPUBLIC OF MACEDONIA –  
GOVERNMENT BUDGET AND  
PUBLIC DEBT**

Veřejné finance v Republice Makedonie - Rozpočet vlády a veřejný dluh

Autor: Aleksandra Kyselová

## **Summary**

This subject of this diploma thesis is to outline the government budget and public debt from a theoretical and real perspective. While thesis's primary focus is on government budget and public debt, it also gives an overview on the part of the public finances such as the fiscal policy and its instruments, the revenues and expenditures. The first part of the thesis theoretically describes the above mentioned economic aspects. In its second part, the thesis presents the actual situation in the Republic of Macedonia. It examines the fiscal policy, revenues-expenditures structure and government budget system in Macedonia. In its further chapters, the thesis concentrates on the structure, origins and evolution of Macedonian budget deficit and public debt in the period between 2006 and 2011. Besides that, it also examines the impact public debt has on Macedonian economy, as well as on the applied debt management, i.e. the solutions taken for public debt sustaining or even possible reduction.

## **Souhrn**

Táto diplomová práca má za cal nastinit vladniho rozpoctu a veejneho dluhu z teoretickej a realnej perspektivy. Zatiaco diplomova praca se primarne zameruje na veejny rozpoct a veejny dluh, praca take poskytuje prehled o asti veejnych financi, jako je fiskalni politika a jeji nastroje, prijmu a vydaje. Prvni ast diplomove prace teoreticky popisuje vyse uvedene ekonomicke aspekty. Ve sve druhe, diplomova praca se zabyva aktualni situaci v republike Makedonie. Zkouma se fiskalni politika, prijmy, vydaje a struktura rozpoctoveho systemu v Makedonii. V dalsich kapitolach se diplomova praca zameruje na vznik, strukturu, a vyvoj rozpoctoveho deficitu a veejneho dluhu v Makedonii v období 2006 a 2011. Krome toho se v praci take zkouma vliv veejneho dluhu na makedonske hospodarstvi, stejne jako i rizeni dluhu, tj. reseni prijata na udrženi veejneho dluhu nebo i jeho pripadne snizeni.

**Keywords:**

Public finance, government budget, public debt, revenues and expenditures, fiscal policy, Macedonia.

**Klíčová slova:**

Veřejné finance, státní rozpočet, veřejný dluh, příjmy a výdaje, fiskální politika, Macedonie.

**JEL Classification:**

E62 - Fiscal Policy

H61 - Budget; Budget Systems

H62 - Deficit; Surplus

H63 - Debt; Debt Management; Sovereign Debt

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## **List of abbreviations**

OECD	Organisation for Economic Co-operation and Development
WB	World Bank
ECB	European Central Bank
CB	Central Bank
MOF	Ministry of Finance
IPA	Instrument for Pre-Accession Assistance
PEP	Pre-Accession Economic programmes
FDI	Foreign direct investments
NBRM	National Bank of the Republic of Macedonia
CEA	Center for Economic Analyses
PRO	Public Revenue Office
USAID	US Aid Organization
MSE	Macedonian Stock Exchange
MINA	Macedonian Intl News Agency
ISSAI	The International Standards of Supreme Audit Institutions
EC	European Commission
GFSM	Government Finance Statistics Manual
MKD	Macedonian Denar

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# 1 Introduction

Current trends in the field of public finance recently show that public debt and associated with it government budget formations are becoming commonly faced issues among countries worldwide. When said worldwide, it is meant mostly the fact that these unfavourable variables are becoming problems not only of developed countries with high economic activity and long public finance history. The government budget and public debt problems of a greater and greater countries' concern, which markets are yet in transition and that have much less experience with public finance management. Moreover, if in past the public debt and budget deficit were mainly discussed on a state level, today it seems they have reached the general public and have become often topic for discussion.

The objective of my diploma thesis along with the above elucidations is to gain theoretical knowledge in the field of public finance with an emphasis on reasons and consequences of government budget and public debt formation. Farther, the objective is to examine and study the respective macroeconomic variables in the case with the Republic of Macedonia. This in particular refers to the level and development of the budget deficit and public debt in Macedonia from the period country holds a candidate status for EU. In addition, the examination of the thesis widens to the origins of the budget deficit and public debt, as well as on the approaches taken in order to sustain and eventually overcome above mentioned economic issues in the Republic of Macedonia.

The information and data used in the diploma thesis are coming from various sources that include a research done from literature, books, economic magazines and journals. Besides that, the investigation involves reviewing and examination of reports and documents from Ministry of Finance and State Statistical Office of the Republic of Macedonia, as well as the data investigated on this subject available from the international financial organizations, such as OECD, World Bank and the International Monetary Fund.

## **2 Public finance – General overview**

Taking an integral place in field of macroeconomics, the study of public finance examines the role and impact of government fiscal policies on state economy. It follows and analyzes financial operations arising from revenue-expenditure processes conducted by governments and measures outcoming economic effects from those operations. Public finance also explores the macroeconomic aspects of government resource-allocating system, including tax system, payments execution, state borrowings, as well as an inflow of new money into economy (Shoup, 2006).

While still part of macroeconomics, public finance together with government sector are the main pillars of public economics study defined as a „*scientific discipline that examines the structure, functioning and effectiveness of part of national economy, which has a non-profit nature and is financed from redistribution processes*” (Pilný, 2007). Public sector, on the other hand represents the state economic activity in terms of providing population with nonmarketable services such as healthcare, education, police, military, utilities. In contrast to market sector, public sector is not oriented on profit maximization and strives for balancing the government budget. Public sectors significantly vary in size, range and structure depending on the economic system (traditional, planned, market, mixed) given state exercises.

Public finance and public sector are closely interconnected and depend one on another. While "healthy" public finance allows public sector deliver prosperous goods to population, an „effective“ public sector management helps retain „healthy“ public finance.

### **2.1 Public finance system**

The public finance system as one of the pre-requisites for building a prosperous and stable state economy deals with wide range of economic aspects. Below section will however narrow its focus on aspects such as state intervention; public sector’s role; and the function of fiscal policy with the involved fiscal institutions and their organization.

### 2.1.1 State intervention

The role of state intervention comes to emphasis when state economy fails to regulate itself. Such failure can be related to insufficient amount of goods, services and common resources, as well as due to occurrence of monopoly and externalities, and existence of assymetric information (Labonte, 2010). State intervention is also important in terms of forcing certain economic entities to exercise favorable activities that otherwise would be neglected, or contraty averting certain entities from activities with a negative economic impact (Pilný, 2007).

In the execution of state intervention, government plays the major role. In order to achieve macroeconomic balance, it government uses fiscal policy as its regulative instrument and creates a structured revenue-expenditure system. Governments' role in the economy is also significant in administration of tax systems as well as in adoption, implementation and control of expenditure programs.

Besides above mentioned positive aspects of government participation in the economy, a scenario of government failure is also a possible. A reason for that could be government obtaning limited information, the effects of interventions being usually very complex, hardly predictive, and with a time-delay, or even due to existence of bureaucratic elements that obstruct from following public interest (Pilný, 2007). For purpose of dealing with similar issues, state imposes the public sector.

### 2.1.2 Public sector

The public sector together with the private sector are forming mixed state economy which nowadays is the most common type of economic system. Ochrana et al., (2010) characterizes public sector from several aspects:

- administrative, as public sector is managed by the public administration;
- institutional, since it includes two types of institutions, i.e. the state and local authorities;
- ownership aspect, as it involves an ownership of both government and public;

- decision-making aspect, as it delivers goods and services of common interest;
- financial aspect, as it is financing goods and services from public budget system.

The size of the public sector towards the private one usually varies among states, and can be measured using production, consumption or expenditure approaches. In international comparisons is commonly applied the indicator measuring public expenditures incurred in relation to GDP (Peková, 2005). As for the relation of public sector to GDP, more liberal states, such as China have public sector participating with around 23.1% of GDP, while social states like Denmark, have larger public sector portion up to 58.4% of GDP. (OECD-ilibrary, 2011). Determination of public sector optimal size is however of a concern of every economic system, as it is mostly dependent on various factors such as economic, historical and geopolitical, demographic, cultural and religious factors, as well as political factors. (Peková, 2005).

The efficiency of public sector is a result of the relationship between its inputs and outputs, where outputs, i.e. products are not sold at market prices, while inputs are actually bought at market prices (Peková, 2005). The efficiency level of public sector is related to the decisions taken in regard to its size, structure, but also the effective use of financial resources.

### 2.1.3 Public institutions

The public sector is conducted by its relevant institutions such as the Parliament, government, as well as ministries, municipalities and regions. These institutions are making decisions on common interest basis and are financed from the government budget (Ochrana et al., 2010).

Of a particular interest for this thesis are institutions that are directly involved and are drivers of the budget outcomes. In this regard important is the role of the government under which are organized the finances of the public and which role encompasses raising and disbursement of government resources., i.e. reaching allocative efficiency (Chand, 2008).



On the other hand, among major decision-makers on budget outcomes is the MOF, especially the position of the minister of finances, who is involved in the budget forming process and budget level determination (Poterba and Hagen, 1999).

Generally, the main goal of these institutions is reduction of budget imbalances for purpose of achieving macroeconomic stability through an efficient delivery of public goods and services (Gupta et al., 2008).

The concept of roles and responsibilities of the institutions among countries is not unified and standardized. At the same time, the political system and its interaction with public institutions is neither similar among countries. The nature of this interactions mostly depends on country's general political settings, i.e. political and electoral system.

## **2.2 Public Revenues and Expenditures**

While state takes number of actions for to build up a prosperous social and economic environment for its citizens, it also requires large amount of available resources for spending, allocating and distributing. Public revenues and expenditures in fact serve as state's working instruments for achieving above mentioned aspects.

### **2.2.1 Public revenues**

Public revenues serve as a financing pool of public expenditures. They represent all sources and methods through which governments make money for further economic arrangements (Jain, 2010). As per Peková (2005), the function of public revenues can be viewed as:

- fiscal, which ensures necessary resources for further government allocation;
- redistribution, that manages resource allocation to become efficient;
- stabilization function, that balances and stabilizes the relationship between public disposable income, consumption and investments.

Public revenues can be distinguished into several different categories based on their role in the public system. Generally public revenues can be distinguished as tax and non-tax revenues. **The tax revenues** are compulsory contributions that governments extract from its citizens and companies in order to finance the general expenses for common goods and services (Chand, 2008). Statistically taxes account for nearly 90% of all received public revenues (Hamerníková et al., 2007), and are the most stable state's sources of income. On the other hand, the sum of collected compulsory contributions represents the imposed state's tax burden towards its taxpayers. It is being measured as a share to GDP and is uneven among different states (Hamerníková et al., 2007).

Generally classified, taxes can either be **direct**, where taxation object is specified, or **indirect**, where taxpayer is not determined in advance (Jain, 2010).

By the taxation subject, taxes are divided into: **income, consumption and property** type of taxes. **Income taxes** are in category of direct taxes. They are collected from taxpayer's earned income on the principle of gathering percentages of income after various tax exemptions and deductions applied. Corporate income taxes is another tax category within the income taxes that is applied on profits earned by companies and corporations (Mukherjee, 2002).

The **consumption taxes** are indirect taxes. They are imposed on goods and services consumption in form of universal Value Added Tax, or specific consumption taxes applied to certain goods with low price elasticity. such as tobacco and alcohol (Peková (2005). Another type of consumption taxes are customs or tariffs. Even though low profitable, they are stable government revenues (Peková , 2005). **Property taxes** are in the scope of direct taxes and includes taxes on both movable and immovable property's useownership, use or transfer, where tax rate is based on property's value at particular time (GFSM manual, 2001). The revenue coming from this type of tax is low, but stable.

**The non-tax** revenues are collected from other resources than taxes and are represented by state commercial and administrative receipts. The commercial revenues are obtained from government sale of goods and services, while administrative revenues are represented by received gifts, grants, fines, penalties, licences and fees (Chand, 2008).

Moreover, non-tax revenues additionally can be in form of settlements arising from judicial processes, voluntary transfers other than grants, as well as miscellaneous other revenue (GFSM manual, 2001).

Besides the above categorization, public revenues can be viewed as **current** and **capital**. **Current** revenues include both taxable and non-taxable revenues, such as collected fines, fees, recoveries, incomes from sales of goods, services and property, but excluding grants (World Bank, 2004). Though with a persistence of fluctuation in the amounts collected, current revenues represent the most constant source of revenues for the state (Peková, 2005). Moreover, in most of economies, they also account for largest revenue share. **Capital** revenues represent sale of fixed state assets, including land, buildings and other constructions, as well as intangible assets, various donations, stocks, loans obtained (OECD, 2003). These public revenues on contrary to the current are one time received, much more fluctuating and are solely non-taxable revenues (Peková, 2005).

On the basis of refundability are existing **non-refundable** or **refundable**. The non-refundable revenues are represented by various types of taxes, benefits, fees, as well as different obtained types of income, while the refundable ones are represented by short-term and long-term state and municipal bonds, bank loans, as well as securities emission (Peková, 2005).

### 2.2.2 Public expenditures

Public expenditures represent sources that state instead of gathering is distributing to the public for purpose of achieving its goals such as economic development and welfare, price stability, employment regulation or even ensuring state defence (Jain, 2010). State authorities are usually facing difficulties with expenditures optimal structure, available capacity, expenditures effective allocation and financing, as well as various effects coming from expenditures consumption (Peková, 2005). Speaking however about the expenditures structure, it is valuable to mention that it is dependent on country's economic and social system.

Public expenditures are also classified into several categories. Generally public expenditures are differed as **government expenditures** and **transfer payments** (Mukherjee, 2002). While government expenditures are used for purchasing of public goods and services, the second category of transfer payments is provided to individuals in form of pensions, unemployment benefits, subsidies payed in cash, social security contribution and public debt interests.

A common distinction of expenditures is also between current and capital public. The **current** expenditures serve for financing of repeatable public needs mostly in form of transfers and are also determined by law (Peková, 2005). The **capital** expenditures, on the other hand are financing long-term investments, such as purchase of physical assets that are expected to be used over one (fiscal) year (Mikesell, 2011). Additionally, capital expenditures include payments on debt costs, such as loan and borrowings repayments. These expenditures are usually not short-term and are exceeding budget or fiscal periods. Generally spoken, in the course of reviewing public expenditure of countries, a definite prevail can be noticed on the side of current expenditures compared to capital expenditures. Moreover, current expenditures are constantly re-appearing, while capital ones are spent usually close to fiscal year end (Peková et al., 2008).

Beside above mentioned categories, expenditures can be also viewed from a **budgetary structure** perspective. Such expenditures are categorized as **refundable** and **non-refundable**. The **refundable** expenditures are usually represented by loans or investments, such as purchases of obligations or term deposits, while the non-refundable expenditures serve for financing of non-market state activities (Peková, 2005). Usually the higher share of participation in total expenditures is constituted of non-refundable expenditures.

A considerable perspective is also whether spent expenditures are of **plan or non-plan** category. The plan expenditures refer to those, which incur for current developments and investments that are done along with the planned proposals (Aggaarwal and Vijay, 2009).

As for non-plan expenditures, they are spent for purpose of meeting past state liabilities (Gupta et al., 2008). These are also the expenditures exceeding the planned budget, and are also used for covering consequences such as those of natural disasters and military conflicts. Besides above mentioned, here also relates the fact, that state laws require financial reserves to be held for unexpected expenditure coverages.

In the context of public expenditures, it is also relevant to mention the area of expenditure programs and projects. Public expenditure programs and projects are defined as a „*systemic proposals for public resources allocation*“ (Peková, 2005). While programs are for ongoing services and activities, the projects are usually described as one-time activities carrying out long-term effects (Langbein and Felbinger, 2006).

Both categories are designed to ensure financing of public needs and increase the effectiveness of public expenditures. Besides that, expenditure programs and projects carry stimulative intentions for inciting or development of certain economic activities, sectors or entities (Hamerníková et al., 2007). Expenditures programs and projects require detailed medium to long-term planning and resource forecasting. Moreover, they undergo measurement and evaluation. Usually before their execution, a cost-benefit analysis is performed, which helps shaping the final decisions before the implementation. As for the evaluation, authorities follow such aspects as impact these programs and projects have on the population or different perspective of program and projects outputs and outcomes (Langbein and Felbinger, 2006).

Dynamics and development of public expenditure structures are analyzed both at state, and local government levels, as well as on a level of international comparison. As per Peková (2005), examination of the expenditures structure is usually involving analysis of the amount, progression and tendencies of governments' spendings into public goods and services. Besides that, under strong observance is the repayment of the national debts among the states.

### 2.3 Function of fiscal policy

The concept of fiscal policy, represents government actions taken for purpose of influencing and managing its objectives in regard to the state economy. Government actions, on the other hand relate to government revenues, spendings and borrowings execution (Gwartney et al., 2009). By using these major tools, government excercises an economic stimulation or vice versa, curbs the economic growth. On a more detailed level, the areas where government depending on its decisions can achieve certain effects are:

- keeping control over state budget and its money outflow;
- regulating unemployment rates and fluctuations;
- impacting economic productivity levels (total production, i.e.GDP);
- adjusting state's agregate demand and supply;
- affecting money value (inflation regulation);
- governing payments balances;
- supervising public debt developement;
- tackling eventual economic turbulences.

Generally are distinguished three types of fiscal policies including the expansionary, neutral or restrictive fiscal policy. The objective of any of these fiscal policies from government perspective is to achieve a particular economic goal. With the **expansionary** fiscal policy, government either increases pulic expenditures, for instance expands the purchases of public good and services, or decreases the receipt of revenues, for instance cuts the taxes. The **restrictive** or contractionary fiscal policy acts with both instruments contrary to the expansionary policy.

While the equivalence of public revenues and expenditures means that fiscal policy has reached equilibrium, the consequences of both expansionary and restrictive fiscal policies create disequilibrium, thus making government budget be either in deficit or surplus respectively. This mechanism is visible in case with the expansionary policy, which increases government budget deficit, and also consequently forces government increase its borrowings from domestic and foreign creditors (Gwartney et al., 2009).

Necessary is also to mention the **countercyclical** and **procyclical** aspects of fiscal policies, which are also acting vice versa. As for the countercyclical policy, that implies government moving the economy opposite direction from the actual business cycle (Gwartney et al., 2009). In other words, in times of recession, government would be applying an expansionary fiscal policy.

Fiscal policy has also long-term and short-term measures. Short-term measures include one time parameter changes in revenue-expenditure system and are taken with an intention of having effects for certain period of time (Peková, 2005). This relates to measures performed for impacting short term reduction of state's deficit.

Contrary to short-term, fiscal policy's long-term measures may act countercyclically or procyclically. If the first case chosen, according to Pekova (2005) such measures comprise setting up stabilizers that can be manifested for instance by progressive taxation, wide range of offered social benefits and unemployment insurances coverings. These unfavourable from a population point of view measures are primarily striving for to alleviate state's recession and bring the economy back to a sustainable level.

### **3 Government Budget**

Government budget represents a centralized monetary fund that serves as a financial plan supported by state financial law (Peková et al., 2008). It forecasts and plans revenue-expenditure management in the economy for a given fiscal year, and represents one of the executives instruments state authorities are applying for fiscal policy conducting.

Besides a discussion on the flow of government budget process, this chapter will also give an overview on government revenues and expenditures, as well as the outcome of their interrelation on the budget.

#### **3.1 Government budget process**

*“The government budget process is a set of decisions of various authorities in regard to public expenditures and revenues which are resulting in a specific budget creation“* (Hamerníková et al., 2007). The goal of this process is to define and organize the interaction between involved authorities while they plan public money raising, spending and saving. Besides that, budget process reflects decisions concerning the optimum allocation of state’s scarce resources.

The involved authorities in the budget process show variation across countries. Among most common executives are the Ministry of finance, government, parliament and the Treasury (IPB, 2010). The chain of several executives in the budget process, makes its acceptance more difficult to pass through and lessens the probability of errors. However, the general responsibility for budget planning, drawing up, implementation and coordination is usually beared by the Ministry of Finance.

The government budget process besides the executive aspect mentioned, incorporates also the legislative aspect. Depending on the country, legislature sets up on the budget process either several annual appropriation laws or a single budget law (Wehner and Banyima, 2004). At the same time, legislature divides budget process into several stages. The usual stages include budget drawing, its approval, budget actual execution,



and at last, budget audit and controlling (IPB, 2010). The stages follow strictly per the budget calendar that is unique for each state and is by law supported.

As previously mentioned, budget process is not a unified process and can significantly differ between countries. However, it follows some common characteristics and procedures that majority of developed countries are following, and which are also recommended by the international financial organizations. Based on the literature used from Wehner and Byanyima (2004) and Hamerníková et al. (2007), they involve:

- initial budget drawing that is planned and assembled by MOF which provides with at least one year budget projection. The preparation process can be also in form of medium-term fiscal framework, i.e. three-year spending plan;
- the preparation and negotiation of draft budget is also done by government based on its policy priorities;
- once a comprehensive budget is drafted, it is proceeded for an approval by the legislature, i.e. parliament in order to become effective. The length of the legislative approval varies significantly between states. Nevertheless, international experts suggest this stage duration to last at least three to four months; The approval usually takes three readings, each followed by discussions, debates and resolutions on individual budgetary chapters;
- upon budget's approval and its execution in ongoing, comes the stage of budget process in which MOF with an eventual participation of Treasury are playing leading roles in ensuring that budget spent resources are in line with approved budget ceilings;
- the very last stage of budget process involves budget auditing and control executed by Public Accounts Committee or other relevant audit department. In some countries however, same institutions, i.e. committees are bearing responsibility for both budget approval and auditing. Moreover, budget auditing and control can be performed by the Supreme Audit Office together with the MOF, government and some other regulatory bodies.

Generally, the budget process contributes to building of a system that organizes, determines, monitors and controls different aspects of state money management. It sets up planned scope of revenues and expenditures, deals with overspending limits and reserves, improves the overall budget transparency. Moreover, the budget process provides with an estimation of economic growth and gives a space for setting alternative options for problem solving.

### **3.2 Structure of budget revenues and expenditures**

While in the previous chapter were discussed public revenues and expenditures along with the main categories they are divided into, here will be covered the structure of budget revenues and expenditures from different classification perspectives.

Revenues and expenditures classification helps government form its fiscal policies, effectively allocate available resources, as well as perform daily government budget administration (Jacobs et al., 2009). Referring to used worldwide classifications, this section will follow the IMF methodology, which is commonly applied in the developed countries and classifies revenues and expenditures as economic and functional. IMF functional classification focuses on the allocation of certain budget resources (Hashim and Allan, 2001), and generally divides both revenues and expenditures into categories per their applicability such as general public services, defence, health, education, social and environmental protection (GFSM Manual, 2001). The economic classification on the other hand, views revenues and expenditures as transactions that are essential for obtaining detailed budget analysis (Hashim and Allan, 2001). This will be more in details described in the following section.

### 3.2.1 Budget revenues

As per GFSM Manual (2001), Jacobs et al. (2009) as well as personal investigation on number of countries' general budget revenues structures, budget revenues are commonly presented by tax revenues that constitute of:<sup>1</sup>

- income taxes that include profits and capital gains, where taxpayers are physical and legal individuals, as well as companies. This category also includes unallocable taxes.
- taxes on goods and services, including VAT and sales taxes;
- taxes on use of goods and on permissions to use goods or perform activities, where as a subcategory are falling motor vehicle taxes;
- taxes on international trade and transactions. These taxes are also subcategorized by customs and import duties, export taxes, exchange profits and taxes;
- taxes on property, encompassing immovable property, estate, inheritance and gift taxes;

Besides above mentioned types of taxes, there are various separate taxes on payroll and workforce, profits of fiscal monopolies, as well as taxes on specific services.

Other categories of revenues economic classification include social contributions, grants and as a last category, the other revenues. While social contributions deal with social securities, employee and employer contributions, the category of grants encompasses the received grants from foreign governments, international organizations or general government units. The category other revenues comprises various of items as property incomes, that involve collected interests and dividends, rents, administrative fees, fines, penalties and forfeits, as well as voluntary transfers, miscellaneous and unidentified revenues.

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<sup>1</sup> full version of revenues available in the appendix 1

### 3.2.2 Budget expenditures

Per same IFM economic classification and additional investigation on most common items appearing on countries' budget expenditures side, the following main categories account for budget expenditures and include: **employee compensations, interest, subsidies, social benefits, grants, use of goods and services, interests, and other expenses** (Jacobs et al., 2009).

As for the employee compensations, they constitute wages and salaries in cash and kind; as well as social contributions, that can be either actual or imputed contributions. The social benefits deal with social security benefits and assistances that can be in cash and kind paid, and in addition to this category fall the employer's social benefits. Similarly to employee compensations and social benefits, there are in cash and kind forms.

The budget subsidies, on the other hand encompass payments towards various public corporations and enterprises. This expenditures category includes the financial, nonfinancial, as well as private enterprises. The grants are of a similar classification with the revenues one, however they refer to grants supplied and released, instead of being received. The last expenditure classification category includes interests, which attribute for interests of general government units, as well as the ones paid to residents and non-residents.

Additionally to the above mentioned budget expenditures, part of the government expenditures constitutes of transfers and debt interest payments (International Monetary Fund, n.d.). For instance Peková (2005) states that the biggest share of [mandatory] expenditures, i.e. expenditures supported by law, are transfers. The transfers, being in the role of government expenditures have several forms and can account for capital, transfers for activities of government non-profit organizations, or transfers to local governments. As transfers to local governments are usually related particularly to the central government expenditures, they require separate consolidation within the budget government, otherwise may create double-counting in both budgets (International Monetary Fund, n.d.).

The clearing of both government budget revenues and expenditures is executed on one single account, which is usually held by the Central Bank (Peková et al., 2008).

### **3.3 Government budget equity**

Managing government budget and its balance is a very complex and demanding process. Nevertheless, state economy and its future development is significantly impacted and dependent on it. A decisive role in this regard plays the government budget equity, i.e. the fact, whether it is balanced, is in surplus or in deficit. In addition, crucially important in this regards are the priorities of state authorities.

Government budget is based on several principles that serve as core pillars for building a stable and prosperous economy. Those are the principles of budget equilibrium that sets up a rule where total budget revenues equal total budget expenditures. Moreover, here is also important the aspect of state borrowings, which should not by any means be considered as revenues, and thus to used to equalize possibly exceeding expenditures.

In practice, government budget estimations and analysis often differ from actual total revenues and expenditures spent at fiscal year end. When revenues prevail, the budget is running into a surplus. The budget surplus might arise however due several reasons. A reason for it can be a situation when available expenditures are not entirely withdrawn due to austerity measures in regard to planned expenditure programs, as well as when there is a complete removal of some sections from the expenditure programs (Pilný, 2007). The surplus is usually what government strives for while conducting budget management. However, large budget surplus is not recommended to sustain, as it does not use efficiently available resources and by that slows down the economic growth.

In spite of „the golden financial rule“ of sustaining a budget equilibrium, recently governments are facing deficit trends. This is later becoming a general problem of the entire state economy. A deficit, or also called a short-term budgetary imbalance may happen in the course of fiscal year. It is quite transparent in terms of formation, as for its

creating is usually responsible a specific government (Pilný, 2007). A reason for deficit can be the negative account balance, which comprises of revenue stagnation or decline, while in parallel accompanied by expenditures growth (Peková, 2005). Moreover, deficit can occur when the revenues are growing slower, or on contrast decreasing faster than the expenditures.

A short-term budgetary imbalance, i.e, deficit, can be also proposed by government. It may occur as a consequence of negative cash flows during the fiscal year, or despite government's involvement, can be created due to impact of external factors (Ochrana et al., 2010).

By its origins, Ochrana et al. (2010) and Pilný (2007) distinguish the deficit as:

- **active** (structural) deficit, where a reason for it can be an expansionary fiscal policy involving decrease of tax rates or growth of government expenditures; government populism, that is recognized by an increase of transfer or tax rates decrease for fulfilling election objectives; as well as a reason for deficit can be the tax smoothing theory;
- **passive** (cyclical) deficit is a phenomenon that government can not affect, as it is impacted by external factors, such as an economic downturn (depression); inflation growth increased prices level of raw materials on world market; nature disaster; growing interest on public debt or debt service changes interfering.

Besides above classification, deficit can be viewed per Pilný (2007) as:

- **primary** (interest-free) deficit, which is recently created, i.e in previous fiscal year;
- **secondary** (interest based) deficit, which is represented by interest payments for outstanding debts from previous periods.

Moreover, author Ochrana et al. (2010) adds that short-term deficit consequences are usually positively accepted, as they are alleviating government budget constraints. However, long-term deficit consequences are rather negative. They must be financed

and thus lead to an increase of public debt formation. From macroeconomic point of view, the budget deficit has an impact on the GDP, inflation and unemployment rates, as well as on the balance of payments.

Budget deficit existence forces government take actions such as selling state owned securities or issuing state bonds. State bonds, however can be afterwards repurchased by the CB, an action called "deficit monetization", nevertheless, this is oftenly restricted by law (Ochrana et al., 2010). Besides that, government may increase the amount of long-term loans, for instance from domestic and foreign creditors (Pilný, 2007). Among other options figurating is performing a decrease of a share of the financial assets and liabilities on the state accounts; gaining revenues from state capital selling); or even increasing the taxation rates

## 4 Public Debt

In contrast to the short-term budget deficit, which can be still harmless, the long-term deficit transforms into public debt. The following chapter will define the nature of public debt and will proceed with such concerns as its impact on the economy, as well as public debt solutions for its effective management and eventual reduction.

Public (state) debt is defined as „a sum of existing obligations of the state, local governments, public institutions, extrabudgetary funds as well as public enterprises, both state and municipal” (Peková, 2005). Additionally, as per the IMF GFSM 2001 manual, the debt of the CB is also assumed as part of public debt (International Monetary Fund, 2005). However, public debt calculation methods differ among countries and are often dependent on a country’s political organization.

### 4.1 Key elements of public Debt

Public debt can occur for various economic reasons and responsibility for its occurrence can be spreaded over several governments altering over years (Pilný, 2007). The formation of public debt foremost arises from budget deficits cumulated from previous years – or from so called „the chronic deficit“. Public debt can evolve due to government performing financing operations towards domestic and foreign economic entities (Ochrana et al., 2010), but can also be a result of taking obligations over by government from other entities, or paying off state obligations from previous years (Peková, 2005). Public debt can also originate from government resource insufficiency after performance of extensive public investments or political elections.

Similarly, as it was the case with the revenues and expenditures, public debt can be classified. Common public debt classification is based on its location and can be viewed as an **internal** or **external**. An internal debt is a debt government acquired from domestic creditors, usually in inner currency, and represents a government obligation towards an asset of private sector (Ghosh and Ghosh, 2008). The external debt involves foreign creditors and are both received and paid off in foreign currency Jain, T. (2010).



External debt is usually higher in the emerging markets, due to their weakly developed domestic markets.

Public debt can also be viewed from a perspective of repayment duration period. In this regard is divided into **short, medium, and long-term** debt, which are due to be paid within one year, ten years or over ten years respectively (Ochrana et al., 2010).

Public debt can be spotted as an **official** (reported) or **hidden debt**. The hidden debt is at its first stages potential, but may eventually become an official, in case the liabilities for which state is a guarantee are not paid (Peková, 2005).

For purposes of international comparison is used a gross debt value, which is also applied for determining and assessing debt to GDP ratio (Peková, 2005). Other indicators, known as Total Debt Indicators are related to GDP and are measuring debt's evolution and government payment capability by using „...interest payments or debt's amount in relation to different income scales...” (ISSAI, 2010).

Both budget deficit and public debt levels are also quantified by the Maastricht criteria. The budget deficit level is set up to max to 3% of GDP, while public debt must not exceed over 60% of GDP. Both criteria are in market prices per ESA 95 (Ochrana et al., 2010).

## **4.2 Public debt economy impact**

The public debt is a phenomenon that has not only an impact on the overall economy, but is directly and indirectly impacting individuals and private sector. Paying out the debt is a long and complex process that puts a strain on government budget for years in advance and thus becomes a burden for future generations. Moreover, it generally reduces the state's economic competitiveness.

Among obvious public debt impacts on the economy is the increase of costs of public debt management. The debt existence requires recording of its due amounts, continuous actions taken towards its redemption, as well as paying off the debt interests (Pilný, 2007). When getting into debt situation, governments as an exit option may choose to

issue bonds and treasury bills, which are usually attractive to investors as they bear low risk. However, by doing so, governments undertake responsibility of paying both the principal and interest rates regardless future development of the public debt (Peková, 2005).

Besides securities issuance, for gaining needed resources governments are negotiating loans and other borrowings. In role of creditors are financial institutions rather than households, as second group usually does not have enough financial means for lending to the state. The loans obtaining can be executed from both domestic creditors, such as Central Bank, domestic commercial banks, but also from foreign creditors, the WB, IBRD, IMF, IDA (Chand, 2008).

However, public debt borrowings and repayments to creditors are also not free of charge and risk. They simultaneously lead to an increase of government expenditures. This is the **budgetary public debt** impact that is manifested in a way that higher is the indebtedness, higher are the compensations paid to creditors. Additionally, higher indebtedness forces government offering its creditors bargain interest rates (Ochrana et al., 2010). Moreover, higher interest rates simultaneously lower the amounts of provided goods and services to citizens, and usually even make governments raise the tax rates (Hyman, 2012). This effect of higher expenditures associated with bailout costs that are forcing tax rates to growth is actually the **redistribution public debt impact** (Peková, 2005). The above facts might restrain both domestic and foreign creditors and investors from further money supply, as they become sceptical about state's exchange rates depreciation and possible insolvency, and thus lower the capacity of the domestic market. This in return may cause a destabilization of the domestic banking sector.

Public debt also impacts **portfolio structure** of private sector, as it prompts the capital outflows, and leads potentially to an increase of the inflation rate (Peková, 2005). However, as public debt is a state variable, an interesting situation can also happen when the debt coverage along with high inflation rate can produce conversely a decline in debt's fair value (Hyman, 2012).

Recent trends show that modern economies can also face a debt trap. Such happens when governments fail to proceed with debt repayments, i.e. are forced to obtain new borrowings in order to pay the interest rate and instalments to the creditors (Ochrana, et al., 2010).

The public debt problem can be viewed as a vicious circle. Higher interest rates transforming into higher budget expenditures that on return form new budget deficits. Therefore, reaching short-term fiscal balance in these cases is not sufficient, as long-term fiscal imbalances keep deepening.

### **4.3 Public debt solutions**

The existence of public debt must not be neglected; instead, an in depth analysis and proper solutions must be performed for its reduction and possible elimination to be achieved. As each state's capacity, political and economic situation are unique, there is no single approach towards managing and maintaining non-risky levels of public debts. Besides that, Pilný (2007) states that public debt solutions, i.e. approaches taken towards its decrease can be passive or active, where by passive approach he assumes variables that are not easily influenced, such as growth tempo of the economy, inflation rate, receiving of grants or debt forgiveness.

The active approach, on the other hand deals with concerns that are more specific and can be influenced by authorities on a greater level. For reason of public debt growth trends that are visible from recent economic indicators, international institutions IMF, WB, OECD and European Commission have adopted number of practices and guidelines for public debt influencing and reduction. The below section will be describing some of the approaches and concerns coming from both international organizations, as well as individual authors.

As the budget deficit and public debt are closely interconnected variables, among most common approaches for to decrease the public debt is also decreasing budget deficit and

targeting to achieve a budget surplus. In fact, the existence of budget deficit makes government borrow additional funds for deficit financing, which among other negative impacts, results in growing of government bonds holdings, and thus adds to the public debt stock growth.

Other solutions for public debt reduction can be imposing higher tax burden on population. However, it is important to respect the fact that besides the positive theoretical outcome of higher taxes that help redeem treasury notes and other state obligations, higher taxes should also increase the investment inflows. This is the case when treasury notes rate decline attracts new investors that consequently help stimulate the overall economy (Alternative Insight, 2009).

Besides pursuing budget surplus or increase of taxes, one of the approaches for efficient public debt management and its reduction, is minimizing both costs and risks of debt's financing and servicing. Respecting that, allows avoiding unfavourable public debt structures. By the structure of public debt is meant debt's composition, for which a preference should be given to debt denominated in domestic currency before foreign one, since higher foreign debt share is most likely to lead to overall higher debt or even banking crisis (Balteanu et al., 2011). In addition, the short-term interest rates should be bypassed in favor of long-term rates. A preference in rates should also be given to the fixed rates, instead of the floating rates (World Bank, 2003). In fact, higher long-term interest rates are dragging additional expenses on the budget and may also cause crowding-out of private investments. Both aspects are especially applicable on securities' emissions that are aimed to reduce country's debt risk, and at the same time to increase the potential of the domestic market development.

Another solution for reducing public debt burden is by executing debt's conversion. In this sense, the conversion of public debt is not assumed as its repayment, but stands for exchanging the old public debt into a new one that eventually bears more favourable interest rates than the debt before.

Besides above-mentioned aspects, according to World Bank (2003) and OECD (2003) there are other public debt management solutions for debt reduction that are stressing the need for:

- decreasing the share of foreign debt in total public debt;
- increasing the maturity of the domestic debt;
- performing when feasible buy-backs on both domestic and foreign debt before reaching their maturity;
- focusing on using sophisticated analytical tools that allow sound performance of liquidity management that provides with reliable actual portfolio value and market forecasts;
- developing an efficient securities trading platform for the domestic market that will help lower operational transactions, and by such decrease the government costs, i.e. the public debt;

Additionally, for public debt reduction and risk limitation can contribute derivatives. Improving the use of these market instruments allows increasing of the liquidity of government securities markets (OECD, 2003), and consequently help achieving greater share of the domestic debt or performing buybacks.

Another aspect that can be applicable for sustaining and potentially decreasing the public debt level is meeting transparency in operations performed by both MOF and CB. The transparency should be applied for achieving a control over public debt due payments, budgetary reportings, as well as government financial accounts (International Monetary Fund, 2001).

However, as for the relation of MOF and CB influences on public debt, it is important to mention that for achieving an effective debt management, the influence of fiscal policy (led by MOF) and monetary policy (led by CB) should be in some regards segregated. The reason for that is limiting debt management decisions to become impacted by information on interest rate decisions coming from CB (OECD, 2003).

On the other hand, debt management and cash management within public finances are recommended to intersect for to prevent from short-run reconciliation differences between public debt and monetary operations (World Bank, 2003).

## **5 Public Finance in the Republic of Macedonia**

Public finance in the Republic of Macedonia has become a significant topic as the country has become actively involved in the EU and NATO integration. Macedonian authorities in the past several years have been attempting to build an efficient public finance system, which has been targeted towards reaching a sound performance of the fiscal policy, as well as gaining a satisfactory level of government budget and public debt transparency and accountability.

### **5.1 Basic characteristics of Macedonia**

The Republic of Macedonia is located in south-eastern Europe, in the middle of Balkan Peninsula. Its surface area is 25,713 km<sup>2</sup> and is completely landlocked. The total population from the last census in 2002 reported 2,022,547 inhabitants, however as per newer statistics from 2011, total population is estimated at 2,059,794 (STAT, 2012).

Capital city of the Republic of Macedonia is Skopje, being the most significant and developed economic, administrative and cultural center. It absorbs around 25% of total population of Macedonia and around 60% of its GDP (STAT, 2012).

Macedonian monetary unit is represented by Macedonian Denar (MKD) equaling 100 Deni. The National Bank of the Republic of Macedonia (NBRM) maintains a managed floating exchange rate. The nominal exchange rate of denar against Euro, which serves as a fundamental is set at 61.5 MKD per Euro, and has been remaining constant over past years. USD dollar for the same period equals 48.9 denars per 1 USD (Q1 2012).

Macedonia actively participates in the international community and is a member of number of organizations including United Nations, Organization for Security and Cooperation in Europe (OSCE), the Council of Europe (CE), World Trade Organization (WTO), Central European Free Trade Agreement (CEFTA), Organization of the Francophonie, International Monetary Fund (IMF), as well as other organizations in the field of finance, trading, environment, technologies and etc.

Macedonia aspires for NATO and European Union integration, and as of December 2005 has a status of a candidate country for EU. Becoming a member of the EU has been one of its strategic goals, thus this topic is on a daily agenda of political leaders. Attempts towards fulfilling the European standards include amendments in areas such as judiciary (new law adoption) and state organization. Macedonia has been also working on number of reforms for to be capable of meeting future EU membership obligations. Besides the economic interventions, these reforms also include focusing on various social and environmental problems.

EU and some other financial organizations, such as World Bank have also taken certain actions to help Macedonian economy stabilize and grow. For instance EU has released the „Instrument for Pre-Accession Assistance“ (IPA) program, which supports market economy development and prepares Macedonia for the competitive EU environment from a political, economic and monetary perspective.

### 5.1.1 Institutional framework

Being one of the six former states of Yugoslavia, Macedonia gained its independence and sovereignty on September 8<sup>th</sup> 1991. After the communist regime, it became a multi-party parliamentary democracy with one ruling and several minor parties. As of November 17, 1991, a constitution was adopted acting as a supreme law. The state power is splitted between the Assembly (*Sobranie*), the Government (*Vlada*) and the judiciary.

As per the Constitution (1991), the Assembly of the Republic of Macedonia, “*is a representative body of the citizens and the legislative power of the Republic is vested in it.*” (art, 61) represented by 120 up to 140 members (art, 62). The Assembly has control over the Constitution; laws; tax system; budget adoption; referendum notice; government elections, monitoring and supervision (art, 68).

Constitution (1991) also defines the Government of the Republic of Macedonia as the holder of executive power (art, 88) that is represented by the president and ministers (art, 89). Its rights and duties are Constitution and law based (art 88). It is first in line



responsible for state administration in terms of law and budget propositions, appointment of the ministries, conducting the foreign relations, state reserves decision making and control (art 91) Last early government elections were held on 5th of June 2011, where the centre-right party VMRO-DPMNE, a national conservative party gained a victory for a third consecutive term. The judiciary power is exercised by courts, which are autonomous and independent (art, 98).

State administration is also Constitution based, however acts as an autonomous authority. Its organization currently has 15 ministries. Those dealing with the government budget and public debt are Ministry of Finance and Ministry of Economy.

Ministry of Finance duties are to conduct (macro)economic, fiscal and taxation policies; predict economic issues; perform fiscal analysis; enforce various financial laws and balance the government budget. As per MOF (n.d.), the Ministry of Finance consists of several affiliated institutions:

- Customs Administration;
- Public Revenue Office;
- Office for Prevention of Money Laundering and Financing Terrorism;
- Financial Police Office;
- Public Procurement Bureau;
- Property and Legal Affairs Office;
- State Foreign Exchange Inspectorate.

Ministry of Economy (MOE) focuses on strategies on improving the business and investment climate; concentrates on business enhancements for to stimulate domestic and foreign direct investments inflow. In its recent agendas, it was also working on industrial policies realization aimed to improve the competitiveness, entrepreneurship, and innovation of SMEs. Regulation of internal market and Consumer Protection are another topics of Ministry of Economy's interest.

Currently the state administration system is in transition mode. It seeks for a better IT infrastructure organization, as well as better streamlining of authorities on an

operational level. The intentions are to built a relevant, modern and as much effective system as of Western European contries.

Macedonia is also divided into 8 regions and has one tier of subnational government level represented by municipalities. As per Constitution (1991) „*municipalities are units of local self-government*” (art, 114), and as of 2004 they account for total of 84, while Skopje as a separate unit, holds additional 10 municipalities within its territory. The average population of a municipality is with around 24,000 people.

## **5.2 Macroeconomic indicators**

Following the acquired EU membership candidate status in December 2005, The Republic of Macedonia started implementing number of reforms and projects that have been having impact on all macroeconomic sectors. The following section will be mainly focused on developements of macroeconomic sectors since 2006, the first fiscal year after acquiring EU membership status, when Macedonia has actually started applying comparative models and methods as of Western countries. As for the data reviewed, the emphasis will be done on the real sector with its GDP and inflation development, as well as the foreign sector situation starting from 2006.

### **5.2.1 GDP development**

The Republic of Macedonia, likewise other countries, as a basic indicator for measurement of its economic activity uses GDP indicator. According to STAT, Macedonia has been already applying the principles of European System of Accounts, ESA95 and EUROSTAT for GDP data management. Moreveover, the data before 2000 has been revised and GDP has been calculated at constant prices, instread of market prices.

For purpose of better view on the development of GDP in Macedonia over the years, below is a summarizing table. The numbers reffered to the below mentioned variables

are based on a consolidated information from MOF and STAT reports of the Republic of Macedonia through years 2006 to 2011.

Table 1 GDP development

Year	GDP Growth Rate (%)	Total GDP (in million of euros)	GDP per capita (in denars)	Inflation Growth Rate (%)
2006	4.0	5.082	2.491	3.2
2007	5.9	5.782	2.829	2.3
2008	5.0	6.507	3.177	8.3
2009	0.9	6.703	3.269	0.8
2010	2.9	7.057	3.434	1.6
2011	3.0	7.308	3.550	

\*Own modification

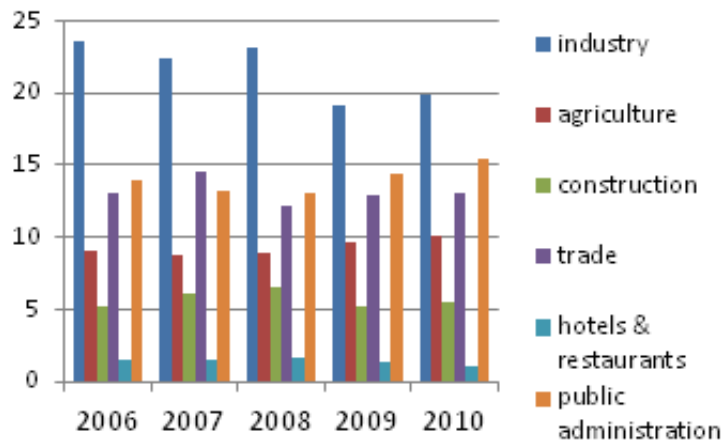
Source: MOF: Annual Reports and Macroeconomic Indicators [online] . Available at: <http://finance.gov.mk/>.

In **2006**, the economic activity expressed in GDP resulted in 4.0% growth, while previously projected at 4%, and amounted in 5.082 million Euro and 2.491 per capita. Applying the production approach, services sector places the biggest amount of contribution share with a total of 47.5%. Within the services sectors, the industrial sector had the largest share of 23.6%. In 2006 industrial sector was successful mostly on the basis of metal and for non-metal products industry.<sup>2</sup> The least active was the sector of hotels and restaurants, with total of 1.5% share.

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<sup>2</sup> Industrial sectors incorporates in itself: Mining and quarrying; Manufacturing; Electricity, gas, steam and air conditioning supply; Water supply; sewerage, waste management and remediation activities.

Graph 1 Production approach: GDP per sectors in years 2006-2010



\*Own modification

Source: MOF, STAT: Annual Reports and Macroeconomic Indicators [online] . Available at: <http://finance.gov.mk/>, <http://www.stat.gov.mk/>.

During **2007**, the economic activity showed the best results since separation from Yugoslavia. The economy generated a real GDP growth of 5.9%, i.e. 5.545 million Euro total, and 2.725 Euro capita. The **services sector** held the largest share of 51.4% of GDP being in a leading position actually since 2003. In overall, the economic of year 2007 was even visible in the hotels and restaurants sector, which grew by 6.8%, reaching a huge progress compared to 2006. The graph below shows the contribution per sectors.

**2008** was the year, when the economic crisis hit the world economy and caused a general economic slowdown. Macedonian real sector in this regard stayed rather stable achieving 5 % of real GDP growth rate. The slowdown was marked in the fourth quarter only, but yet with a positive trend. The total GDP was 6.720 million Euros and GDP per capita 3.283 Euros. According to the production approach, out of four figurating sectors (agriculture, industry, construction and services), the main contributor was the industrial sector with growth of 23.2%.

Year **2009** was already replicating the 2008 crisis and Macedonian economy showed signs of negative economic tendencies. For the first time in a sequence of several years, the real GDP was contracted with a real negative growth rate of 0.9%. First three quarters had negative tendencies, while only in the fourth quarter the economy started

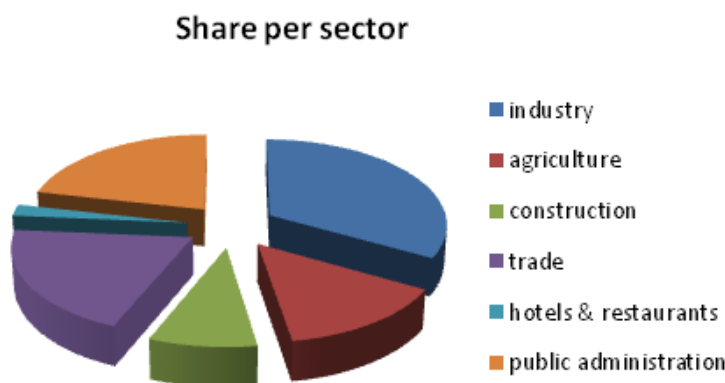
recovering. The total GDP accounted for 6.703 million Euros and per capita reached 3.269 Euros. The main driver per production approach was the **construction sector**, however it was much lower compared the years before and had an average growth of 4.2% (PEP13, 2011). The industry also worsened

In **2010**, the economy began to slowly healing and its real GDP growth rate resulted in 2.9%. Total GDP in market price in Euros accounted for 7.057 million, while per capita it reached 3434. Similarly to the previous year, out of all sectors, the **construction sector** experienced most significant increase of 14.9%. Nevertheless, the lasrgest share held the in

Real GDP growth in **2011** did not show a big contrast in comparison to 2010 and accounted for 3.0%. Total GDP in Euros was calculated at 7,308 million and GDP per capita in Euros reached 3.550 million. Construction sector in 2011 was again the most contributing with its 15.6% of growth.

For the period of 2012-2014, the real GDP growth range has been predicted between 3.0% and 4.7%. However as per latest reports for the first quater of 2012, it achieved only 2.5% real growth. In regard to inflation evolution over same years, as it will be visible from the following discussion, Macedonian economy has been suffering from some downturns in between some consecutive years.

Graph 2 GDP contribution per sector average value for years 2006-2010



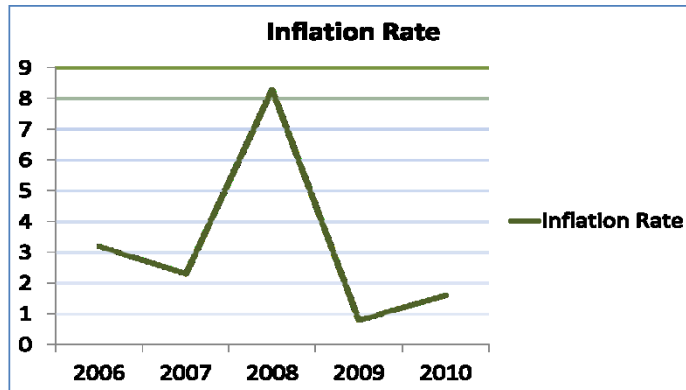
\*Own modification

Source: MOF; STAT: Annual Reports and Macroeconomic Indicators [online] . Available at: <http://finance.gov.mk/>, <http://www.stat.gov.mk/>.

## 5.2.2 Inflation development

In addition to the GDP overview, below graph consolidates the inflation changes in Macedonia from year 2006.

Graph 3 Inflation rate



\*Own modification

Source: MOF: Annual Reports and Macroeconomic Indicators [online]. Available at: <http://finance.gov.mk/>.

As for the year **2006**, the inflation accounted for 3.2% , while expected at the average rate of 1.8% (MOF06, 2007). It was driven by the increased prices of tobacco products and beverages, which has the biggest participation for the inflation move.

The **2007** inflation was more moderate, and reached 2.3%. However, it was intensified with every upcoming quarter in 2008, and generally followed the trends of the world market prices.

In **2008**, after a low, but yet stable growth during several years, inflation scrambled from 2.3% in 2007 to 8.3%. There is no doubt that a reason behind was the world financial crisis, and that for a small and open economy like Macedonia is, it was inevitably global market prices directly to affect its domestic market. The prices measured by the CPI index indicated a significant increase of oil and oil derivatives prices, as well as an increase of costs for food. These were actually the main drivers of the inflation.

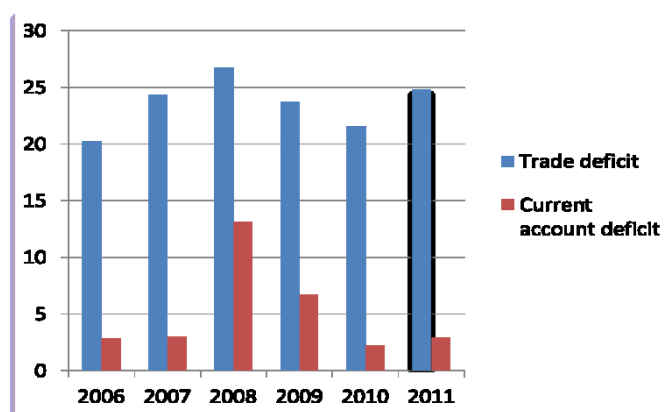
In **2009** the inflation rate had a negative trend and fell dramatically to 0.8% in almost all categories: consumer basket, services, education and transport.

Inflation in **2010** reached 1.6%, and was mostly a result of price rise for heating and lighting, while in **2011** for the inflation of 3.9% were responsible marked up prices in the food category.

### 5.2.3 Foreign sector

Likewise the real sector, the foreign sector has been keeping pace with the external market developments. Being a small economy, Macedonia has been heavily dependent on its foreign partners, mainly the EU partners (majority of trades is done with Greece, Hungary, Slovenia) and developing countries as Russia, Turkey and Ukraine.

Graph 4 Trade and current account deficit development



\*Own modification

Source: MOF: Annual Reports and Macroeconomic Indicators [online] . Available at: <http://finance.gov.mk/>.

In **2006**, a significant increase of prices on the foreign stock markets, especially the oil prices have caused Macedonian trade deficit to reach 20.2% of GDP, while its current account deficit to be 2.8% of GDP. The current account deficit was mainly impacted by higher transfers income, in particular the private once.

In **2007** the situation even worsened, and the trade deficit accounted for 24.3% of GDP. At the same time, the current account deficit reached 3% of GDP. A negative impact on

Macedonian trade balance, besides other factors had Bulgaria joining EU and bringing by that a decline in the trading volumes. This was due to laws changings, as well as other implied restrictions.

In **2008**, trade deficit reached 26.7%, while current account deficit was 13.1% of GDP. Trade deficit decrease was mainly caused by the import increase, expecially the import of oil products and electricity. Moreover, Macedonia being heavely dependent on import of raw materials, had to supply its small domestic market by importing in U.S. dollar currency, which was that time depreciating. On the other hand, the export was accepted in Euros (MOF08). Also, the fact that Bulgaria, which was also among Macedonian major business partners, when joining EU in 2008 caused a decline of Macedonian export.

The external sector in **2009** was still under strong impact of the global crisis, although Macedonian trade deficit went down to 23.7%, while the current account deficit to 6.7% of GDP. The biggest trading partners for both export and import affairs remained the EU partners and the downturn of their economies has significantly decreased Macedonian export. The trades were mainly executed using Euro currency. On the other hand, trades with Ukraine and Turkey have also showed a decline. Overall import and export continued the downward trend, however import was declining faster and thus was causing shirinking of the trade deficit.

In **2010**, a graduate recovery of both domestic economy and partner's demand for goods was noticeable. The trade deficit accounted for 21.5% and the account deficit accounted for 2.2% of GDP. The contribution was mostly on the export side, improving its performance expecially second half of 2010. Exports with iron and steel were taking a considerable share in the trade balance. Moreover, for the generall goods production contributed climate's favourable conditions and positive trends in metal prices. EU kept the role of being among largest export partners for Macedonia, besides already significant decline of exports going to Greece which was fighting the recession (PEP14, 2012).

Trade deficit in **2011** was represented by a higher rate of 24.8% of GDP, while current account deficit went up to 2.9%. For the export to increase mostly contributed



commodity prices. In case of Macedonia, increased prices had an impact on the export of steel and iron. The trade with EU also expanded. However, the trade deficit formation was going up due to simultaneously increased import of intermediary goods which were Macedonia was using for further production. Those were mostly raw materials, fuel and lubricants (MOFtrends, 2012).

In 2012 and 2013, the expectation for the trade deficit is rather positive. A decline has been anticipated mostly due to faster recovery of exports than imports in the future. As for current account deficit, it is predicted to be in a range between 4.7 % and 5.6% of GDP (PEP14, 2012).

### **5.3 Fiscal Policy**

Following the confirmation of candidate status for EU, government of the Republic of Macedonia has started adjusting its fiscal policy management according to European standards. Moreover, since 2007, government obliged itself preparing and reporting Medium-term and PEP programs to European Commission annually. These documents deal primarily with projections of macroeconomic attributes and plannings, as well as with amendments and developments done in Macedonian public system for the period. According to the fiskal policy for years 2011-2013 (MOFfis, 2010), the pre established targets that Government has been pursuing in the recent years are towards reaching:

- growth and sustainability of the national economy and increasing its competitiveness;
- lower rates of unemployment and providing population with better living standards;
- stronger integration with EU and NATO Alliance;
- achieving better control over the crime and corruption;
- law enforcement;
- increasing investements in education and healthcare systems.

In addition to that, Government has been striving for to build a compatible government budget and public debt regulation system, as well as to fully implement international standards of accounting data presentation. ESA 95 Accounting Standards have been introduced in Macedonian public administration since 2010, amended to previously used GFSM 1986 system. However, these standards have not been yet covering the entire Macedonian financial data.

### 5.3.1 Fiscal policies for period of 2006-2010

The fiscal policies in years **2006** and **2007** were rather expansionary. Macedonian authorities were mostly engaged implementing reforms aiming to improve the tax and tariffs systems. These included tax burden reduction by imposing 10% flat tax on both corporate and personal incomes, as well as cutting from the VAT taxes, particularly on agricultural products from 18% to 5% (PEP10, 2007). Moreover, an intensification of structural reforms was going in direction of moving the small and weak Macedonian economy towards open market practices. Besides that, from period of 2007, Macedonian MOF started regular preparation of PEPs, which haven been including analyses and projections on mid-term and two years fiscal steps.

The fiscal policy in **2008** was mainly concerned with the emerging economic and financial crisis, which as mentioned in the previous section had mostly negative impact on Macedonian trade deficit. Already in that period, the government was more leaning towards anticyclical policy. Fiscal policy was concentrating on macroeconomic stability and fiscal consolidation. Special attention was paid on poverty decreasing and sustaining low unemployment and inflation rates. In 2008 fiscal policy was also aiming for establishing new administrative institutions and law modification, that would correspond and allow Macedonia to better meet EU membership criteria.

Reforms in tax system were also put in place. This was mainly emphasized by the tax burden reduction. Writing-off interests on personal, income and profit taxes were performed, as well as reduction of VAT for certain products was adjusted. Government

made amendments in the judiciary system for reaching better control over the underground economy and thus increasing the budget revenues.

Maintaining a low level of budget deficit (around 1.5% of GDP along the year), as well as giving preferences to domestic sources of financing were additionally parts of the projections made for 2008. These actions assuredly aimed to improve the general credibility of Macedonia.

**2009** continued to be a turbulent year for the world economy. Nevertheless Macedonian government managed to maintain a satisfactory economic activity and stability. As it was in the previous years, in order to balance the decreased demand in the domestic market, government proceeded with countercyclical fiscal policy. This helped stimulating the public spendings. Politics of lower taxation from previous years together with the reduced contribution rates and profit tax collection (applied only to dividend profits), provided Macedonian economy with a sound support (PEP12, 2010). Although the unfavorable economic conditions were persisting, the government budget was not surpassing the projection and accounted for 2.7% of GDP in PEP 2011-2012, besides the fact it was mostly financed from the external sources.

Fiscal policy in **2010** was planned prudently. Government was following similar goals from previous years. While in a short-term, government was struggling to neutralize the consequences of the global economic crisis by maintaining a moderate expansionary fiscal policy, in a long-term, it targeted to stabilize the level of public debt, while still keeping a moderate level of budget deficit (MOFfis, 2010). The projection of targeted budget deficit was at 2.5% (PEP13, 2011), and for purpose of its retention, Macedonian government adopted a Supplementary Budget in July. In accordance with the PEP for period of 2011-2013, government revenues and expenditures were revised and marked down by 3%. Associated with that, government proceeded with freezing of public salaries, cutting down the number of new public employment contracts, as well as streamlining the customs operations. Besides all arrangements, the economy did not sustain and by the beginning of 2010 went down by 1.1%. A negative impact had also the fact, that Greece in parallel was heavily confronting its debt crisis, and as a geographical neighbour and close business partner, inevitably suppressed Macedonian

economy. Positive tendencies however occurred by the end of 2010, mostly due to the gradual revival in domestic demand.

Fiscal policy in **2011** was set already with assumptions of better economic climate. The anti-cyclical fiscal policy was continued. Overall, moderate increase in both final consumption and investments were observed. Budget revenues increased last quarter of 2011, compared with same period in 2010. Government also put better control over the non-productive costs for to change and improve the budget structure in favour of investments in the capital projects (PEP14, 2012).

Generally, in both years 2010 and 2011 government was pursuing macroeconomic stability and was tuning its budget frameworks in accordance with plans provided in the programmes. Tax burden along with tax rates were rather modest and remained unchanged. Budget administration improved its discipline level by showing positive courses in both expenditure structures, as well as in keeping control over them.

With the Pre-Accession Economic Programme for the period between **2012-2014**, Macedonian government set its goals towards continuously supporting the economic growth, however without jeopardizing budget deficit and public debt under the Maastricht criteria. In addition to that, government arranged strengthening of the amount of capital investments for to reach better infrastructure and physical capital. Efforts are also made to keep the price level and Macedonian Denar exchange rate stable. Number of reforms have been envisaged to enhance the social systems, especially the healthcare. Furthermore, attention has been paid on refining the legal and judicial systems. Such amendments, according to the PEP for years 2012-2014 have been taken with a consideration to cut the costs for doing business in Macedonia, attract additional new FDI inflow, but also in return to achieve new jobs creation.

## **6 Government Budget of Macedonia**

The following section will discuss the Government budget system in the Republic of Macedonia with an emphasis on the Central Government budget as its share and significance for the overall budget's structure have been the most prominent. The section will describe particularly the budget planning, preparation and execution process including the roles and responsibilities of the involved authorities.

### **6.1 Government budget system**

The government budget system in the Republic of Macedonia is based on the Law on Budget, further only Budget Law, that has been derived from the old budgetary system inherited from Yugoslavia. The latest law update was done in 2011 and as per its definition, Macedonian government budget represents the *"annual plan of revenues and other receipts appropriations that relates to the [central government] budget users and includes [in itself] basic budget, donations, budget loans and budget fund raising activities"* (Budget Law, 2011,2,5). Macedonian budget users are represented by the central government and municipalities, as well as by users carrying out public authority. (Budget Law, 2011, 2,1) Moreover, budget users are differed into a second layer, the so-called spending units. They are in fact second-line budget-users, that are financed by the budget-users (OECD, 2008).

The budget organization includes both administrative and legal framework engagements. Similarly to Western countries' systems, MOF prepares and delivers the central budget to Government, which than consolidates the proposal and forwards it to the Assembly for finalization and adoption.

In accordance with the Budget Law article 3,2, the preparation, execution and reporting of Macedonian budget is in line with principles of comprehensiveness, economy, efficiency, effectiveness, transparency, and sound financial management. The approved budget is in force for one fiscal year, which in the Republic of Macedonia starts 1<sup>st</sup> of

January and closes 31<sup>st</sup> of December. The entire budget process is organized by Budget calendar, which is also legislatively supported.

As per the budget calendar and Budget Law 15.1, Government defines the strategic priorities by April 15<sup>th</sup> for the current year that are later incorporated by budget users in programs and subprograms. By 31<sup>st</sup> of May (16.2), MOF delivers a mid-term Fiscal Strategy. The strategy contains the Draft Budget priorities and targets; available resources and financing evaluations, as well as financing predictions for the period for the next three years (Budget Law, 2011, 17). The macroeconomic predictions are prepared in Macedonia based on the NBRM results and international economic trends, rather than by using econometric models.

By 15<sup>th</sup> of June, budget users obtain Budget Circulars from MOF for to arrange the Budget Draft preparation (Budget Law, 19). Their submission to MOF is by September 1<sup>st</sup> (Budget Law, 22). In return, MOF reviews the Draft Budget and hands it over to Government by 1<sup>st</sup> November at the latest (Law, 29, 1), while by 15<sup>th</sup> of November the same procedure occurs between Government and Assembly (30.1).

In respect of Assembly's procedure, budget approval process features common characteristics of Western countries. According to Macedonian Assembly legislation (Assembly, n.d), the first budget reading occurs if at least 15 Assembly Members within a time-frame of seven days from obtaining the particular budget law proposal request a general debate. The continuation on the same budget matter is held at The Second budget reading where eventual amendments are submitted, voted and adopted. Once Assembly succeeds of budget amendments adoption, the second reading of budget text is revised, and becomes both legally and technically eligible for The Third reading. While third reading of the budget law proposal, budget amendments can take a place again, but only to previously submitted articles. After debates on the amended articles are finished, the submission and proposal are to follow.

Assuming that all above procedures have gone smoothly, Assembly adopts the Budget by December 31<sup>st</sup> (Budget Law, 30.2) In case of Budget adoption delay, MOF approves monthly ceilings of recourses until March 31<sup>st</sup>. However, they can not be exceeding one

third of total expenditures assigned to the first quarter of previous fiscal year (Law, 32.1).

For better control over initially planned resources and budget transparency, budget users are obliged to spend at least 30% of the budget during the first half of the fiscal year (OECD, 2008). On the other hand, budget users are allowed to execute reallocations within the range of previously approved resources, however only upon MOF approval. The resources up to 5 million denars (81,232.64 Euro as of 2.7.2012) are approved by MOF (Budget Law, 33.2) , while the larger amounts are subject to Government control (Budget Law, 33,4).

Furthermore, Macedonian budget process involves management of current and permanent reserves. As predetermined, reserves are collected maximum up to 3% of current expenditures value and serve for ensuring coverage of unpredictable social and natural events, as well as rectification of events'consequences respectively (Budget Law, 11).

The accounting part of the budget is managed by the Treasury Department, which is in the scope of MOF. Besides that, Treasury Department role involves budget users' registraion; budget liquidity management; monitoring and distribution of budget revenues collected; as well as processing queries upon budget users' requests (Treasury, n.d.). For purpose of managing of Government budget, a Treasury Account at the NBRM is open, which is recording all transactions occured under Treasury Ledger.

The accounting principles are however currently in transition towards ESA95, the process which should be finalized by the end of 2012. Moreover, Macedonian authorities has been working on implementation of further improvements of Macedonian budget system. Such included preparation of multiyear budget projections and plannings, enhancing the scope of macroeconomic indicators used, as well as reaching civic participation in budgetary process. The last has been so far suffering from a significant lack of improvement.

## 6.2 Budget revenues and expenditures

The following section will be based on the economic classification of Macedonian budget revenues and expenditures. Both budget categories are classified and managed similarly to international standards and practices.

### 6.2.1 Budget revenues

Macedonian macroeconomic system generally distinguishes budget revenues as tax and non-tax revenues, social contributions, foreign donations as well as revenues from repayment of loans. Besides that, both tax and non-tax revenues are also stated as primary revenues (NBRM, n.d.). In order to define budget revenues on an item level, below has been taken a more detailed look at Macedonian budget balance reports.

In accordance with the reviewed Macedonian budget execution reports<sup>3 4</sup>, the tax revenues include:

- income taxes, which are represented by the:
  - o personal income taxes
  - o profit taxes
- consumption taxes represented by the:
  - o value added taxes imposed from 1.4.2000;
  - o excises, which also include domestic taxes and fees for rendered goods and services;
  - o customs duties, charges and payments, which are coming from international trades and transactions executed related mainly to import;

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<sup>3</sup> *Budget Reports | Ministry of Finance*. [online] Available at: <http://finance.gov.mk/node/898> [Accessed: 23 Jul 2012].

<sup>4</sup> *Budget Closing Account*. [online] Available at: [http://finance.gov.mk/files/u6/Budzetot\\_na\\_RM\\_za\\_2009\\_godina\\_za\\_objavuvanje.pdf](http://finance.gov.mk/files/u6/Budzetot_na_RM_za_2009_godina_za_objavuvanje.pdf) [Accessed: 21 Jul 2012].



- capital gains;
- other taxes, which can be related to specific services or represent imposed taxes for using and getting permits on activities performed.

Within tax revenues, there are also contributions that cover:

- Pension insurance contributions;
- Unemployment contributions;
- Health insurance contributions (social welfare contributions from payments)

For non-tax revenues are accounted per rules for revenues classification by MOF<sup>5</sup>:

- Profits of public financial institutions, such as profits from NBRM, interests on deposits and loans given, property and rent incomes;
- Administrative fees and charges including also fines, court and consular fees, local administrative fees;
- Health co-payments;
- Road Fund Fees;
- Other non- tax revenues such as entrepreneurial and property incomes and other government services;

In regard to capital revenues, based on the budget execution reports and rules for revenues classification they include:

- Sale of capital assets, sale of goods, stock and land, as well as incomes from companies' dividends;
- Foreign and domestic donations, including both goods or money, as well as received transfers, subsidies and gifts.

Among others are revenues from repayment of loans, as well as revenues from budget financing, for instance sale of securities, domestic and foreign borrowings. The last ones serve mainly for covering budget deficits (Law, 2011).

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<sup>5</sup> [http://finance.gov.mk/files/u6/Pravilnik\\_za\\_klasifikacija\\_na\\_prihodite.p](http://finance.gov.mk/files/u6/Pravilnik_za_klasifikacija_na_prihodite.p)

## 6.2.2 Budget expenditures

Budget expenditures of the Republic of Macedonia as per standardized economic classification are divided into two general groups on current and capital expenditures.

The current and capital budget expenditures incorporate as per rules for expenditure classification (2008) and budget execution reports:

The current expenditures:

- wages and allowances such as public salaries and various compensations paid;
- goods and services , including rents and fees;
- transfers, which involve:
  - o social transfers, such as pension funds, unemployment benefits, social benefits and health care;
  - o other transfers and subsidies to public and private enterprises, as well as no-profit organizations;
- domestic and foreign interest payments

The capital expenditures on the other hand are encompassing:

- Fixed assets, such as purchase of equipment and machinery, buildings and non-financial goods;
- Capital transfers.

## 6.2.3 Government budget deficits

The outcome of revenues collection and expenditures disbursement in the Republic of Macedonia over the past several years has not been one a direction tendency. The government budget evolution had shown a path of uneven patterns, unfortunately most of the time with a negative signs. Nevertheless, as it has been targeted in yearly PEPs sequencing already for six years, Macedonian Government has been successfully managing budget deficits within a frame of Maastricht criteria not exceeding 3% of GDP.

## 6.2.4 Budget deficits for period of 2006-2011

Before providing with a extended overview of the budget deficit development in the Republic of Macedonia over the years 2006-2011, below is a summarization of every consequitive years on the budget situation. Moreover, the examination of reasons and consequences of the budget balance, has been also based on the sources used for the tabulation.

Table 2 Budget deficit development

<b>Budget in mil Euro</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
<b>General Budget Revenues</b>	1.700	1.955	2.227	2.097	2.148	2.230
<b>General Budget Expenditures</b>	1.728	1.920	2.289	2.275	2.320	2.416
<b>General Budget Deficit/Surplus</b>	-28	35	-62	-178	-171	-187
<b>in % of GDP</b>	-0,5	0,6	-1,0	-2,7	-2,5	-2,5
<b>Central Budget Revenues</b>	1.029	1.245	1.401	1.281	1.323	1.451
<b>Central Budget Expenditures</b>	1.039	1.233	1.448	1.437	1.463	1.644
<b>Central Budget Deficit/Surplus</b>	-10	12	-47	-156	-140	-155
<b>in % of GDP</b>	-0,2	0,2	-0,7	-2,4	-2,0	-2,1

\*Own modification

Source: MOF, MOF06, MOF07, MOF08, MOFbul06, MOFbul08, MOFbul09, MOFbul10, MOFfis, MOFind, NMBR : Annual Reports and Macroeconomic Indicators [online] . Available at: <http://finance.gov.mk/>, <http://www.nbrm.mk>.

General Budget revenues of the Republic of Macedonia in **2006**, including the revenues of the Central Budget and Budget Funds amounted in 1.700 million Euro, while general budget expenditures amounted in 1.728 million Euro.

As for the Central Budget, the total revenues calculated by MOF were at 1.029 million Euro. The largest contribution was coming from tax revenues, which participated with 93,6% of the total revenues gain. The biggest share held VAT with 47,5%, while the lowest was profit tax with only 8,2% of total tax revenues. In fact, one third of all collected taxes in the budget accounted for indirect taxes. The capital revenues stayed rather low, and similar situation emerged with non-tax revenues, which ended up poor mainly due to sluggish enterprises' incomes in 2006.

Central Government expenditures reached 1.039 Euro Million. The biggest participation as expected were current expenditures, out of which transfers accounted for 38.5% ,

while salaries, wages and allowances for 35% of total expenditures. The capital expenditures arised by purchase of capital funds and released transfers that accounted for 93.9% of total capital expenditures.

Generally, the revenues performance improved compared to 2005. Main reasons for such effect were newly implemented reforms in the tax system intruding enviromental fees based on the modifications in Law on Tobacco and Health Care. However, this was not successfull enough to avoid a creation of budget deficit. Besides that, in 2006 were held Government elections, which also had an inevitable impact on budget deficit. General Government budget deficit in 2006 ended up at 28 million Euro and accounted for 0.5% of GDP, while the central budget deficit reached 10 million Euro, i.e. a share of 0.2% GDP. The main reason for the central budget deficit was the spending of budget funds, even though the revenues progressed in compare to 2005.

In **2007** General Government revenues were at 1.955 million Euro, whils expenditures were reaching 1.920 million Euro.

Splitting from the consolidated budget, Central budget revenues accounted for 1.245 million Euro, which represented an increase of 216 million Euro, or 21% GDP growth compared to 2006. The biggest share was constituted of tax revenues that accounted for 1.125 million Euro and had a participation as high as 90.4% of total revenues. Not a remarkable difference happened in the contribution structure of the revenues, as again VAT participated with 49.35%, while the profit tax with its lowest part had 8.9%. Interestingly enough is to mention the fact that in 2007, Government imposed new tax law on income taxes by which they became flat at rate of 12%, while previously were at 24%, 18% and 15%. The position of Public Revenue Office was also strengthened by this reform and tax collection system became generally more efficient. Both non-tax and capital revenues increased in 2007. First category expecially surged due to received divideds from corporations, which in 2006 were unpaid.

Central budget expenditures also increased in 2007 and accounted for total of 1.233 million Euro, an increase of 194 million or 18.7% growth compared to 2006. Out of current expenditures, the most significat part was spent on transfers, salaries and allowances. Only transfers themselves accounted for 40,1% of total expenditures.

Moreover, Government this year increased capital expenditures, and as it will be visible in the following sections, this trend will be sustainable over next fiscal years.

With the above achieved fiscal numbers, General Government Budget went the only time within this scope of years into surplus and accounted for 35 million Euros or 0.6% of GDP. Central Government budget in parallel reached a surplus 12 million Euro or 0.2% of GDP.

The actual General Government Budget revenues in **2008** accounted for 2.227 million Euro and expenditures ended up at 2.289 million Euro.

Central budget revenues reached 1.401 million Euro and accounted for 21.5% of GDP. Out of current revenues, the tax revenues had lower than in 2007, but yet solid participation of 88.4% and where VAT sustained its highest share in the total by reaching 47.7%. Since January 2008 came the second wave of tax burden reduction, bringing profit incomes tax to 10% flat rate.

Beside this fact, income tax revenues still managed to increase by 11.5%. Customs on the other hand, participated with only 8.3% and thus resulted to be the weakest participant in total tax revenues. Also remarkable for 2008 were non-tax revenues which increased by 45.0% from the previous year. The improvement was mainly due profits gained from NBRM.

Central budget expenditures reached 1.448 million Euro and accounted for 22.2% of GDP. The dominant role had again spent transfers, salaries and allowances, where transfers participated with 41.9% of total expenditures, while salaries and allowances with the rest 21.8%. Capital expenditures increased in 2008 mainly due capital projects. Significant investments were put into construction of museum buildings, football fields, as well as spendings in education system.

Overall calculated General budget deficit reached 62 million Euro or 1.0% GDP, while Central Budget deficit accounted for 47 million Euro, participating with 0.7% of GDP. Importantly to mention in this regard is that deficit creation occurred predominantly in the last quarter of 2008 when global crisis hit, while over the first three quarters budget balance had surprisingly even positive digits. With the above assumption, it is visible

that Macedonian economy has yet not been severely impacted by the 2008 crisis. However, with the last quarter negative trend, there was no doubt that external negative turbulences are yet to come.

The General Government budget revenues in **2009** were 2.097 million Euro, while expenditures ended at 2.275 million Euro.

As for the Central budget, the revenues accounted for 1,281 million Euro, achieving a decrease from 2008 up to 8,6%. This was to say so still a situation keeping pace with the current economic downturn. Expenditure in parallel were reported at 1.437 million Euros, showing considerable outreach compared to revenues. Government concerned with the crisis negative impacts on domestic economy which showed stronger activity only within in the last several years, decided to promulgate even more expansionary fiscal policy. On the other hand, in 2009 Government also implemented a cut in social contribution rates from 32% to 22%, despite the adverse economic climate. The most dominant portion of the expenditure again represented transfers, which accounted for 50.4%.

With such apportionment, the General Government deficit deepened to 178 million Euro and represented 2.7% of GDP, while Central Budget deficit resulted in 156 million Euro, i.e. 2.4% of GDP. This in fact matched with the projections for period of 2009-2011, where central budget deficit fluctuation was foreseen around 2.0% to 2.4% of GDP.

General Government budget revenues in **2010** were at 2.148 million Euro. The budget expenditures on the other hand reached 2.320 million Euro.

Central government revenues enlarged compared to 2009 and were 1.323 million Euro outperforming 2009 year by 3.7%. In fact, all categories of revenues had better results than appeared in 2009 with an exception of profit tax, which had a shrinkage of 16.8%. On the other hand, VAT had a share of 52.2%, which was a recored growth of 7.2%. This was the largest share of total tax revenues staying unaltered from previous years.

Central Budget expenditures accounted for 1.463 million Euros, participating with 21.1% of GDP. Even though total expenditures increased by 2.2% from previous year, it

was not unexpected move. As per envisaged PEP 2010-2012, Government anticipation particularly of capital expenditures was as high as 18% compared to 2009. Traditionally, in 2010 as it was in past several years, transfers accounted for largest spendings in current expenditures. With respect to 2010, they with 50.4% of GDP.

With above figures, the General Government deficit deepened to 171 million Euro or 2.5% of GDP. In case of the Central budget, the deficit resulted in 140 million Euro, representing 2.0% of GDP. A positive conclusion in regard to both deficits is however the fact, that they did not exceed the projected plans. In fact, according to the the PEP for period 2010-2012, the predicted ceilings were set up at 2.5% and 1,6% - 2% of GDP respectively.

General Government budget revenues in **2011** were 2.230 million Euro and budget expenditures total of 2.416 million Euro. As for the Central budget revenues, unfortunately only unrevised indicators have been currently available to work with. Nevertheless, as per the PEP 2010-2012 they were targeted at 1.451 million Euro or 19.6% of GDP, while expenditures at 1.644 million Euro or 22.% GDP. With those assumptions, Central Budget deficit was reaching 193 million Euro or 2.6% of GDP.

The data for the General budget has been however available and its deficit in 2011 accounted for 187 million Euro. Expressed in GDP, it stayed stable in the frame of 2.5%. As for Central budget situation, the deficit in 2011 slightly deepened reached 155 million Euro or 2.1% of GDP (MOFtrends, 2012). However this outcome is rather positive, as it is less than planned as per fiscal strategy in the PEP 2010-2012.

## 7 Public Debt

Before gaining its independence in September 1991, the public finance system, including public debt management of the Republic of Macedonia, was within a frame and under responsibility of Yugoslavia. Since the disintegration, Macedonia was forced to implement a corresponding public finance system, which at the same time would meet standards of Western countries, as Yugoslavian system methodologies significantly varied from Western ones. Until 2005 Macedonia was using the GFSM 1986 methodology, while from 2005, the authorities incorporated reporting that would be more in compliance with EU ESA95 methodology, and in addition started publishing the public debt data on an annual basis (International Monetary Fund<sup>1</sup>, 2006).

### 7.1 Public debt origins

It was not only the public methodology system that Macedonia inherited from Yugoslavia, but it also undertook a part of Yugoslavian federal public debt, making today's Macedonian public debt portfolio to comprise the Yugoslavian inherited debt portion, as well as other borrowings from international financial institutions and markets. Significantly to mention for this instance is the fact that after the breakup from Yugoslavia, Macedonia was mainly facing problems with the extension of its external debt, rather than domestic. The total Yugoslavian debt towards a number of creditors resulted in 15.9 billion USD by the end of 1991, out of which, Macedonia inherited 850 million USD (Stanič, 2001). Among largest creditors turned out to be some of the international organizations.

Slicing down the debt by creditors, total Yugoslavian debt towards IMF equaled 683 million USD, from which Macedonia was appointed to reimburse 5.4%, i.e. 36.9 million USD (Stanič, 2001). Besides that, a large debt burden was inherited from the Paris and London Clubs of Creditors. Until 2006, the London Club actually accounted for Macedonian largest single creditor. Yugoslavian debt towards **London Club of Creditors** was amounting in 4.4 billion USD (Mrak, 1998), while Macedonia made an



agreement with London Club in 1997 to take under responsibility about 5% of Yugoslavian debt(International Monetary Fund, 1998).

Upon that, Macedonia issued bonds in total amount of 228.7 million USD in 1997 (Mrak, 1998). Macedonian debt towards the London Club of creditors was afterwards increasing up to year 2000, mostly due to additional borrowings made by Macedonia. In 2000 debt reached 253 million USD (MOFbul06, 2006), but the same year it was early redeemed. Concerning the **Paris Club of Creditors**, total debt Yugoslavia had in 1991 was 4.2 billion USD (Stanič, 2001). After several years of arrangements going on, in 1995 Macedonia reached an agreement to take over 323 million USD on its behalf (Mrak, 1998). Moreover, Yugoslavia also left debt towards **World Bank**, which resulted in 2 billion USD. Macedonia inherited 7.5% or 153.9 million USD from it in 1994. (Mrak, 1998).

Table 4 Public debt

<b>Debt in mil Euro</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Total Public Debt</b>			2.029,5	1.927,8	1,869.8	2.128,8	2,5	
<b>in % of GDP</b>			40,4	35,3	28,2	32,1	35,2	
<b>General Government Debt</b>			1.673,6	1.430	1.386,7	1.597,2	1,710.8	
<b>in % of GDP</b>			33,3	26,2	20,9		24,6	
<b>External Debt</b>			1.223	1.027,9	1,115.67	1.373,7	1,710.8	
<b>in % of GDP</b>			60,3		59,6		63,4	
<b>Domestic Debt</b>			806.5	899.9	754.1	755,0	973,7	
<b>in % of GDP</b>			39,7		40,4		36,6	

Source: Own Modification

The other concept having an inevitable impact on Macedonian public debt portfolio has been the problem with recent budget deficits. In addition to them, the „chronicle” ones from early years of Yugoslav independence has been as well reverberating. Macedonia leaving the former federation with the poorest economic evolution among all six former federal countries, in 1991 had to fight with it very small, underdeveloped closed market. Budget deficits over the years from 1991 were very unstable. For instance, there was a larger positive fluctuation from 13.4% in 1993 up to 2.9% deficit in 1994, and even a downslope from a surplus of 1.8 % in 2000 to a deep deficit of 7.2% in 2001 (MOFbul05, 2005). The first positive slump was a result of a disinflation in 1994, while the failure in 2001 came out of a crisis, which occurred between Macedonian and Albanian ethnic groups and induced large spendings on security and military

equipment. Within the next year, budget deficit had a low pattern recovery reaching 1.1% of GDP in 2003 and in 2004 even a surplus of 0.1% (MOFbul05, 2005).

Different issues having an overall impact on Macedonian economy also accompanied the period in between 1994 and 2000. In 1995, Greece imposed a yearlong trade embargo against Serbia, which at the end considerably slowed down Macedonian market economy as it was still in its early transition stages (USAID, 1997).

In addition, in 1998 Macedonian Government faced another issue striking that time the largest commercial bank “Stopanska banka”. During the second half of 1998, the bank failed to fulfill minimum reserve requirement, and thus forced Government to take a decision of its recapitalization. Same year were issued euro-denominated bonds in total amount of 133.6 million USD<sup>6</sup>, which additionally enlarged Macedonian public debt (Drummond, 2000).

The total external debt due the above-mentioned major reasons was ranging in years 1993 to 2005 between the highest point of 45.4% of GDP in 1993 and the lowest 26.5% in 1996 (NBRM, 2012). As for the domestic debt, since 1999 it generally increased in relation to the external. This improvement was mainly reached due to development of the domestic financial market, which has been one of MOF targets since the year of independence.

Table 3 Public debt development before 2006

<b>Debt in mil Euro</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Total Public Debt</b>			2.029,5	1.927,8	1.869,8	2.128,8	2,5	
<b>in % of GDP</b>			40,4	35,3	28,2	32,1	35,2	
<b>General Government Debt</b>			1.673,6	1.430	1.386,7	1.597,2	1.710,8	
<b>in % of GDP</b>			33,3	26,2	20,9		24,6	
<b>External Debt</b>			1.223	1.027,9	1.115,67	1.373,7	1.710,8	
<b>in % of GDP</b>			60,3		59,6		63,4	
<b>Domestic Debt</b>			806,5	899,9	754,1	755,0	973,7	
<b>in % of GDP</b>			39,7		40,4		36,6	

Source: Own Modification

<sup>6</sup> In the original source, the amount is Deutsche Mark 235 Mil.

## 7.2 Public debt development

The following section will leave the historical aspect of Macedonian public debt and will be focusing on its evolution over recent years, particularly from the moment of Macedonia gaining the candidate for EU, which happened end of 2005.

### 7.2.1 Public debt methodology

The Public debt Law of the Republic of Macedonia defines public debt as a sum of „government debt and all financial liabilities created by municipalitie borrowings, as well as borrowings by the city of Skopje, public enterprises and companies being fully or predominantly owned by the state” (Law on Public Debt, 2005). This public debt definition omits the NBRM debt and is assumed to be a national methodology. However, Public Debt Law was revised in 2008 in order to become in accordance with the IMF Government Financial Statistics Manual, i.e. GFS methodology. Since than, the debt of NBRM has also become part of public dept, but national methodology has been still kept and used in the reports. In the below section, the figures will be presented solely per IMF Government Financial Statistics Manual.

### 7.2.2 Public debt trends

For better view on Macedonian public debt development situation through years, below there is an illustrative table with the significant indicators:

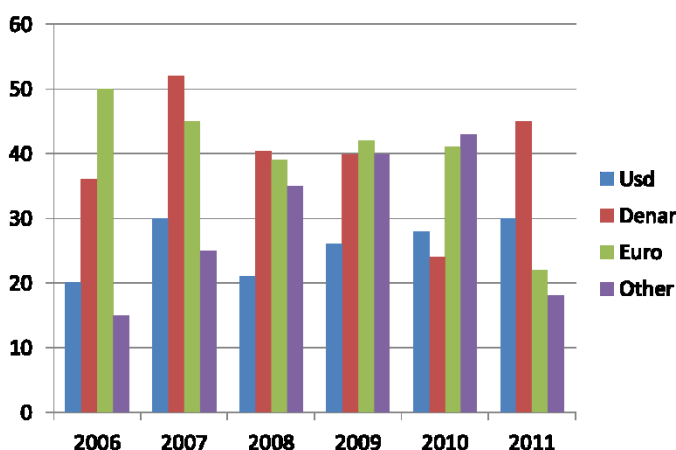
Table 5 Debt evolution

Debt in mil Euro	2006	2007	2008	2009	2010	2011
<b>Total Public Debt</b>	2.029,5	1.927,8	1,869.8	2.128,8	2,5	
<b>in % of GDP</b>	40,4	35,3	28,2	32,1	35,2	
<b>General Government Debt</b>	1.673,6	1.430	1.386,7	1.597,2	1,710.8	
<b>in % of GDP</b>	33,3	26,2	20,9		24,6	
<b>External Debt</b>	1.223	1.027,9	1,115.67	1.373,7	1,710.8	
<b>in % of GDP</b>	60,3		59,6		63,4	
<b>Domestic Debt</b>	806.5	899.9	754.1	755,0	973,7	
<b>in % of GDP</b>	39,7		40,4		36,6	

\*Own modification

Source: MOF, NMBR (2012): Annual Reports and Macroeconomic Indicators [online]. Available at: <http://finance.gov.mk/>, <http://www.nbrm.mk>.

Graph 5 Debt currency structure



\*Own modification

Source: MOF, NMBR (2012): Annual Reports and Macroeconomic Indicators [online]. Available at: <http://finance.gov.mk/>, <http://www.nbrm.mk>.

As for the year **2006**, the **total public debt** amounted in 2.029,5 million Euro, i.e. 40.4% of GDP, while **general government debt** was 1.673,6 million Euro, which equaled 33.3% of GDP. The **external debt** amounted in 1.223 million Euro and represented 60.3%. The structure of the debt by creditors was divided mostly among multirelateral creditors that were participating with more than half of the debt including IMF, EBRD, IDA, while private and bilateral creditors had significantly lower participation. As for the **domestic debt**, it accounted for 806.5 million EURO, and was

39.7% of the total debt. This was in fact an increase in ratio to the external debt from year 2005, which happened mainly due to the promotional issuance of treasury bills for monetary purposes by NBRM and the fifth sequence issuance of denationalisation bonds (the first started in 2002). The denationalisation bond was in the amount of 34 million Euro (MSE, 2011).

Both the **interest and currency rate structures** have been changed positively from 2005. Great deal in this tendencies was the fact that in 2006 Macedonia has managed to lower its euro-denominated debt with a variable interest rate through an early debt redemption towards the London Club of Creditors. The full instalment amounted in 184.3 million EUR. This also meant cleaning the old Yugoslavia inherited debt from with the largest creditor. Fixed interest rate at this point was covering 60.0% of the total public debt, while euro-denominated debt was rectified from 55% to 58% in 2006.

As for the **borrowings** in 2006, the gross (external and domestic) amount accounted for 153.2 million Euro and was mostly created from commercial creditors such as IMF, EBRD, IBRD and EIB. Total borrowings amount reached was indeed a good accomplishment, as projected target in 2005 was estimated at 180 million euro. Out of total borrowings, the domestic debt resulted in 67 million Euro, representing only 43.7% of total share, a result however seeking further improvement.

In year **2007**, **total public debt** resulted in 1.927,8 million EURO and represented 35.3% of GDP. Compared to 2006, this was a decline by 4.9%. **General government debt** accounted for 1.430 million Euro and participated with 26.2% of GDP, an actual decline of 7.1% from 2006. For debt declining tendency mostly contributed the early repayment of the Italian old debt carried out from Yugoslavia, which was part of the Paris Club of Creditors and amounted in total of 9.2 million Euro (MOF07, 2008). Besides that, a contribution had the early repayments in favor of IMF of 32.8 million Euro and IBRD in 96.1 million Euro (PEP10, 2007).

**External debt** reached 1,027.9 million Euro, staying mostly comprised of official creditors such as WB, EIB and EBRD. Behind external debt increase of 195.1 million Euro among other partial factors was the sixth issuance of denationalization bond in total 18 million Euro (MSE, 2011). The amount lower than in 2006, but yet significant

for such weak developed economy. The **domestic debt** in 2007 reached 899.9 million Euro.

**Interest rate structure** has slightly changed in favour of improving the share of debt towards fixed interest rate. This was a result of an early redemption of Stopanska Banka rehabilitation bond of 23.9 million Euro, which was with variable interest rate. However, the interest rate structure did not change positively to a huge extent as authorities unfortunately did not manage to agree upon prevailing fixed interest rate on the majority of government issued securities in 2007. As per the statistics end of 2007, fixed interest rate encompassed 62%, while variable was the rest 38%.

As for the **currency rate structure**, denar-denominated share of debt remained with the same ceiling of 11% of total public debt from 2006. The euro-denomination structure grew and ended up to be 66% of total debt structure (MOF08, 2009).

The new **borrowings** executed in 2007 were much lower than in 2006 reaching 90.2 million Euro, vis-à-vis the projected 203 million Euro. Among largest ones done were from the WB on the basis of Second Programmatic Development Policy Loan, which amounted in 23.3 million Euro. The rest constituted of several smaller borrowings in projects, each amounting around 10-15 million Euro.

In **2008 total public debt** was measured at 1,869.8 million Euro, a percentage portion of 28.2% of GDP. This was a successful decrease of 7.1% p.p. from 2007. The **government debt** same year was at 1,386,7 million Euro, being 20.9% of GDP. The shrinkage of the overall debt resulted due to the politic of general borrowings reduction. This especially applied towards to end of 2008, when global crisis obviously suppressed the economies. Moreover, the NBRM debt has decreased from 344.3 to 285.2 million Euro and total liquidation of treasury bills for monetary purposes has been process in 2007.

Out of total public debt, **external debt** represented 59.6% of GDP, i.e. 1,115.67 million Euro, and **domestic debt** decreased to 754.1 million Euro, for same reasons as discussed of the total public debt decrease.

In regard to the **interest rate structure**, there was significant increase in the variable interest rate of total public debt portfolio, resulting in 2008 with 48%. Even though fixed interest portion was retaining the bigger part of the total debt (53%), this was an unfavourable progress since 2007 of 9 p.p. The reason for that was NBRM issuing bank bills predominantly with variable interest rate varying between 4.7% and 8.0% (NBRM1, 2012).

The **currency structure** improved for both denar and euro currencies compared to 2007. While the denar-denominated debt accounted for 23%, the euro-denominated debt for 57% of the total debt (MOF08, 2009). Prevailing euro currency was maintained due to majority borrowings done in Euro. However, the improvement of denar structure was as result of MOF has managing to issue two Continuous government bonds in the total amount of 1.670,2 billion Denar in 2007 (MSE, 2011).

The **new borrowings** amounted in 183.2 million Euro, while initially projected borrowings were set at 530 million Euro (MOFDebt08, 2009). Among most significant were the borrowings from the WB, the Third Programmatic Development Policy Loan for 16.7 million Euro. Another large borrowing in 2008 was done with the Regional and Local Roads Program Support Project, however it was USD denominated and amounted in total of 105.2 million USD (World Bank, n.d.).

In **2009**, the **total public debt** resulted in 2.128,8 million Euro, i.e. 32.1% of GDP. At the same time, **government debt** increased from 2008 by 210.5 million, and measured in total 1.597,2 million Euro. For the more significant debt increase in comparison to previous years are responsible the issuance of Eurobond of 175 million Euro and in parallel the eight denationalisation bond of 23 million Euro (MSE, 2011). Moreover, in 2009 was imposed restriction on general allocation of special drawing rights in the IMF, causing public debt to increase for additional 258.1% million Euro (Debt Strategy, 2010).

The **external debt** amounted in 1.373,7 million Euro. Its increase is directly related to the Eurobond issuance. As for the **domestic debt**, it accounted for 755 million Euro, remaining almost unchanged from 2008.

Fixed and variable **interest rates** kept relatively equal share in the interest structure of the total public debt portfolio. At the end of 2009, the fixed interest rate filled in with 51%, while the variable interest participated with 49%.

The **currency structure** results in 2009 revealed that the euro-denominated debt again was keeping the dominant share, accounting overall for 65% of the total debt, while domestic currency participated with only 14% in the total public debt portfolio, a lower outcome compared to 2008 for 9 p.p. For such decline in denar, and respectively an increase of euro-denominated currency structure, again comes into account the Eurobond issuance along with the denationalisation bond, where both were euro-denominated.

The **new borrowings** in 2009 were summed up to 96.8 million Euro including projects in roads and railways infrastructure, municipal services developing, as well as other projects for social and municipal development.

The **2010 total public debt** was 2.458 million Euro and equaled 35.2% of GDP. **government debt** at the same period resulted in 1,710.8 million Euro, or 24.6% of GDP.

The **external debt** amounted 1.484.3 million Euro, while the **domestic debt** increased. In 2009 it was 755 million Euro, while in 2010 it grew to 973.7 million Euro, participating with 39.6% share. Its origins were mainly coming from the increase of NMBR debt, which almost doubled in 2010. Generally, the largest share for total debt increase in 2010 compared to 2009 was on the side of the domestic debt, more specifically due to NBRM continuous government securities increasing. These included both treasury bills and treasury bonds volume expansion.

**Interest rate** ratios were 44.6% share of fixed rate and 55.4% of variable rate. Trend mostly influenced by the issued securities, as well as the money borrowed for projects, which for the most had arrangements of variable interest rates.

The **currency structure** situation stayed almost unchanged, where the euro-denominated debt towards denar-denominated was prevailing was the debt in Euros. It was representing 58% from the total debt portfolio, while denar-denominated debt 22%. This little negative change in favor of euro-denominated share could be explained by



the 10<sup>th</sup> emission of denationalization bond in 2010 amounting in 30 million Euro (Eurobroker, n.d.).

The **new borrowing in 2010** were predominantly used for buildings' reconstruction, including medical centres, road improvements, investments in energy sector sphere, but also projects for processing MOF reforms (MOFbul10, 2011). They all resulted in total of 162.4 million Euro borrowed, versus 350 million Euro previously projected.

### **7.3 Public Debt Solutions**

Taking a retrospective look at the previous sections, where firstly was discussed government budget and then was a section dealing with public debt development over years 2006-2011, one can notice that Macedonia has managed to maintain rather a sound evolution of both macroeconomic variables without reaching very large fluctuations over the past half decade. Moreover, both variables have been sustained within the frame of proposed Maastricht criteria. This especially applies in relation to the low public debt, making Macedonia remain among countries with a moderate indebtedness. That public debt has been kept stable, have been even proving recently performed stress tests on it. However, besides these results, Macedonian general public debt management has been still in transition and adjusting to practises of Western developed economies.

Over last half decade, Macedonian state authorities have taken measures for maintaining public debt low, but have been even more concentrating on diminishing debt's overall risk. For reaching such improvements, as well as per following the recommendations of European Commission, MOF has started preparing annually public debt plans and projections in its Fiscal Policy and Public Debt Management (PDM) documents. As for the PDM, its yearly publishing has started since 2005. A particular focus, besides maintenance of macroeconomic and fiscal sustainability has been to predetermine and withhold public debt to GDP ratio.

Moreover, as per Debt Strategy (2010), all released PDM strategies have been set in accordance with principles of:

- establishing an optimal debt portfolio structure and harmonizing it with the national macroeconomic policies;
- harmonizing debt portfolio costs set of the state budget on yearly and mid-term basis;
- restriction and emination of risk effects on public debt sustainability on mid-tem and the long run basis.

Going onwards, as a part of the Fiscal strategy for 2012 year, MOF envisaged the fiscal deficit to be reaching maximum of 2.5% GDP (PEP14, 2012) This projection was later examined by IMF experts, who approved it as an attainable, however suggested to decrease the deficit ceiling in order to not jeopardize the debt sustainability in the upcoming period (MINA, 2011).

With regular proposals and help from the experts other international financial organizations and institutions, Macedonian state authorities have been continuously working on **lowering the interest rates** on items borrowed or issued, as well as trying to create a more favourable **interest rate structure** with fixed interest rate prevailing. This trend has not been yet stabilized in regard to Macedonian public debt, but some steps have been partly processed. Starting from 2002 and all the way to 2009, MOF has issued eight denationalisation bonds in total amount of 250.6 billion Euro, which have been agreed upon annual fixed interest rate of 2%. This incrementation of debt portion with fixed interest rates should help Macedonia avoid the risk of future interest rates fluctuations. Besides that, there have been done attempts towards **extention of the maturity period** of government issued securities. With eight editions of issued denationalization bonds, MOF managed to reach 10 years maturity date on each. Moreover, this direction has been also applied towards Yugoslavian debt handling, for instance when state authorities agreed with both London and Paris Club of Creditors on a postponement of the debt liquidation.

The **currency structure** of Macedonian public debt has been also highly taken in condideration. In this regard, state authorities have been striving to keep the debt

prevalently in Denar currency, while EURO denomination is a second most preferred option. For that purpose, Macedonia has significantly enlarged the issuance of government securities and treasury bills for monetary purposes in Denar denomination. In 2006 was issued the Compensation bond of NMBR selective credits in total amount over 1,039 billion Denar, followed same year by the Rehabilitation bond of Stopanska Banka also over 1 billion Denar. In 2008, this trend has been continued with issuance of two Continuous Government bonds No.2 and 3 amounting in over 210 billion Denar. In addition, NBRM Bank kept on issuing treasury bills in Denar denomination to even greater extend in 2010. Unfortunately, in all these cases were not reached agreements on fixed interest rates.

As for the Euro-denomination debt, Macedonia has processed its first issuance of Eurobond in December 2005, and the second one in 2009. The state authorities also planned to issue another Eurobond, but it was cancelled in 2010, due to the turmoil in international markets and Greek financial problems, which were aggravating.

Many discussions have been going on about this topic. At some instance, Macedonian Finance Minister was even criticized by local observers, who were suggesting that instead of Eurobonds, Macedonia should obtain loans from IMF that have more favorable interest rates (Marusic, 2010). On the other hand IMF evaluated Macedonian PDM Strategy towards Eurobond markets as an „appropriate on balance“, although suggesting in order to sustain a low public debt level, Macedonia has to focus on expanding its domestic debt market and keep more balanced budget policy, i.e. lower its fiscal deficit (International Monetary Fund, 2011). Moreover, IMF experts believe that the expansion of domestic debt market should help Macedonia reduce the external financing vulnerabilities and that greater availability of domestic financing sources will diminish the reliance on external fundings. This has been particularly related to the third principle of the PDM strategy, which targets to maximally restrict and eliminate the risk effects on the public debt sustainability.

The **foreign sector** is another significant working point Macedonian authorities have been working on for to improve the public debt condition. The stimulation and improvement of the country's trade balance, i.e. growth of exports, should help shrinking the external debt. In this regard, Macedonian state authorities are expecting in

the upcoming four years both exports and foreign direct investments to be increased. As for the export, its growth is expected to be from 8.0% to 10.0% annually Government (n.d.).

Continuous improvement on the structure of **public debt portfolio** has been also part of debt strategy Macedonia leads over past several years. This is particularly emphasized in attempts to avoid of external debt accumulation. The sequence of successful managing of this issue has been however still fluctuating in Macedonia. The domestic debt of 40% share out of total public debt is an average condition of Macedonian domestic debt. Year 2007 was in this regard the most successful, when domestic debt reached 47% share (MOFDebt08, 2009).

Besides that, Macedonian authorities are constantly seeking for advantages of **early debt redemptions**. This was the instance in 2006, when Macedonia managed to achieve an early repayment to its largest foreign creditor the London Club of Creditors. The next year, a significant share of the debt was repaid towards the Paris Club of Creditors, the so-called Italian debt. Such actions were done in order to ensure a smooth temporary repayment profile and reduce the overall public debt risk. Moreover, these approaches helped also create a reduction of the external debt share, an indebtedness that cannot be forfeited.

The subject matter with the **sovereign guarantees** issuance is of another major concern when coming to public debt sustainability and its risk reduction. The recent increase of sovereign guarantees in Macedonia over past several years are most likely to negatively to affect Macedonian public debt stock, particularly its servicing costs due to call up options. Currently, state authorities are attempting to put in place a strictly controlled process that will involve certain criteria fulfillment. In addition to that, the process will be followed by more complex approval procedure. Such sanctions are to be especially applicable towards enterprises with stronger liquidity problems.

## 8 Conclusion

This diploma thesis focused on areas of public finance aspects such as government budget and public debt. The object of the thesis strived to explore and depict the government budget and public public formations, impact, as well as the management of the public debt. The first part of the thesis was aimed to provide with a theoretical view on government budget and public debt, as well as to discuss the additional macroeconomic variables related to these areas, such as fiscal policy fuction and revenues-expenditure structures. The analytical part was devoted to the same public finance issues, but in the real enviroment, i.e. on the situation with the Republic of Macedonia.

As previously mentioned, the main object of my thesis was to explore and examine the government budget and public debt of the Republic of Macedonia. For achieving such, the thesis reviews the level, structure and the development of government budget and public debt over last several years untill recently. First, the thesis focused on the deficit and public debt between 1991 and 2005, since in 1991 Macedonia gained independenc and that fact provided with solid answers on the origins of the Macedonian public debt. The particular focus was however on the examination on the budget and debt situation from the end of 2005, when Macedonia officially gained a candidate status for EU, and started implementing number of rules for improving the methodology, stability and reliability on reporting of its macroeconomic data.

To summarize the main findings serve the fact that Macedonia is a developing country and suffers from fiscal imbalances in both short-term and long-term. Even though in some of the years, as it was the case with 1998 and 2007 the government budget went into surplus, the overall trend of this variable tends to stay chronically in deficit, i.e. budget deficit.

Based on the research done on the particular years, among most significant factors that contributed to the budget deficit creation were the expansionary and contracyclical types of fiscal policies lead by the Macedonian government. A big role in this regard also played the unstable economic activity and growth, as wel as existance of an underdeveloped domestic market. In addition, importantly to mention here is the fact

that some external impacts were also worsening the budget balance. Such effect had for instance the global financial crisis in 2008.

However, on the other hand, although with the persistence of the above negative tendencies, Macedonian public debt generally fulfilled the Maastricht criteria. The proportion of the government budget deficit and public debt were not exceeding the 3% and 60% of GDP respectively over the examined years. The highest ceilings were reached with government budget being 2.7% and public debt of 26.4% in 2009. Nevertheless, the economy still keeps facing various issues with budget deficit and public debt.

For that purpose, many improvements have been proceeded. Such included: switching to the Western style reporting methodologies, periodical preparation and presentation of data, completeness of reportings that have not been previously kept track. Besides that, Macedonian authorities have started setting up objectives for further economic activity improvement, providing with projections and preparation of various programs, as well as continuous development of the domestic market.

Among main recommendations for successful decrease of budget deficit and consequently public debt in Macedonia would be a stronger persistence on decreasing the government expenditures and at the same time increasing the public revenues. Contrary to this, however Macedonia being so called a „tax heaven“, imposed even lower taxation rates in 2008, which on one hand side „activated“ the economy, but in a long run, decreased the receipt of government revenues.

Besides that, if looking at the structure of the public debt, there is a noticeable prevalence of foreign share of debt, a foreign currency denominated debt and floating interest rates on the debt servicing. For Macedonia to succeed on public debt sustainability and even decreasing, the above aspects should be taken into consideration to a greater extent. That would involve working on attracting of FDIs, increasing the activity of the domestic market, as well as achieving agreements on more favourable borrowing conditions.

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## Annexes

### Appendix 1 Stock of public debt in the Republic of Macedonia (1999 – 2006)

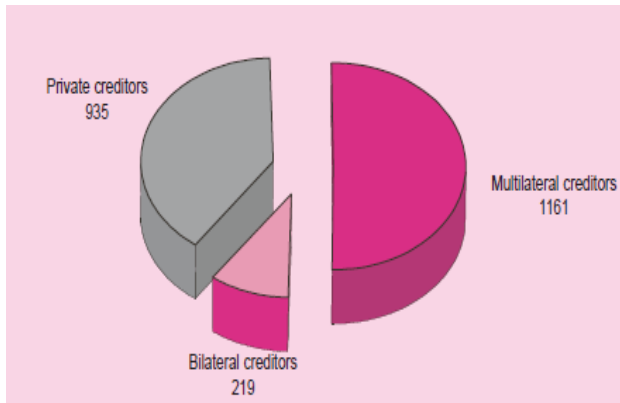
basis	year							
	1999	2000	2001	2002	2003	2004	2005	2006
<b>EXTERNAL PUBLIC DEBT*</b>	<b>1.289,6</b>	<b>1.427,7</b>	<b>1.397,6</b>	<b>1.267,6</b>	<b>1.178,9</b>	<b>1.178,6</b>	<b>1.441,2</b>	<b>1.223,0</b>
General Government Debt	1.024,7	1.153,9	1.191,9	1.089,0	1.005,5	993,2	1.245,4	1025,2
Central Government (consolidated)	1.024,7	1.153,9	1.191,9	1.089,0	1.005,5	993,2	1.245,4	1025,2
Central Government	971,5	1.101,0	1.144,1	1.050,4	972,8	982,3	1.208,0	981,9
Public Funds	53,2	52,9	47,8	38,6	33,0	30,9	37,4	43,3
Municipalities	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Central Bank	101,2	87,7	80,3	64,7	54,7	46,0	52,7	42,4
Public enterprises	163,6	186,2	125,4	114,0	118,7	139,4	143,2	155,4
<b>DOMESTIC PUBLIC DEBT</b>	<b>113,6</b>	<b>791,0</b>	<b>733,3</b>	<b>676,0</b>	<b>665,0</b>	<b>663,9</b>	<b>750,4</b>	<b>806,5</b>
General Government Debt	79,9	711,7	681,5	626,9	593,6	589,8	603,7	648,4
Central Government Debt	79,9	711,7	681,5	626,9	593,6	589,8	603,5	648,2
Structural bonds	79,9	711,7	681,5	626,9	593,6	557,9	533,5	479,7
Stopanska Bank Rehabilitation Bond	58,7	53,6	48,1	42,7	37,2	31,9	26,8	21,3
Small Bond	4,0	2,0	0,0	0,0	0,0	0,0	0,0	0,0
Bond for selective credits	17,1	17,1	17,0	17,0	17,0	16,9	17,0	17,0
Stopanska Bank Privatization Bond	0,0	120,2	111,6	103,0	94,4	85,8	77,2	68,7
Bond for old foreign exchange savings	0,0	518,9	504,9	482,4	408,9	357,7	306,5	254,9
Denationalization Bond (I, II, III, IV and V issue)	0,0	0,0	0,0	1,9	36,2	65,6	106,2	117,8
Continuous Government Securities	0,0	0,0	0,0	0,0	0,0	31,9	70,0	168,6
o.w. Treasury bills for monetary purposes	0,0	0,0	0,0	0,0	0,0	0,0	0,0	75,9
Municipalities	0,0	0,0	0,0	0,0	0,0	0,0	0,2	0,2
Central Bank	33,8	79,3	51,8	49,1	71,4	74,1	146,7	155,3
Public enterprises**	N/A	N/A	N/A	N/A	N/A	N/A	N/A	2,8
<b>TOTAL PUBLIC DEBT-GFS</b>	<b>1.403,2</b>	<b>2.218,7</b>	<b>2.130,9</b>	<b>1.943,7</b>	<b>1.843,9</b>	<b>1.842,5</b>	<b>2.191,6</b>	<b>2029,5</b>
GDP***	3.448,1	3.893,0	3.839,0	4.001,0	4.105,0	4.324,0	4.523,0	5028,0
Average export***	1.117,0	1.433,0	1.290,0	1.180,0	1.204,0	1.348,0	1.640,0	1913,5
External public debt as % of the public debt	91,9	64,3	65,6	65,2	63,9	64,0	65,8	60,3
Domestic public debt as % of the public debt	8,1	35,7	34,4	34,8	36,1	36,0	34,2	39,7
Public debt as % of average GDP	40,7	57,0	55,5	48,6	44,9	42,6	48,5	40,4
Public debt as % of average export	125,8	154,8	165,2	164,7	153,1	136,7	133,6	106,1
<b>General Government Debt-GFS</b>	<b>1.104,6</b>	<b>1.865,5</b>	<b>1.873,4</b>	<b>1.715,9</b>	<b>1.599,1</b>	<b>1.583,0</b>	<b>1.849,0</b>	<b>1673,6</b>
External debt of the General Government as % of the General Government Debt	92,8	61,9	63,6	63,5	62,9	62,7	67,4	61,3
Domestic debt of the General Government as % of the General Government Debt	7,2	38,1	36,4	36,5	37,1	37,3	32,6	38,7
General Government debt as % of the average GDP	32,0	47,9	48,8	42,9	39,0	36,6	40,9	33,3
General Government debt as % of the average export	98,9	130,2	145,2	145,4	132,8	117,4	112,7	87,5
<b>Public debt calculated on the basis of the Public Debt law****</b>	<b>1.268,2</b>	<b>2.051,8</b>	<b>1.998,8</b>	<b>1.829,9</b>	<b>1.717,8</b>	<b>1.722,4</b>	<b>1.992,2</b>	<b>1755,9</b>
External public debt as % of the public debt	93,7	65,3	65,9	65,7	65,4	65,8	69,7	67,2
Domestic public debt as % of the public debt	6,3	34,7	34,2	34,2	34,6	34,2	30,3	32,8
Public debt as % of average GDP	36,8	52,7	52,1	45,7	41,8	39,8	44,0	34,9
Public debt as % of average export	113,5	143,2	154,9	155,1	142,7	127,8	121,5	91,8

Source: MOF:

[http://finance.gov.mk/files/u4/y\\_for\\_public\\_debt\\_management\\_for\\_2006\\_actual.pdf](http://finance.gov.mk/files/u4/y_for_public_debt_management_for_2006_actual.pdf)

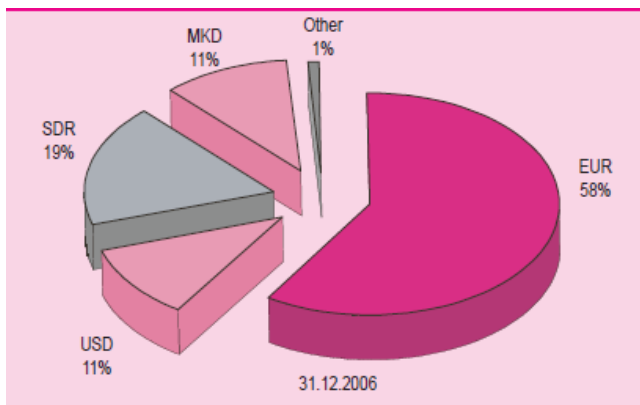
(Accessed: 20 Jul 2012).

Appendix 2 Creditors' structure of public debt in the Republic of Macedonia (2006)



Source: MOF, [http://finance.gov.mk/files/u9/Godisen\\_06\\_MF\\_ANG\\_0.pdf](http://finance.gov.mk/files/u9/Godisen_06_MF_ANG_0.pdf) (Accessed: 20 Jul 2012).

Appendix 3 Currency structure of public debt in the Republic of Macedonia (2006)



Source: MOF, [http://finance.gov.mk/files/u9/Godisen\\_06\\_MF\\_ANG\\_0.pdf](http://finance.gov.mk/files/u9/Godisen_06_MF_ANG_0.pdf) (Accessed: 20 Jul 2012).