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ALEKSANDRA KYSELOVÁ

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Nárožní 2600/9a, 158 00 Praha 5

DIPLOMOVÁ PRÁCE

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MANAGEMENT FIREM

Vysoká škola ekonomie a managementu

+420 841 133 166 / info@vsem.cz / www.vsem.cz

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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JMÉNO A PŘÍJMENÍ / STUDIJNÍ SKUPINA

Aleksandra Kyselová / MF04

JMÉNO VEDOUCÍHO DIPLOMOVÉ PRÁCE

Ing. Peter Vymětal, Ph.D.

PROHLÁŠENÍ STUDENTA

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 citied.

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podpis studenta

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VYSOKÁ ŠKOLA EKONOMIE A MANAGEMENTU

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

Veřejné finance v Makedonii - rozpočet vlády a veřejný dluh

Author: Aleksandra Kyselová

Summary

The subject of this diploma thesis is to analyze the government budget and public debt from both theoretical and real perspectives. The first (theoretical) part of the diploma thesis (chapters two to four) defines the theoretical aspects of the above mentioned economic areas. In addition, it includes discussions on the fiscal policy function, revenue-expenditure structures, government budget system, as well as on the origins of public debt, its impact, and solutions adopted for its reduction. The second (analytical) part of the diploma thesis, i.e. chapters five to seven discusses the actual situation in the Republic of Macedonia. Its main goal is to analyze and depict the level and development of the government budget deficits and public debt from years 2006 to 2010. In order to achieve as comprehensive analysis as possible, aspects discussed in the theoretical part have been also applied on a real example.

Souhrn

Předmětem této diplomové práce je zanalyzování státního rozpočtu a veřejného dluhu v teoretické a reálné perspektivě. První (teoretická) část diplomové práce (kapitoly dva až čtyři) definuje teoretické aspekty výše uvedených ekonomických oblastí. Dále diskutuje funkce fiskální politiky, strukturu příjmů a výdajů, systém státního rozpočtu a také veřejný dluh, jeho dopad a potřebná řešení pro jeho redukci. Druhá část diplomové práce (analytická), tj. kapitoly pět až sedm, analyzuje aktuální situaci veřejných financí v republice Makedonie. Jejím hlavním cílem je zanalyzovat a popsat vývoj deficitu Makedonského státního rozpočtu a státního dluhu v období mezi roky 2006 až 2010. Aspekty zpracované v teoretické části, byly v analytické části aplikovány na reálném příkladě, ve snaze dosáhnout co možná nejkomplexnejší analýzy.

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, Makedonie.

JEL Classification:

E62 - Fiscal Policy

H61 - Budget; Budget Systems

H62 - Deficit; Surplus

H63 - Debt; Debt Management; Sovereign Debt

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Jméno a příjmení:	Aleksandra Kyselová
Studijní program:	Ekonomika a management (Ing.)
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Vedoucí DP:	Ing. Petr Vymětal, Ph.D.

Prof. Ing. Milan Žák, CSc.
rektor

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Content

List of abbreviations

CEA	Center for Economic Analyses
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
FDI	Foreing Direct Investements
GFSM	Government Finance Statistics Manual
IDA	International Development Association
IPA	Instrument for Pre-Accession Assistance
MINA	Macedonian Intl News Agency
MKD	Macedonian Denar
MOE	Ministry of Economy
MOF	Ministry of Finance
MSE	Macedonian Stock Exchange
NBRM	National Bank of the Republic of Macedonia
OECD	Organisation for Economic Co-operation and Development
PEP	Pre-Accession Economic Programmes
PRO	Public Revenue Office
UN	United Nations
USAID	US Aid Organization
WB	World Bank

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1 Introduction

Current trends in the field of public finance show that the public debt and the government budget deficit formations associated with it are becoming commonly faced issues among countries worldwide. These public finance areas have recently become challenges not only for the developed countries with a high economic activity and long public finance history, but also for the countries which markets have been still in transition and have little experience with public finance management. Moreover, if in the past public debt and government budget deficits were mainly discussed on a state level, nowadays they have reached public and have become common topics for discussion.

Besides broadening theoretical knowledge in the above mentioned public finance areas, the first and main goal of the diploma thesis is to analyze and describe the level and development of government budget deficits and public debt formations of the Republic of Macedonia since the period country holds a EU candidate status. The second goal of the diploma thesis seeks answers on what reasons and factors are behind these unfavorable formations. The last goal of the diploma thesis strives to identify solutions and actions taken by the state authorities for public debt level maintenance, or even its possible reduction.

The structure of the diploma thesis is divided into two parts, a theoretical and analytical part. The theoretical part of the diploma thesis is based on a literature research. It is constituted of chapters two to four. While the first chapter provides with a general overview on the public finance system, the following chapters include discussions on the revenue-expenditure structures, fiscal policy function, government budget system and process, as well as discussions on the key elements of public debt, public debt economy impact and the possible solutions for its reduction.

The analytical part of the diploma thesis consists of chapters five to seven. It applies already discussed concepts of the theoretical part on a real environment, i.e. the Republic of Macedonia. The analytical part of the diploma thesis breaks down into researches, analyzes and descriptions of Macedonian government budget balance, public debt, as well as the related macroeconomic variables applied to this areas. The focus of the analytical part is on the period from years 2006 to 2010. In December 2005, the Republic of Macedonia gained a EU candidate status and has started modifying and improving the records of its public finance system. The year 2010 on the other hand, is the most recent year for which the examined records for the subject of diploma thesis are available.

The methodology of the diploma thesis is based on analysis and comparisons done on the above mentioned subject areas. It predominately involves examination and investigation of various reports and documents from the Ministry of Finance and State Statistical Office of the Republic of Macedonia, as well as from the international financial organizations such as OECD, World Bank and the International Monetary Fund. The rest of the information and data used in the theoretical and analytical parts are collected from academic books, journals, and economic news.

2 Public Finance – General Overview

Taking an integral place in the field of macroeconomics, the study of public finance examines the role and impact of fiscal policies on the state economy. It follows and analyses the financial operations arising from revenue-expenditure processes conducted by governments. Public finance explores also the macroeconomic aspects of government resource-allocating system, including tax system, payments execution, state borrowings, as well as the inflow of new money into economy (Shoup 2006, p. 3).

While still part of macroeconomics, public finance together with public sector are the main pillars of the public economics study that is 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, p. 7). Public sector on the other hand, represents state‘s economic activity in terms of providing population with nonmarketable services such as healthcare, education, police, military and utilities (Anderson 2011, p. 6). In contrast to market sector, public sector is not oriented on profit maximization, but strives for balancing of government budget. Public sectors may significantly vary in their size, range and structure depending on the economic system (traditional, planned, market, mixed) given state exercises.

The areas of public finance and public sector are closely interconnected and depend one on another. While sound public finance allows public sector deliver prosperous goods to population, an „effective" public sector management helps retain sound public finance.

2.1 Public finance system

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 narrow its focus on the state intervention aspect; public sector‘s role; as well as on the functional aspect of fiscal policy along with the involved in it institutions.

2.1.1 State intervention

The role of state intervention comes to an emphasis when the market economy fails to regulate itself. Such failure can be related to insufficient amount of goods, services and common resources; occurrence of monopoly and externalities; or existence of asymmetric information (Labonte 2010, p. 14-17). State intervention forces certain economic entities to exercise favorable activities in the economy that otherwise would be neglected; or on contrary, it averts certain entities from executing activities that have a negative impact on the economy (Pilný 2007, p. 13).

The governments play major role in the execution of state intervention. In order to achieve macroeconomic balance, governments conduct fiscal policies through which they strive to create well structured revenue-expenditure system that besides administration of taxes; also involves adoption, implementation and control over various expenditure programs and projects.

Besides the above governments‘ positive role in the economy, a scenario of government‘s failure can also occur. As per Pilný (2007, p. 13), a reason for that can be government obtaining limited information on the economic effects coming from the state interventions that are usually complex, hardly predictive, and with a time-delay. Another reason for government‘s failure can be existence of bureaucratic elements in the economy that obstruct from following the public interest. For purpose of dealing with similar issues, state imposes the public sector.

2.1.2 Public sector

The public sector, as part of the public finance system deals with providing and allocation of public services. Together with the private sector, they form the mixed state economy, which today represents the most common type of economic system.

Author Ochrana et al. (2010, p. 17) characterizes public sector from several aspects:

- administrative aspect, as public sector is managed by the public administration;
- institutional aspect, since it includes two types of institutions - the state and the local authorities;
- ownership aspect, as it involves both government and public ownership;
- decision-making aspect, as it delivers goods and services of public interest;
- financial aspect, as it finances goods and services from the budget system.

The size of the public sector towards the private sector usually varies among states and can be measured using production, consumption or expenditure approaches (UN 2000, p. 13). In the international comparisons is commonly applied the indicator measuring incurred public expenditures in relation to GDP (Peková 2005, p. 35). In this regard, there are states such as China that have public sector with lower participation of 23,1 % of GDP; as well as more social states such as Denmark, which have larger public sector participating with 58,4 % of GDP (OECD ilibrary, 2011).

The determination of public sector‘s optimal size is of a concern of every economic system as it is mostly dependent on various factors such as the (Peková 2005, p. 37-38):

- economic factor, where an impact on public sector’s size has the development phase, the economic performance or the availability of financial resources;
- historical and geopolitical factor upon which the size of the public sector depends on the conditions of nature. The tougher is climate, the bigger is public sector, which role is to ensure safer and more quality life for the population;
- demographic factor, where significant is population‘s growth associated with an increase of public goods and services demand;
- cultural and religious factors that are supporting the human potential;
- political factor that is closely related to the elections cycle. This especially applies to populist approaches which commonly occur before elections.

2.1.3 Public institutions

Public sector is conducted by its relevant institutions such as the parliament, the government, as well as the ministries, municipalities and regions. These institutions are making decisions on public interest basis and are financed from the government budget (Ochrana et al. 2010, p. 18). Of a particular interest for this thesis are the institutions that are directly involved in the budget making system and process. In this regard, important is the role of the government which organizes the public finances, and which encompasses in itself the responsibility of raising and disbursement of the government resources, i.e. reaching of an allocating efficiency (Chand 2008, p. 5-6). On the other hand, among major budget decision-makers is the Ministry of Finance (MOF), especially the position of the Minister of Finance, who is involved in the budget forming process, as well as in the budget level determination (Poterba and Hagen 1999, p. 8-9). The role of the parliament is to impose control over the government actions, as well to execute financial, taxation and legislative control over the revenues-expenditure system and the government budget.

The concept of roles and responsibilities of public institutions among countries is not unified and standardized. Nevertheless, institutions‘ main goal includes reduction of budget imbalances for purpose of achieving macroeconomic stability through an efficient delivery of public goods and services (Gupta 2008a, p. 6-12).

The transparency is another significant concern when discussing the public institutions. In this regard, transparency indicates an availability of information on all executed government activities to the participants and public, as well as consolidation of the fiscal accounts (Poterba and Hagen 1999, p. 3).

The political system and its interaction with the public institutions should neither be neglected. The nature of this interaction mostly depends on country‘s general political settings, i.e. its political and electoral system.

In more detailed manner, the roles of the above mentioned institutions will be described in the section dealing with the government budget process.

2.2 Public revenues and expenditures

While the state takes number of actions for building 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 serve as state's working instruments for achieving the above mentioned aspects.

2.2.1 Public revenues

The 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, p. 4). As per Peková (2005, p. 268), the function of public revenues can be viewed as:

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

Public revenues are divided into several different categories based on their role in the public system. Generally they can be distinguished as tax and non-tax revenues. The **tax revenues** are compulsory contributions that government extracts from its citizens and companies in order to finance the general expenses for common goods and services (Chand 2008, p. 62). Tax revenues usually account for largest share of all public revenues, and are the most stable sources of state‘s income. On the other hand, the sum of the collected tax revenues represents state's imposed tax burden towards its taxpayers. This aspect is measured as a share to GDP and is commonly characterized as being uneven among different states (Hamerníková et al. 2007, p. 118).

By other classification, taxes can be viewed as **direct taxes**, where taxpayer is specified, and **indirect taxes**, which do not pre-determine the taxpayer (Jain 2010, p. 61).

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 are applied (Reed and Swain 1997, p. 79). Corporate income taxes or profit taxes are in another tax category within the income taxes that is applied on profits earned by companies and corporations (Mukherjee 2002, p. 148).

Consumption taxes are indirect taxes**.** They are imposed on goods and services in form of a universal VAT, or on certain goods with a low price elasticity such as tobacco and alcohol are (Peková 2005, p. 286). Another type of consumption taxes are customs and tariffs. Even though low profitable, they represent stable revenues for the state (Peková 2005, p. 287).

Property taxes are in the scope of direct taxes. These taxes are imposed on the movable and immovable property‘s ownership, usage or transfer; and are calculated based on property‘s value at a particular time (GFSM manual 2001, p. 51). The revenues coming from this type of taxes are usually low, but stable state income (Peková 2005, p. 289).

The **non-tax revenues** are collected from other recourses than taxes and are represented by state‘s commercial and administrative receipts. The commercial receipts are obtained from government‘s sale of goods and services, while the administrative receipts are state‘s received gifts, grants, fines, penalties, licences and fees (Chand 2008, p. 63). The non-tax revenues can also be in form of settlements coming from judicial processes and voluntary transfers other than grants (GFSM manual 2001, p. 47-48).

Besides above categories, public revenues can be viewed as current and capital. The **current revenues** include both tax and non-tax revenues such as collected fines; fees; recoveries; incomes from sales of goods, services and property; but excluding grants (WB 2004, p. 225). Even though with a persistence of fluctuation in the amounts collected, current revenues are the most constant state income (Peková 2005, p. 271). Moreover, in most of economies they also account for largest revenue share.

The **capital revenues** represent state's sale of fixed assets that include land, buildings and other constructions; as well as intangible assets, various donations, stocks and loans obtained (OECD 2003, p. 326). Capital revenues on contrary to current revenues are solely non-tax and are one time received income (Peková 2005, p. 272).

Another classification of revenues according to Peková (2005, p. 274) is based on their government ascription level. In this regard public revenues are viewed as **state revenues** that are part of government budget or extra-budgetary funds. **Local government revenues** are revenues that are available to the local authorities, regions, and municipalities.

2.2.2 Public expenditures

Public expenditures are sources that state is distributing to the public for purpose of achieving economic development and welfare, price stability, employment regulation or even ensuring the state‘s defence system (Jain 2010, p. 4). State authorities are usually facing difficulties with expenditures‘ optimal structure, available capacity, effective allocation and financing, as well as various other effects coming from their consumption (Peková 2005, p. 194). The expenditures’ structure is usually dependent on state‘s economic and social system.

Public expenditures are also classified into several categories. Generally, public expenditures are differed as **government expenditures** and **transfer payments**. While the government expenditures are used for purchasing of public goods and services; the transfer payments are provided in form of pensions, unemployment benefits, subsidies paid in cash, social security contributions and public debt interests (Mukherjee 2002, p. 131).

Public expenditures can also be distinguished as **current and capital expenditures.** Current expenditures serve for financing of repeatable public needs that are mostly in form of transfers and are pre-determined by law (Peková 2005, p. 198). Capital expenditures are financing long-term investments such as purchases of physical assets that are expected to be used over one (fiscal) year (Mikesell 2010, p. 288). Additionally, capital expenditures include payments on debt costs coming from loans and borrowings obtained. Generally spoken, in the course of reviewing public expenditure per countries, a definite prevail can be noticed on the side of current expenditures compared to the capital ones. Moreover, current expenditures are constantly re-appearing, while capital expenditures are often spent close to the fiscal year end (Peková et al 2008, p. 258).

A considerable aspect is also whether public expenditures are of **plan** or **non-plan** nature. Planned expenditures refer to those which incurred due current developments and investments done along with planned proposals (Aggaarwal and Vijay 2009, p. 362). As for non-planned expenditures, they mainly serve for meeting past state liabilities (Gupta 2008b, p. 82). These expenditures are exceeding the planned budget ceilings and are used for covering consequences of natural disasters or military conflicts. The state laws usually require some financial reserves to be held for unexpected expenditure coverage.

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 „*systemic proposals for public resources allocation*“ (Peková 2005, p. 213). While the programs are for on-going services and activities, the projects are usually described as one-time activities caring out long-term effects (Langbein and Felbinger 2006, p. 3). Both categories are designed to ensure financing of public needs and increase the effectiveness of public expenditures. Besides that, expenditure programs and projects carry simulative intentions for inciting or development of certain economic activities, sectors or entities (Hamerníková et al. 2007, p. 84).

Expenditures programs and projects require detailed medium to long-term planning and recourse forecasting. Moreover, they undergo certain measurements and evaluations. Usually before their execution cost-benefit analyses are performed. As for the evaluation, the authorities usually evaluate the impacts programs and projects are having on the population; or different aspects of programs and projects outputs and outcomes (Langbein and Felbinger 2006, p. 10).

2.3 Function of fiscal policy

The concept of fiscal policy is represented by the government actions taken for purpose of influencing and managing its objectives in regard to the state economy. These government actions relate to the execution of government revenues, expenditures and borrowings (Gwartney et al. 2008, p. 242). By using these major tools, government exercises stimulation of the economy or vice versa, curbs the economic growth. On a more detailed level, the areas where governments can achieve certain effects in the economy involve (Chand 2008, p. 259-262; Hamerníková et al. 2007, p. 244; Ochrana et al. 2010, p. 75-79):

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

There are generally distinguished three types of fiscal policies: the expansionary, neutral and the restrictive fiscal policy. From a government perspective, the objective of any of these fiscal policies is to achieve particular economic goal. With the **expansionary** fiscal policy, the government either increases public expenditures, i.e. expands the purchases of public goods and services; or decreases the receipt of revenues, for instance cuts the taxes (Arnold 2005, p. 248). 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 the fiscal policy reaches equilibrium, the consequences of the expansionary and restrictive fiscal policies create disequilibrium, thus making government budget be in deficit or in surplus respectively. An example of how this mechanism works is the case with the expansionary policy which increases government budget deficit and consequently forces government to increase its borrowings from domestic and foreign creditors (Gwartney et al. 2008, p. 243).

Besides the expansionary and restrictive aspect, there is also **countercyclical** and **procyclical** aspect of the fiscal policies. Countercyclical and procyclical fiscal policies are also acting contrary to each other. The countercyclical policy refers to a situation when government is moving the economy opposite direction from its actual business cycle (Gwartney et al. 2008, p. 245). In other words, in times of recession, government is applying an expansionary fiscal policy, while in case with the procyclical policy, government imposes a restrictive fiscal policy although the economy is growing.

Fiscal policies can also refer to government long-term and short-term measures. The short-term measures include one time parameter changes in the revenue-expenditure system and are taken with an intention of having effects only for a certain period of time (Hansen 2003, p. 307). This mainly relates to measures performed for achieving short term reduction of government budget deficit. The fiscal policy‘s long-term measures act countercyclically. According to Peková (2005, p. 399) such measures comprise setting up of automatic stabilizers that are manifested by progressive taxation; unemployment insurances and social transfers; existence of subsidies and contributions. These measures are primarily striving to alleviate the state’s recession and bring the economy back to a sustainable level.

3 Government Budget

In its first section the following chapter will deal with the government budget focusing particularly on the flow of its process. The following sections will discuss the classification of government revenues and expenditures, as well as their impact on the government budget outcome.

3.1 Government budget process

Government budget represents a centralized monetary fund serving as a financial plan that is supported by law (Peková et al. 2008, p. 254). It refers to the state's management of revenues and expenditures and is one of the executive instruments that state authorities are applying for conducting of fiscal policies. On the other hand, the government budget process represents „*...a set of decisions of various authorities in regard to the government expenditures and revenues, which are resulting in a specific budget creation...*" (Hamerníková et al. 2007, p. 188). The goal of this process is to define and organize the interaction between involved state authorities while they plan public money raising, spending and saving. Besides that, budget process reflects the decisions concerning the optimum allocation of state's scarce resources (Burkhead and Miner 2007, p. 12).

The involved state authorities in the budget process show variation across countries. Among most common executives are the Ministry of Finance (MOF), the Government, the 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, implementation and coordination is usually carried by the Ministry of Finance (Sänger 2009, p. 1).

Besides the executive aspect mentioned above, the government budget process also incorporates in itself a legislative aspect. Depending on a particular state, legislature sets up on the budget process either several annual appropriation laws or a single budget law

(Wehner and Byanyima 2004, p. 83). At the same time, legislature divides budget process into several stages. Usual stages include budget drawing, budget approval, budget execution, as well as budget audit and control (IPB, 2010). These stages are executed strictly per budget calendar, which every state has uniquely organized.

Even though budget processes are not unified between states, they have some characteristics in common. Moreover, they often follow similar procedures that are recommended by some of the international financial organizations. Based on the literature used from Wehner and Byanyima (2004, p. 30-50) and Hamerníková et al. (2007, p. 190), budget processes involve the following stages:

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

The budget process contributes to building of a system that organizes, determines, monitors and controls different aspects of state money management. It sets planned scope of revenues and expenditures; deals with overspending limits and reserves; improves the overall budget transparency and provides with an estimation of the state's economic growth.

3.2 Structure of revenues and expenditures

While previously were discussed public revenues and expenditures along with their categories, the following section will be covering the structure of budget revenues and expenditures from different classification perspectives. This particular classification of revenues and expenditures helps government form its fiscal policies; effectively allocate the available resources; as well as perform its daily government budget administration (Jacobs et al. 2009, p. 1). Referring to the used worldwide classifications, below text will be applying the IMF methodology, which is commonly applied in the developed countries.

3.2.1 Budget revenues

As per the GFSM Manual (2001, p. 47-49) and Jacobs et al. (2009, p. 16), but also as per applied personal investigation on number of states' general budget revenue structures, budget revenues are commonly presented as **tax** revenues that constitute of:[1]

- income taxes that include profits and capital gains, where taxpayers are physical and legal individuals, as well as companies. This category also includes unallowable taxes.
- taxes on goods and services, including VAT and sales taxes;
- taxes on use of goods and permissions to use goods or perform activities, where as a subcategory are included motor and vehicle taxes;

[1] Full version of GFSM 2001-Classification of Revenue in Annex 1.

- taxes on international trade and transactions. These taxes are further subcategorized to customs and import duties; export taxes; exchange profits and taxes;
- taxes on property that encompasses the immovable property; as well as the 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 per GFSM classification include the **social contributions,** the **grants** and the category of **other revenues.** While social contributions category deals with social securities, employee and employer contributions, the category of grants encompasses received grants from foreign governments, international organizations, as well as grants received from general government units. The category of other revenues comprises items such as property incomes, which in itself among others includes the collected interests, dividends, rents, and withdrawals from incomes of quasi-corporations. The other revenues in this category are receipts from sales of goods and services, administrative fees, fines, penalties and forfeits; as well as miscellaneous and unidentified revenues.

3.2.2 Budget expenditures

In difference to budget revenues, the budget expenditures are classified as economic and functional. The GFSM functional classification focuses on the allocation of budget resources (Hashim and Allan 2001, p. 47). It distinguishes budget expenditures per their applicability in the fields of general public services, defense, health, education, social and environmental protection (GFSM Manual 2001, p. 78).[2]

The economic classification views budget expenditures as transactions that are essential for obtaining detailed budget analysis (Hashim and Allan 2001, p. 46). This classification will be in more details described in the following text.

[2] Full version GFSM 2001-Economic Classification of Expense in Annex 3.

According to the economic classification of budget revenues per the GFSM Manual (2001, p. 62-78) and Jacobs et al. (2009, p. 17-18), as well as per investigation done on most common items appearing on state‘s budget expenditures side, the following main categories account for budget expenditures: **employee compensations, social benefits, subsidies, grants, interest, use of goods and services, consumption of fixed capital,** and **other expenses**.[3]

As for the fist category, the employee compensations, it constitutes of wages and salaries paid 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 also paid in cash and kind. In addition, within this category are the employer's social benefits. Similarly to social security benefits and assistances, there are in cash and kind forms.

The budget subsidies on the other hand encompass payments towards various public corporations and enterprises. This expenditure category includes releasing subsidies to the financial, nonfinancial, and private enterprises.

The grants are of a similar classification with the revenue grants, however they refer to grants released, instead of received.

The expenditure category of interests attributes for interests paid to the general government units, but also to interests that are paid to the residents and non-residents. Additionally, part of these budget expenditures includes the debt interest payments (IMF, n.d.), as well as interests on government issued securities.

The transfers represent another category of budget expenditures. Peková (2005, p. 151) states that transfers account for largest share of mandatory expenditures (expenditures supported by law). Transfers can be in a form of capital transfers; transfers for activities of government non-profit organizations; or transfers towards local governments.

[3] Full version GFSM 2001-Functional Classification of Expense in Annex 2.

Transfers to the local governments are usually also related to the central governments and require separate consolidation within the budget, otherwise they may create double counting in both local and central budgets (IMF, n.d.).

The clearing of both government budget revenues and expenditures is usually executed on one single account which is usually held at the state‘s Central Bank (Peková et al. 2008, p. 254).

3.3 Government budget balance

Development of the economies is significantly impacted and dependent on the government budget balance, i.e. the fact whether government budget is balanced, is in surplus or in deficit. Nevertheless, managing of the government budget balance is a complex and demanding process, where crucially important are the priorities of state authorities.

Government budget is based on a principle of budget equilibrium, which assumes that total budget revenues equal total budget expenditures. However in practice, this „golden financial principle“ is not easily reachable and prevailing any of the budget components, either revenues or expenditures, leads to a creation of government budget surplus or deficit. Besides that, the government budget estimations and analysis done often differ from the actual total budget revenues and expenditures spent over one fiscal year.

There can be various reasons for government budget to be reaching surplus or deficit. According to Pilný (2007, p. 57), government budget surplus can occur when the available expenditures are not entirely withdrawn due to austerity measures in regard to the planned expenditure programs. A reason for budget surplus can also be a complete removal of some parts of the expenditure programs from the approved budget.

The government budget surplus is usually what governments are striving for. However, sustaining of large budget surplus is not recommended either. It prohibits from efficient usage of available state resources, and by such slows down the entire economic growth.

Similarly, as it was with the surplus, government budget deficit can occur for several different reasons. Budget deficits are quite transparent in terms of their origins since for their creations are usually responsible specific governments (Pilný 2007, p. 195).

According to Peková (2005, p. 420), one of the reasons for government budget deficit formation can be the negative account balance which occurs due to revenues' decline or stagnation, and at the same time the expenditures' growth. Moreover, government budget deficit can be created when budget revenues are growing slower or on contrast are decreasing faster than the expenditures.

As per author Ochrana et al. (2010, p. 138), government budget deficit can be proposed by the government itself or on contrary it can occur despite government's involvement. Responsibility for its formation in that case is carried by external factors. Based on that, authors Ochrana et al. (2010, p. 140-141) and Pilný (2007, p. 198) are distinguishing two types of government budget deficits:

- **active** (structural) deficit, a reason for which can be an expansionary fiscal policy that involves decrease of tax rates or growth of government expenditures. Another reason can be the political populism that is recognized by increase of transfers or decrease of tax rates;
- **passive** (cyclical) deficit that government can not influence, as it is impacted by external factors such as an economic downturn (for instance depression); inflation growth evolving due to increased level of prices; nature disasters; growing of the interests on public debt; other changes occurring in regard to the debt repayment.

In addition to the above, government budget deficit can be viewed from a short-term and a long-term perspective. Author Ochrana et al. (2010, p. 142) adds that the short-term deficit consequences are usually positively accepted as they are alleviating government budget constraints. The long-term budget deficits are viewed negatively as they have to be later financed and lead to a public debt formation.

From an overall macroeconomic point of view, budget deficits are influencing the GDP, the inflation, the unemployment rates, as well as the state's payment balances. The existence of budget deficit forces government to take actions such as selling of state owned securities or issuing of government bonds. The government bonds can afterwards be repurchased by Central Banks, an action that is called „deficit monetization", which is however often restricted by laws (Ochrana et al. 2010, p. 143).

The decrease of the budget deficit, respectively the public debt will be on a more detailed level discussed in the following chapter.

4 Public Debt

The following chapter will define the nature of the public debt. It will also deal with such concerns as public debt impact on the economy, as well as possible solutions for public debt effective management and reduction.

4.1 Key elements of public debt

In contrast to the short-term budget deficit which can be still harmless, the long-term deficit transforms into public debt. Public debt is defined as „*a sum of existing obligations of the state, local governments, public institutions, extra budgetary funds, as well as public enterprises, both state and municipal*" (Peková 2005, p. 445). As per the GFSM manual 2001, the debt of the Central Bank is assumed as part of public debt (IMF, 2005), nevertheless, its calculation methods often differ among states.

Public debt can occur for various economic reasons and the responsibility for its occurrence can be extended over several governments altering over years (Pilný 2007, p. 196). Its formation foremost arises from budget deficits' accumulation, i.e. from „chronic deficits". Public debt can also occur due governments performing financing operations towards domestic and foreign economic entities (Ochrana et al. 2010, p. 144). Additionally, the debt can also be a result of governments taking obligations from other entities or paying off its obligations from previous years (Peková 2005, p. 452). The insufficiency of government resources after performance of extensive public investments or the political elections can other reasons for public debt formation.

The most common classification of the public debt is based on its location. According to it, public debt can be **domestic** (internal) and **external**. A domestic public debt is a debt that government acquires from its domestic creditors and is usually in inner (domestic) currency (Ghosh and Ghosh 2008, p. 272). An external public debt, on the other hand involves foreign creditors and is both received and paid off in foreign currency (Jain 2010, p. 102). The external public debt is usually higher in the states with emerging markets due to their underdeveloped domestic markets (IMF, 2003a).

Public debt can also be viewed from a perspective of the repayment period duration. In this regard, it 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, p. 145).

For purpose of international comparison it is commonly used the gross public debt value, which is also applied for determining and assessing the public debt to GDP ratio (Peková 2005, p. 446). Both budget deficit and public debt levels are also internationally 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 (EC, 2004). In both criteria are applied market prices as per ESA95 (Ochrana et al. 2010, p. 145).

4.2 Public debt economy impact

Public debt impact is not only on the overall economy, but it is also directly and indirectly impacting individuals and the private sector. Paying out the public 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 (Wagner 2012, p. 48). Moreover, it generally reduces the state's economic competitiveness.

Among most obvious public debt impacts on the economy is the increase of costs on the public debt management. The existence of the debt requires recording of its due amounts, continuous actions taken towards its redemption, as well as paying off the debt interests (Pilný 2007, p. 206). When getting into debt situation, governments as an exit option are commonly choosing issuing of government bonds and treasury bills. These securities are usually attractive to investors as they bear low risk, however, by doing so governments undertake responsibility of paying both the principal and the interest rates regardless the future public debt development (Peková 2005, p. 451). For gaining of needed recourses, governments are also negotiating loans and other borrowings. In the role of creditors are more often financial institutions rather than households, since the second group usually does not have enough financial means for lending them to the state. Among domestic creditors are usually Central Banks and domestic commercial banks, while such institution as WB, IBRD, IMF, IDA, represent the foreign creditors (Chand 2008, p. 226-227).

Public debt borrowings and repayments to the creditors are not free of charge and risk and lead to an increase of budget expenditures. The indebtedness pushes up the interest rates. On the other hand, higher interest rates simultaneously lower the amounts of goods and services provided to the citizens, and usually make governments raise the tax rates (Hyman 2010, p. 500). Moreover, higher indebtedness also forces governments to offer its creditors bargain interest rates (Ochrana et al. 2010, p. 148). 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, p. 453). The above facts can additionally restrain the domestic and foreign creditors from further money supply in the given economy as they become sceptical about state‘s exchange rates depreciation and state‘s possible insolvency (Pilný 2007, p. 207). Such chain of reaction declines the domestic market capacity, and may even cause a destabilization of the domestic banking sector.

Public debt can also affect the portfolio structure of the private sector as it prompts the capital outflows, and leads potentially to an increase of the inflation rate (Peková 2005, p. 453). However, as the public debt is a state variable, an interesting situation can occur when the debt coverage along with high inflation rates produces conversely a decline of public debt‘s fair value (Hyman 2007, p. 484).

Recent trends show that modern economies are facing debt traps. According to Ochrana et al. (2010, p. 148), such happens when governments fail to proceed with debt repayments and are forced to obtain new borrowings for to repay interest rates and installments to the existing creditors.

The public debt problem can be generally viewed as a vicious circle. Higher interest rates are transforming into higher budget expenditures that on return form new budget deficits. 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 the public debt in the economy 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 level of public debt.

Pilný (2007, p. 208) states that public debt solutions, i.e. approaches taken towards debt’s decrease can be passive or active. By passive approach, he assumes variables that are not easily influenced, such as economy growth tempo, inflation rate, receiving of grants or even debt forgiveness. The active approach on the other hand, deals with concerns that are more specific and can be influenced by state authorities on a greater level.

Recent trends of public debt growth among the states have made international organizations such as IMF, WB, OECD and EC adopt number of practices and guidelines for public debt influencing and reduction. Below section in addition to those practices will be also describing public debt solutions coming from individual authors.

As the budget deficit and public debt are closely interconnected, among most common approaches for public debt reduction is decreasing the budget deficit and targeting an achievement of budget surplus. In fact, the existence of budget deficit makes government borrow additional funds for budget deficit financing, which besides other negative impacts, increases the government bonds‘ holdings and simultaneously results in public debt growth (Hall and Lieberman 2012, p. 738).

Among other solutions for public debt reduction is imposing of higher tax burden on the population. However, the positive theoretical outcome of higher taxes that helps redeem state’s obligations should also be balanced with an increase of investment inflows in the economy (Alternative Insight, 2009).

Besides striving for achieving of budget surplus or increasing of taxes, another approach for an efficient public debt management and public debt reduction includes minimizing of both costs and risks of debt‘s financing and servicing (IMF, 2001). This consequently allows avoiding unfavorable public debt structures. By public debt structure on the other hand is understood the debt's composition. In that regard, a preference should be given to the public debt denominated in a domestic currency before the foreign currency debt, since larger foreign public debt share is most likely to lead to overall higher public debt level or even to a banking crisis (Balteanu et al. 2011, p. 6).

Additionally, the short-term interest rates should be bypassed in favour of the long-term rates, and preference should be given to the fixed interest rates, instead of variable (floating) interest rates (WB 2003, p. 10-20). Higher long-term interest rates are dragging additional expenses on the budget and may also cause crowding-out of private investments (ECB 2010, p. 10-11). Both aspects are especially applicable on securities' emissions that are aimed to reduce country's debt risk and at the same time increase the potential of the domestic market development. In addition, these aspects should be applied to the government borrowings.

Another solution for reducing public debt burden is executing debt's conversion. In this sense, the conversion of the public debt is not assumed as its repayment, but stands for exchanging of the old public debt into a new one that eventually will bear more favorable interest rates than the debt before (Dalton 2006, p. 282).

Besides the above mentioned aspects, IMF (2003b, p. 5-25) and OECD (2002, p. 69-80) state other solutions helping reduce public debt which include:

- decreasing the share of foreign debt in total public debt;
- extending the maturity of public debt payments;
- performing when feasible debt buy-backs or early redemptions before reaching debt maturity;
- focusing on using sophisticated analytical tools that allow better liquidity management, provide with reliable portfolio value and perform more accurate market forecasts;
- developing efficient securities trading platform for the domestic market which would help lower the operational transactions, and by such decrease the government costs, i.e. the public debt.

For public debt reduction and its risk limitation can also contribute the derivatives. Improving the use of these market instruments allows increasing of the liquidity of the domestic securities markets (OECD, 2012, p. 26). Using of derivate additionally helps achieve greater share of the domestic public debt and even execution of early redemptions.

Another aspect that can be applicable for sustaining and potentially decreasing the public debt level is achieving greater transparency in operations performed by both MOF and Cenral Bank. The transparency should be applied for reaching better control over public debt due payments, budgetary reporting, as well as government financial accounts (IMF, 2001). However, as for the MOF and the CB influences on the public debt, it is important to mention that for achieving an effective public debt management, the influences of fiscal policies (led by MOF) and monetary policies (led by CB) should be in some regard separated (OECD 2002, p. 25). The same OECD source states that the reason for such separation is to limit the public debt management decisions to become impacted by the information on interest rate decisions coming from the Central Bank. On the other hand, it is also recommended that public debt management and cash management closely correlate between themselves for to prevent the occurrence of short-run reconciliation differences between public debt and monetary operations (WB 2003, p. 26).

5 Public Finance in the Republic of Macedonia

The field of public finance in the Republic of Macedonia has particularly gained on its significance since country became involved in EU and NATO integration. Macedonian authorities have been actively attempting to build an efficient public finance system over the past several years. This approach has been especially targeted towards reaching a sound performance of fiscal policies, gaining a satisfactory and sustainable level of government budget balance and public debt, as well as improving the transparency and accountability of these areas.

5.1 Basic characteristics of Macedonia

The Republic of Macedonia is located in southeastern Europe, in the middle of Balkan Peninsula. Its surface area is 25 713 km^2 and it is completely landlocked. The total population from last census in 2002 reported 2 022 547 inhabitants (SSO 2011, p. 56), however as per newer statistics dated from December 2011, the population was estimated at 2 059 794 inhabitants (SSO, n.d.).

The capital city of the Republic of Macedonia is Skopje that is the most significant and developed economic, administrative, and cultural center of the country. It absorbs 25 % of total population and accounts for around 60 % of GDP of the Republic of Macedonia (SSO 2012a, p. 42).

Macedonian Denar (MKD) equaling 100 Deni represents Macedonian monetary unit. The National Bank of the Republic of Macedonia (NBRM) maintains fixed exchange rate. Macedonian Denar nominal exchange rate against Euro serves as a fundament and is set at 61,5 Denar per Euro, while U.S. dollar equals 48,9 Denar per U.S. dollar.[4]

Macedonia actively participates in the international community and holds membership in number of organizations. It is participating in such organizations as United Nations (UN), Organization for Security and Cooperation in Europe (OSCE), Council of Europe

[4] Both currencies are representing an average value in Q1/2012.

(CE), World Trade Organization (WTO), Central European Free Trade Agreement (CEFTA), Organization of the Francophonie and International Monetary Fund (IMF), as well as other organizations in the field of finance, trading, environment, and technologies. Besides that, the Republic of Macedonia also aspires for EU and NATO integration and ss of December 2005 holds a status of a candidate country for EU.

Becoming a member of EU has been one of the strategic goals of the Republic of Macedonia and has been a topic that is on a daily agenda of Macedonian political leaders. For that purpose, Macedonian authorities have been working on number of reforms and amendments to become capable of meeting future EU membership obligations. This predominantly includes various economic interventions towards fulfilling European standards in areas such as judiciary (new law adoption), state organization, as well as reforms that focus on social and environmental problems.

EU and some other financial organizations, such as World Bank have also taken certain actions to help Macedonian economy stabilize, grow and meet EU membership obligations. For instance, EU has released the „Instrument for Pre-Accession Assistance“ (IPA) program which supports the development of Macedonian market economy and prepares the country for the competitive EU environment from a political, economic, and monetary perspective (IPA 2005, p. 1-2). The World Bank, on the other hand with its „Country Partnership Strategy“ program helps country enhance the sustainability of its public finances; improve the performance of its social protection system, as well as develop a resilience of its financial sector (WB 2012, p. 9).

5.1.1 Institutional framework

Being one of the six former states of Yugoslavia, the Republic of Macedonia gained its independence and sovereignty on September 8th 1991. After Yugoslavian communist regime, it became a country with a multi-party parliamentary democracy system with one ruling and several minor parties. As of November 17th 1991, a constitution was adopted acting as a supreme law. Today‘s state power in the Republic of Macedonia is divided between the Assembly (*Sobranie)*, the Government (*Vlada*) and the judiciary.

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"* (Constitution, § 61). It constitutes of maximum of 140 Assembly members. Under its control are the Constitution itself; state laws; tax system; adoption of budget; referendum notices; as well as the government elections, their monitoring and supervision (Constitution, § 68).

The Government of the Republic of Macedonia is defined as a holder of an executive power that is represented by the President and the ministers (Constitution, § 88 and § 89), whose rights and duties are also defined by the Constitution and laws. The Government is first in line responsible for the state administration in terms of law and budget propositions; appointment of ministries; conducting of foreign affairs; as well as making decisions on state reserves and having control over them (Constitution, § 91). Last early government elections were held on 5th of June 2011, where the centre-right party VMRO-DPMNE (Internal Macedonian Revolutionary Organization - Democratic Party for Macedonian National Unity), a national conservative party gained a victory for 3rd consecutive term.

The judiciary power in the Republic of Macedonia is exercised by courts which are acting autonomously and independently (Constitution, § 98).

The Republic of Macedonia is divided into eight regions and has one tier of subnational government level represented by the municipalities. As per the Constitution (§ 114) municipalities are defined as *„units of local self-government"*. As of year 2004, they account for 84 units. The average population of Macedonian municipality is 23 800 inhabitants (Ott 2006, p. 6). The capital city Skopje is a separate unit and integrates additional 10 municipalities within its territory.

The state administration of the Republic of Macedonia is also Constitution based and similarly to the judiciary power is acting as an autonomous authority. Its organization currently constitutes of 15 ministries. The ministries that are predominantly involved and have impact on the government budget and public debt management are the Ministry of Finance (MOF) and the Ministry of Economy (MOE).

The MOF duties involve conducting of (macro) economic, fiscal and taxation policies; predicting economic issues; performing fiscal analyses; enforcing various financial laws and balancing of government budgets. As per MOF Institutions (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.

The MOE focuses not only on strategies that help improving business and investment climate in Macedonia, but also concentrates on business enhancements that stimulate the domestic and foreign direct investments (FDIs) inflow in the country (MOE, 2011). In its recent agendas, MOE has been also intensifying the industrial policies that are aimed to improve the competitiveness, entrepreneurship, and the innovation of Macedonian SMEs. The regulation of the internal market and the consumer protection are other topics of MOE‘s interest.

Although above actions taken, the state administration system in the Republic of Macedonia is still being in a transition mode with intentions to build a relevant, modern, and as much effective system as of the developed countries. The state administration system keeps seeking for better IT infrastructure organization and better streamlining of Macedonian authorities on both an organizational and operational level.

5.2 Macroeconomic indicators

Following the acquired EU candidate status in December 2005, the Republic of Macedonia started implementing number of reforms and projects, which have been influencing country‘s all macroeconomic areas. The following section will focus on the macroeconomic evolution of the country since 2006 that is in fact the first fiscal year after acquiring EU membership status when Macedonia started applying comparative methods and reporting as of those used in the developed countries. The emphasis will be mainly on the examination of the GDP and inflation developments, as well as the trends in the foreign sector over years 2006 to 2010.

5.2.1 GDP development

The Republic of Macedonia likewise other countries uses as a basic indicator for measurement of its economic activity the GDP indicator. Until 2005, the country was using the GFSM1986 (Government Finance Statistics Manual) methodology, however since 2005, Macedonian authorities incorporated reporting of the data in compliance with the ESA95 methodology (IMF 2006b, p. 49). The data before year 2000 has been also revised and the GDP has been calculated at constant prices instead of at market prices as it was previously done (SSO 2010, p. 4).

For purpose of achieving a comprehensive view on Macedonian GDP development over the examined years, below is presented a summarizing table that will be explained in more details in the following text. The values in the table are derived from information found in several MOF and SSO sources.

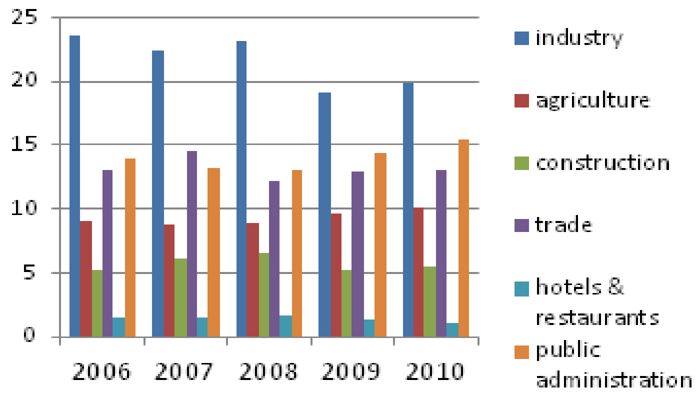
Table 1 GDP development

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

Source: MOF, 2007a; MOF, 2008a; MOF, 2009a; MOF, n.d.

The examination of the GDP development is based on the production approach. Besides the table, the following graph additionally provides with an overview on the most significant sectors participating in Macedonian GDP formation, as well as it depicts the correlation between the sectors.

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



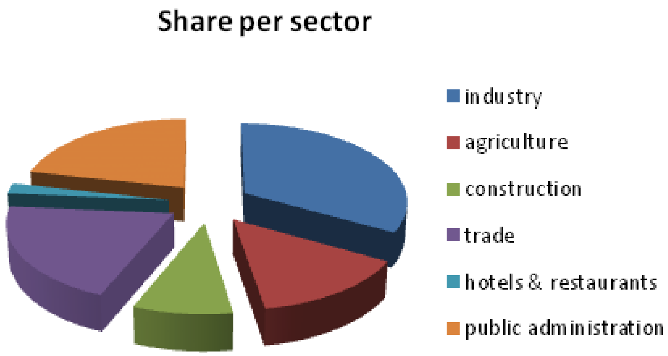
Source: MOF, 2007a; MOF, 2008a; MOF, 2009a; SSO, 2012.

In **2006**, the economic activity expressed in GDP resulted in 4,0 % growth rate and amounted in 5.082 million Euro, while per capita it reached 2.491 Euro (MOF 2009a, p. 82). Applying the production approach, the services sector had the highest participation share in GDP with a total of 47,5 % and within it, the industrial sector[5] participated with 23,6 % (MOF 2007a, p. 13). The industrial sector‘s success was mostly based on the metal and non-metal products which showed positive production progress in 2006. The same positive range of success of this sector will however not sustain in the following years. The least active sector in 2006 was the sector of hotels and restaurants with its participation of 1,5 % in GDP (MOF 2007a, p. 13).

As it will be also visible from the following years, generally the highest contribution will be carried by the industry sector, while the lowest will remain on the side of hotels and restaurants sector. Nevertheless, the proportions of sector’s participation in total GDP will be somewhat evening out over the examined years. These statements are supported by the below graph which is depicting the average values of discussed sectors for the period of years 2006 to 2010.

[5] Industrial sector incorporates in itself: mining and quarrying; manufacturing; electricity, gas, steam and air conditioning supply; water supply; sewerage, waste management and remediation activities.

Graph 2 GDP average contribution per sector in years 2006-2010



Source: MOF 2007a; MOF2008a; MOF 2009a; SSO, 2012b.

During the year **2007**, the economic activity showed best results since the separation from Yugoslavia in 1991. The economy generated a real GDP growth of 5,9 %, and resulted in 5.782 million Euro in total and 2.829 Euro per capita (MOF 2009a, p. 82). The services sector held the largest share of 51,4 % of GDP (MOF 2008a, p. 35) being actually in a leading position since 2003. An economic growth in 2007 was also visible in the hotels and restaurants sector which grew by 6,8 % (MOF 2008a, p. 35) compared to 2006.[6] On the other hand, the share of the industry sector decreased and accounted for 22,4 % of GDP (MOF 2008a, p. 35).

2008 was a year, when the economic crisis hit the world economy and caused general economic slowdown. Macedonian economy at this point stayed rather stable achieving 5 % of real GDP growth rate. The actual slowdown of the economy was noticed only in the fourth quarter, however it was yet showing a positive trend. The total GDP accounted for 6.507 million Euro, while the GDP per capita accounted for 3.177 Euro (MOF 2009a, p. 82). According to the production approach, out of six examined sectors (the agriculture, industry, construction, services, trade, public administration and hotels and restaurants sector), the main GDP contributor was again the industry sector. It resulted in 23,2 % of GDP, while the GDP result for hotels and restaurants sector was 1,7 % of GDP (MOF 2009a, p. 31). This was an improvement of 0,2 p.p. compared to year 2007.

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[6] As the rounding of the decimals is set up to two decimals in the entire diploma thesis, the GDP share of the hotels and restaurants sector remained at 1,5 % of GDP.

The year **2009** was already replicating the 2008 global 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. It resulted in a real negative growth rate of 0,9 % of GDP (MOF, n.d.). The first three quarters of 2009 had negative growth, while only in the fourth quarter the economy started slowly recovering. The total GDP was 6.703 million Euro and per capita was 3.269 Euro (MOF, n.d.). The main driver was the industry sector that reached only 19 % of total GDP, while the sector of hotels and restaurants, which has been standardly having low GDP contribution, has even dropped to 1,3 % of GDP in 2009 (SSO 2012b, p. 30).

In **2010**, the economy began slowly healing. Its real GDP growth rate was positive achieving 2,9 % of GDP, and when expressed in market prices, it reached 7.057 million Euro, while per capita it reached 3.434 Euro (MOF, n.d.). Out of all sectors, the construction sector experienced the most significant growth that resulted in 5,5 % of GDP, while in 2009 it was 5,2 % of GDP (SSO 2012b, p. 30). The industry sector kept the largest share in GDP and resulted in 18,8 % of GDP, being followed by the public administration sector that resulted in 15,4 % of GDP (SSO 2012b, p. 30).[7]

5.2.2 Inflation development

The inflation development in the Republic of Macedonia, as it will be visible from the following discussion, has been also experiencing downturns between some consecutive years. The below graph together with the table 1 in the previous section consolidates the inflation development and fluctuations between the years 2006 and 2010.

[7] Public sectors includes in itself: public administration and defence; compulsory social security; education and human health and social work activities.

Graph 3 Inflation rate 2006-2010

Source: MOF, n.d.

In year **2006**, the inflation accounted for 3,2 % (MOF, n.d.), while the expected rate was 1,8 % (MOF 2007a, p. 12). The inflation was mostly driven by the increased prices of tobacco products and beverages.

The inflation in **2007** was more moderate compared to 2006. It reached 2,3 % (MOF, n.d.). Nevertheless, it was intensifying with every upcoming quarter in 2007 as it was influenced by the upraised trends of world market prices.

In **2008**, after keeping moderate fluctuation during several years, the inflation scrambled from 2,3 % in 2007 to 8,3 % (MOF, n.d.). There is no doubt that a reason behind was the world‘s financial crisis, and that for a small and open economy like Macedonia, it was inevitably that global market prices directly affect its domestic market. The prices measured by then CPI index indicated a significant increase of oil and oil derivatives prices, as well as an increase of costs for food (MOF 2009a, p. 33). These items actually became the main drivers of the inflation in 2008. Their growth was mostly noticeable over the last quarter of 2008.

In **2009,** the inflation rate had a negative trend and fell dramatically from 8,3 % in 2008 to 0,8 % (MOF, n.d.). It was mirroring the overall low economic activity in the domest and foreign markets. The market prices declined in almost all categories, including the consumer basket, services, clothing and footwear, education and transport, as well as oil and oil derivatives. A declining trend of the economic activity persisted in all quarters.

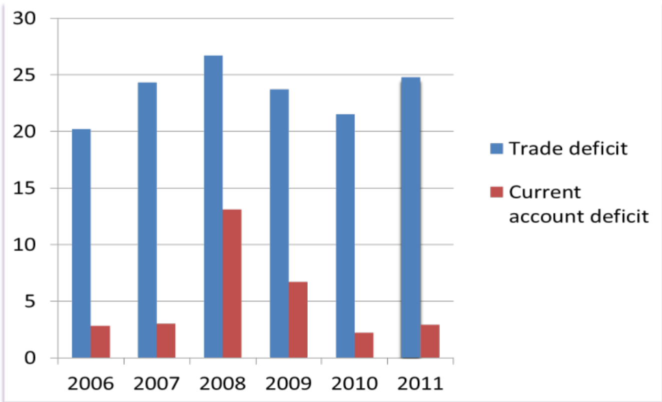
The inflation rate in **2010** reached 1,6 % (MOF, n.d.). Undoubtedly, this was viewed positively, as it seemed that the inflation has returned to its low fluctuation pattern seen in the previous years. The inflation was mostly driven by the upsurge of prices for heating and lighting, as well as the electricity prices that on average grew by 8,9 % and 9,9 % respectively compared to 2009 (MOF 2011a, p. 5; MOF 2011b, p. 5).

5.2.3 Foreign sector

Likewise, the GDP and the inflation, the foreign sector in the Republic of Macedonia has been also keeping pace with the domestic and external market developments. Being a small economy, Macedonia has been very dependent on its foreign partners, mainly the EU partners (majority of trades have been done with Greece, Hungary, and Slovenia), and the developing counties, such as Russia, Turkey, and Ukraine.

Below graph is summarizing values that will be examined in the following section. It shows the foreign trade deficit and the current account deficit values, as well as depicts their development and the co-relation between them over the years 2006 to 2010.

Graph 4 Trade and current account deficit development



Source: MOF, 2007a; MOF, 2008a; MOF, 2010a; MOF, 2011c; MOF, 2012a.

In **2006**, a significant increase of prices on the foreign stock markets, especially the oil prices had caused Macedonian foreign trade deficit to reach 20,2 % of GDP (MOF 2007a, p.11). The current account deficit resulted in 2,8 % of GDP (MOF 2008a, p. 22). It was mainly affected by higher transfers, particularly the private transfers.

In **2007**, the situation with Macedonian foreign sector even worsened. The foreign trade deficit accounted for 24,3 % of GDP, while at the same time the current account deficit accounted for 3 % of GDP (MOF 2008a, p. 54). A major negative impact on the trade balance had the fact that Bulgaria joined EU in 2007. This brought a significant decline in the trading volumes between the Republic of Macedonia and Bulgaria. This occurred to a great extent due to changes in laws, as well as other imposed restrictions related to EU norms that Bulgaria had to meet when entering EU.

In **2008**, the foreign trade deficit reached 26,7 % of GDP, while the current account deficit ended up at 13,1 % of GDP (MOF 2010a, p. 8). The foreign trade deficit decrease was mainly caused by the import increase, especially due to import of oil products and electricity. Moreover, Macedonia being heavily dependent on raw materials import was forced to accept imports predominantly in U.S. dollar currency in order to supply its small domestic market. This was unfavorable situation, as U.S. dollar was depreciating in that period. On the other hand, the exports were mainly accepted in Euro currency (MOF 2009a, p. 45), which was somewhat neutralizing previously mentioned negative effect.

The foreign sector in **2009** was still under world‘s financial crisis impact. Nevertheless, Macedonian foreign trade deficit went down to 23,7 % of GDP and the current account deficit was also lower, reaching 6,7 % of GDP (MOF 2011c, p. 20). As the biggest trading partners for both export and import affairs were the EU partners, the downturn of their economies also decreased Macedonian export (MOF 2009b, p. 6). Similar situation occurred with the trades executed with Russia, Ukraine, and Turkey. On the other hand, even though both import and export continued the downward trend, the import decline was faster in 2009 and thus it was causing shrinking of both deficits.

In **2010**, a graduate increase of demand for Macedonian goods was noticeable. The foreign trade deficit again decreased and accounted for 21,5 % of GDP, while the current account deficit decrease reached 2,2 % of GDP (MOF 2012a, p. 17). The contribution was mostly on the export side, since it boosted particularly in the second half of 2010. Exports with iron and steel were taking a considerable share in the trade balance (MOF 2012a, p. 13). Moreover, for Macedonian good’s production to improve, helped favorable climate conditions, as well as increased prices for metal. EU kept being Macedonian largest export partner; however, there was a decline of exports with Greece. Being Macedonian geographical neighbor and close business partner, Greece‘s economic downturn in 2010 caused inevitable suppression for Macedonian economy.

5.3 Fiscal policy

Following the confirmation of candidate country for EU, the Government of the Republic of Macedonia started adjusting its fiscal policy management according to the European standards. Since 2007, the Government obliged itself on preparation and reporting of Medium-term and Pre-Accession (PEP) Programmes to the EC annually. These documents intended primarily to provide with projections and plans on macroeconomic moves, as well as with the amendments and developments done in Macedonian public system for a given period. According to the fiscal policy for years 2011-2013 (MOF 2010b, p. 3), as well as the fiscal policies for other years, the pre-established targets that Government has been pursuing recently are set towards:

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

In addition to that, the Government has been striving to build a compatible government budget and public debt regulation system, as well as to fully implement the international standards for accounting data presentation. In this regard, the ESA95 accounting standards, as well as the GFSM2001 methodology have been introduced to Macedonian public system since 2010, which was an upgrade of the previously used GFSM1986 methodology (MOF 2007b, p. 72). These standards however have not been yet covering the entire Macedonian financial data even though number of revisions have been executed on the old documents and reports.

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. Among most significant reforms was the tax burden reduction by imposing 10 % flat tax rate on both corporate and personal incomes, as well as cutting from the VAT, particularly on the agricultural products from 18 % to 5 % (MOF 2007c, p. 5). Moreover, an intensification of the structural reforms was going in direction of moving the small and weak Macedonian economy towards open market practices.

The fiscal policy in **2008** was mainly concerned with the emerging global crisis, which as mentioned in the previous sections had mostly negative impact on Macedonian trade deficit. The Government was more leaning towards expansionary and anti-cyclical fiscal policies. Special attention was paid on decreasing of poverty and sustaining low unemployment and inflation rates in the country. This was mainly emphasized by the additional tax burden reduction that allowed writing-off interests on personal, income and profit taxes, as well as by the adjustments done on the VAT for certain products. The fiscal policy helped establish new administrative institutions and proceed with certain law modifications which would correspond more to the European ones (COF 2011, p. 12). In addition, the Government made certain amendments in the judicial system for reaching better control over the underground economy and for purpose of increasing of budget revenues (MOF 2007d, p. 9). Maintaining low level of the budget deficit (which would not exceed 1,5 % of GDP yearly), as well as giving preference to the domestic sources of financing (MOF 2007b, p. 9), were the additional projections made by the state authorities in 2008. These actions assuredly aimed to improve the general credibility of Macedonia.

The year **2009** continued to be a turbulent for the world economy. Nevertheless, Macedonian Government managed to maintain a satisfactory economic stability and activity. As it was with the previous years, in order to balance the decreased demand in the domestic market, Government proceeded with an expansionary fiscal policy. This helped stimulating the public spending. The politics of rather low taxation from the previous years, together with the reduced contribution rates and profit tax collections (applied only to dividend profits), provided Macedonian economy with a sound support in 2009 (MOF 2010a, p. 24). Although the unfavorable economic climate was still persistent, the Government budget deficit was not surpassing its projections, and accounted for 2,7 % of GDP, although it was mostly financed from external sources (MOF 2011c, p. 49).

The fiscal policy in **2010** was planned prudently. The Government was following similar goals as from the previous years. While in a short-term, the Government was struggling to neutralize the consequences coming from the global crisis and was maintaining a moderate expansionary fiscal policy; in a long-term, the goal of the Government was to moderate the government budget deficit and stabilize the public debt level (MOF 2010b, p. 6). The projection of the targeted budget deficit was set up at 2,7 %[8] of GDP and for purpose of its retention, Macedonian Government adopted a Supplementary Budget in July (MOF 2011c, p. 60-69). The Government afterwards proceeded with freezing of public salaries, cutting down number of new public employment contracts, as well as streamlining of customs' operations (MOF 2009c, p. 5). A negative impact on the economy however had the fact that Greece was heavily confronting its debt crisis and by such was dragging down Macedonian foreign sector. At the beginning of 2010 the economy did not sustain stable and experienced a decline of the economic activity by 1,1 % of GDP compared to 2009 (MOF 2010b, p. 3). The positive tendencies occurred only by the end of 2010, mostly due to gradual revival of the domestic demand (MOF 2010b, p. 4) The economy growth reached 2,9 % of GDP (MOF n.d.).

Over the examined years 2006 to 2010, Government's general goal was pursuing macroeconomic stability and tuning its budget frameworks in accordance with plans provided in the reported macroeconomic programmes. The tax burden was remaining modest. At the same time, the budget administration was gradually improving its discipline level by showing positive course in shrinking of budget expenditures, as well as in executing better control over them.

[8] By the end of 2010, the budget deficit reached 2,5 % of GDP, being a positive result compared to the expected one.

6 Government budget of Macedonia

The following section will be discussing the Government budget system in the Republic of Macedonia. The emphasis in the section will be on the Central government budget since it represents the largest share and is the most significant item within the state budget. The section will be particularly describing the budget planning, preparation and execution process, as well as reviewing 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 Budget Law that was derived from the old budgetary system inherited from Yugoslavia. The latest Budget Law modification dates from the year 2011. As per its definition, Macedonian government budget represents an *“annual plan of revenues and other receipt appropriations that relates to the budget users and includes* [in itself] *basic budget, donations, budget loans and budget fund raising activities*“ (Budget Law 2011, art. 2, § 5). Budget users on the other hand are represented by the central government and the municipalities, as well as by users carrying out public authority (Budget Law 2011, art. 2, § 1). These are the budget users representing the first layer. There is however another layer of budget users that is represented by the second-line users. They are so-called the spending units and are financed by the first layer budget-users (OECD 2008, p. 2).

The budget organization in the Republic of Macedonia includes both administrative and legal framework engagements. Similarly, to the Western countries’ systems, MOF prepares and delivers the central budget to the Government, which afterwards consolidates its proposal and forwards it to the Assembly for finalization and adoption. As for the judicial system in the Republic of Macedonia, it is given a budgetary autonomy; however, its budget also requires Assembly’s approval (IMF 2006a, p. 8).

In accordance with the Budget Law (2011, art. 3, § 2), the preparation, execution and the reporting of the government budget of the Republic of Macedonia is in line with the 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 on 1st of January and closes on 31st of December. The entire budget process follows the budget calendar that is supported by the legislation.

As per the budget calendar and Budget Law (2011, art. 15, § 1), the Government defines its strategic priorities by April 15th for the current year that are later incorporated by the budget users in their respective programs and subprograms. By 31st of May, the Ministry of Finance (MOF) delivers a mid-term fiscal strategy (Budget Law 2011, art. 16, § 2). The respective strategy contains the draft budget that includes in itself: the budget priorities and targets; the available resources and financing evaluations; as well as the financial predictions for the following three years period (Budget Law 2011, art. 17). All macroeconomic predictions are based on the reporting done by the National Bank of the Republic of Macedonia (NBRM) and the current international economic trends, instead of using various econometric models (IMF 2006a, p. 16).

By 15th of June, the budget users obtain budget circulars from the MOF for purpose of arranging the budget draft preparation (Budget Law 2011, art. 19). The submission of the budget draft to the MOF is done no later than September 1st of the current year (Budget Law 2011, art. 22). In return, MOF reviews the draft budget and hands it over to the Government by 1st November at the latest (Budget Law 2011, art. 29), while by the 15th of November, the same procedure occurs between the Government and the Assembly (Budget Law 2011, art. 30, § 1).

In regard to the Assembly's procedure of the Republic of Macedonia, the budget approval process features common characteristics as of those applied in the Western countries. According to the Macedonian Assembly‘s legislation (Assembly, n.d.), the first budget reading occurs if at least 15 out of 140 Assembly Members are requesting general debate within a period of seven days from obtaining the budget law proposal. The continuation of the same budget matter is held at the second budget reading, where eventual amendments are submitted, voted, and adopted. Once the Assembly succeeds in adopting of budget amendments, the second budget reading text is revised, upon what it becomes both legally and technically eligible for the third reading. During the third reading of the budget proposal, additional amendments might occur. These amendments however refer only to the previously submitted articles. Once the debates on the amended articles are finished, a submission of the budget is to follow.

Assuming that all of the above procedures have gone smoothly, the Assembly adopts the Budget by December 31st (Budget Law 2011, art. 30, § 2). According to the Budget Law (2011, art. 32, § 1), in case of budget adoption delay, the MOF approves monthly ceilings of recourses until March 31st that cannot exceed one third of total expenditures assigned to the first quarter of the previous fiscal year.

For achieving better control over the initially planned resources and the budget transparency, budget users are obliged to spend at least 30 % of the budget resources during the first half of the fiscal year (OECD 2008, p. 5). On the other hand, budget users are allowed to execute some reallocations within the range of previously approved resources, however only upon MOF's approval. The resources up to 5 million MKD[9] are approved by the MOF (Budget Law 2011, art. 33 § 2), while larger amounts are subject to Government's approval (Budget Law 2011, art. 33 § 4).

Macedonian budget process additionally deals with management of current and permanent reserves. As pre-determined, these reserves are collected to maximum of 3 % of current expenditures value and serve for ensuring the coverage of unpredictable social and natural events, as well as for rectification of events' consequences (Budget Law 2011, art. 11).

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

[9] Approximately 81.232,64 Euro as of 2.7.2012.

The accounting principles are however currently in transition towards the ESA95 reporting standards, a process that is planned to be finalized by the end of 2012. Moreover, Macedonian authorities have been constantly working on implementation of further improvements on the budget system. Such improvements include preparation of multiyear budget planning and projections; enhancing the scope of the macroeconomic indicators used; as well as involving a civic participation in the budgetary process. The last area has been particularly suffering from a significant lack of improvement.

6.2 Budget revenues and expenditures

The goal of this section is to present separately the structures of budget revenues and expenditures of the Republic of Macedonia. Both structures are generally corresponding to the international standards and practices. Their presentation will be based on the economic classification, since this classification provides with more in-depth overview on the items found in the budget reports of the Republic of Macedonia.

6.2.1 Budget revenues

Macedonian macroeconomic system divides budget revenues into three general categories: tax revenues, non-tax revenues and capital revenues. Both tax and non-tax revenues are as per the NBRM also called the primary revenues (NBRM, n.d.). In order to define the budget revenues on an item level, it was performed a detailed examination on several budget reports of the Republic of Macedonia. For achieving the same goal, was also analyzed and used information from other sources related to this subject.

In accordance with the above mentioned, the **tax revenues** include (MOF 2009f, p. 1-22; MOF, 2012b; PRO, n.d.; Revenue Rules 2008, p. 1-13):

- income taxes, which are represented by the:
    - personal income taxes calculated at 10 % rate,
    - profit taxes (mainly corporate taxes) that are also calculated at 10 % rate,

- consumption taxes represented by the:
  - VAT that are imposed in the Republic of Macedonia as of April 1st 2000, and are calculated at the rates of 5 % and 18 %,[10]
  - excises, which include various domestic taxes and fees for rendered goods and services,
  - various customs duties, charges and payments coming from an execution of international trades and transactions and are mainly related to imports,
- property taxes ranging from 0,10 % to 4 % tax rate and involving taxes on gift inheritance and real estate turnovers;
- capital gains;
- other taxes that are related to specific services or represent imposed taxes for using and getting permits on activities performed.

To tax revenues also belong the contributions which are covering the:

- pension insurance contributions;
- unemployment contributions;
- health insurance contributions, i.e. the social welfare contributions from payments.

For the **non-tax revenues** are accounted the:

- profits of public financial institutions such as profits from the NBRM; interests on deposits and loans given; property and rent incomes;
- administrative fees and charges including fines; court and consular fees; local administrative fees;
- health co-payments;
- road fund fees;
- other non-tax revenues such as entrepreneurial and property incomes, as well as other government services.

[10] 18 % tax rate is the general tax rate, while 5 % is the privileged tax rate applied on special products such as products for human nutrition and publications, medical products and various machines.

The **capital revenues** based on the budget execution reports and the rules for revenues classification include:

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

Other budget revenues are the revenues from repayment of loans, but also revenues received from budget financing. The last category mainly refers to sale of securities, as well as to domestic and foreign borrowings.

6.2.2 Budget expenditures

The budget expenditures of the Republic of Macedonia similarly to the previously discussed economic classification, as well as the examination done on Macedonian expenditure reports are divided into two general categories. These categories are dealing with current and capital budget expenditures.

The **current expenditures** as per the MOF document on Expenditure rules (2008, p. 2-9) and MOF budget reports (2012b) include:

- wages and allowances such as public salaries and various compensations paid;
- goods and services, but also rents and fees paid;
- domestic and foreign interest payments;
- transfers that involve:
    - social transfers such as pension funds, unemployment benefits, social benefits and health care,
    - other transfers and subsidies towards public and private enterprises, as well as towards non-profit organizations.

The **capital expenditures** on the other hand are encompassing as per the Expenditure rules (2008, p. 9-12) the:

- fixed assets such as purchases of equipment and machinery, buildings, and non-financial goods;
- capital transfers.

6.3 Government budget deficits

The following section of the diploma thesis will focus on the development of the government budget in the Republic of Macedonia over the years 2006 to 2010. It will be examining the level and structures, as well as the major factors and reasons that were having impact on the budget balance outcome for that period. For purpose of achieving more detailed analysis on the government budget, there will be distinguishing between the general and central government budgets along with their respective revenues and expenditures. The main stress will be however done on the central budget, as it accounts for largest share of the government budget and at the same time has the strongest impact on the overall budget outcome.

6.3.1 Budget deficits for period of 2006-2010

Before providing with an extended overview of the government budget development in the Republic of Macedonia over years the 2006 to 2010, a table below summarizes the government budget situation in every consecutive fiscal year.

Table 2 Budget deficit development

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

Source: MOF, n.d.; MOF, 2006; MOF, 2007a; NBRM, 2012a; MOF, 2008a; MOF, 2009a; MOF, 2009b; MOF, 2009c; MOF, 2011c; MOF, 2011d.

The 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 the general budget expenditures amounted in 1.728 million Euro (MOF, n.d.).11

According to MOF (2007a, p. 33-37), the central budget revenues were at 1.029 million Euro. The largest contribution was coming from tax revenues which participated with 93,6 % in the total revenues gain. Out of total tax revenues, the biggest share constituted of indirect taxes, i.e. of VAT which represented 47,5 % of total tax revenues. On the other hand, the lowest share held the direct taxes, i.e. the profit taxes. They accounted for only 8,2 % of total tax revenues.

The capital revenues stayed rather low in 2006. A similar situation emerged with the non-tax revenues. They had poor performance mainly due to the sluggish enterprises' incomes in 2006.

The central budget expenditures reached 1.039 million Euro in 2006 (MOF 2007a, p. 34). The biggest contribution, as it was expected was coming from the current expenditures where transfers held the largest share. Transfers represented 38,5 % of total expenditures, followed by the salaries, wages and allowances that together resulted in 35 % of total expenditures (MOF 2006, p. 10). The capital expenditures accounted for 9 % of total expenditures in 2006 (MOF 2007a, p. 35). They were mainly created by

[11] MOF presents government budget data in million MKD, however, for better compatibility with other sections; the entire data of this section is converted into Euro currency in accordance with the NBRM (2012a) average yearly rate.

purchases of capital funds. Such purchases resulted in 93,9 % of total capital expenditures in 2006 (MOF 2007a, p. 35).

Generally, the performance of budget revenues improved in 2006 compared to 2005. Among main reasons for reaching the positive effect was implementation of certain reforms in the tax system. Of a particular interest were newly introduced environmental fees based on processed modifications in the Tobacco Law and the Health Care system (MOF 2007a, p. 34) that allowed increasing of budget revenues. Nevertheless, this was not enough to avoid the creation of budget deficit.

The general 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 representing 0,2 % of GDP (MOF 2006, p. 10). The main reason for central budget deficit creation (even though budget revenues progressed compared to 2005) was the excessive spending of budget funds. State authorities failed to effectively regulate the budget ceilings, i.e. they allowed exceeding of planned expenditures. This is in fact a general problem the Republic of Macedonia has been facing in its public finances management. Additionally to that, in 2006 were held Government elections, which also had inevitably negative influence on Macedonian budget deficit.

In **2007** the general budget revenues were at 1.955 million Euro, while the general budget expenditures reached 1.920 million Euro (MOF, n.d.).

Splitting from the consolidated budget, the central budget revenues accounted for 1.245 million (MOF 2008a, p. 43), which was an increase of 216 million Euro compared to 2006.

According to MOF (2008a, p. 43-45), the biggest contribution had the tax revenues that accounted for 1.245 million Euro. Their participation was 90,4 % of total revenues. A the same time, not a remarkable change occurred within the revenues contribution structure. The VAT participated with 49,4 % that was almost half of total tax revenues; while the profit taxes, being the weakest item, accounted for only 8,9 % of total tax revenues.

Interestingly enough is to mention the fact that in 2007, Government imposed new tax law on profit taxes. According to it, taxes became flat at rate of 12 %, while previously were at 24 %, 18 % and 15 % rate, depending on the specific tax regulations (CEA 2008, p. 6). The position of the Public Revenue Office (PRO) was also strengthened by this reform, and the tax collection system became generally more efficient.

As for the categories of non-tax and capital revenues, they both increased in 2007. The non-tax revenues surged especially due to received dividends from corporations which in 2006 were left unpaid.

The central budget expenditures also increased in 2007. They accounted for 1.233 million Euro, which when expressed in percentage, resulted in a growth of 18,7 % compared to 2006 (MOF 2008a, p. 46). Out of current expenditures, the most significant amount was spent on transfers, as well as on salaries and allowances. Only transfers themselves accounted for 40,1 % of total expenditures (MOF 2007e, p. 12), while expenditures on salaries and allowances accounted for 35,4 % of total expenditures (MOF 2008a, p. 46).

As for the capital expenditures, they were intentionally increased by the Government in 2007, and as it will be visible from the following text, this trend will be remaining rather sustainable over the next several fiscal years.

With the above fiscal numbers, the general budget had surplus, which was in fact reached the only time within the scope of analysed years. It accounted for 35 million Euro, or expressed in percentage represented 0,6 % of GDP. The central budget reached surplus of 12 million Euro and represented 0,2 % of GDP.

In **2008,** the general budget revenues accounted for 2.227 million Euro, while the general budget expenditures accounted for 2.289 million Euro (MOF n.d.).

At the same time according to MOF (2009a, p. 53-57), the central budget revenues reached 1.401 million Euro. The tax revenues were lower than in 2007 and accounted for 88,4 % of total revenues. The VAT share also decreased, however it remained largest in the tax revenues structure reaching 47,7 % of total tax revenues. Contrary to them, the profit taxes surged and accounted for 11,3 % of total tax revenues.

Interestingly enough, since January 2008 came the second wave of tax burden reduction in the Republic of Macedonia. This reform brought profit taxes to 10 % flat tax rate from previously 12 % tax rate (PRO, n.d.). Besides this fact, revenues received from the profit taxes managed to increase in 2008, as it is visible from the previous paragraph.

Also remarkable for 2008 was the progress of non-tax revenues which increased almost by half compared to 2007. This improvement was mainly due to the profits gained from the NBRM.

The central budget expenditures reached 1.448 million Euro (MOF 2009a, p. 55). The dominant role was on the side of transfers, followed by the salaries and allowances. Transfers participated with 41,9 % of total expenditures, while salaries and allowances participated with only 21,8 % of total expenditures (MOF 2008b, p. 13).

The capital expenditures increased in 2008 mainly due to the capital projects. Significant investments were put into construction of museum buildings, football fields, as well as spending done in the education system (MOF 2009a, p. 57).

In 2008, calculated general budget deficit reached 62 million Euro and represented 1 % of GDP. The central budget deficit at the same time accounted for 47 million Euro and was 0,7 % of GDP. Importantly to mention in this regard is that the deficit creation occurred predominantly in the last quarter of 2008, when the global financial crisis hit. Over the first three quarters of 2008, the budget stayed in surplus. Even though in fiscal year 2008 it was visible that Macedonian economy was not yet severely impacted by the crisis, the negative trend of the last quarter proved that the external negative turbulences would not bypass Macedonian economy later.

In **2009**, the general budget revenues were 2.097 million Euro, while the general budget budget expenditures resulted in 2.275 million Euro (MOF n.d).

As for the central budget, 1.281 million Euro were reached as central budget revenues (MOF 2009b, p. 6), while the central budget expenditures were reported for the same period at 1.437 million Euro (MOF 2009c, p. 16). This was a considerable outreach of central budget expenditures towards central budget revenues. However, that was not huge outreach in million Euro compared to 2008, as central budget expenditures increased only by 11 million Euro in 2009. This stronger overlap of budget expenditures over budget revenues can be explained by the fact Government was concerned with the crisis negative impacts on the domestic economy and decided to promulgate even more expansionary fiscal policy. This was especially with a purpose to support higher activity of the market that was achieved over the previous years, and which was losing on its dynamics in 2009. On the other hand, the same year Government also implemented cut of social contribution rates from 32 % to 22 %, despite the adverse economic climate (MOF 2009c, p. 8).

The tax revenues accounted for 80,7 % of total revenues, which was a decrease of 7,7 % compared to 2008 (MOF 2009b, p. 6). The VAT was again the most contributing. Its share in tax revenues increased and accounted for 52,4 % of total tax revenues, while profit taxes decreased almost by half and had a share of 6 % in total tax revenues (MOF 2009g, p. 9).

The situation with the non-tax revenues based on the reviewed central budget report was also with a negative trend. The main contribution was coming from corporation dividends and the NBRM profits, which were however much lower than in the previous years.

The most dominant share in budget expenditures was again represented by the current expenditures. Transfers accounted for 50,4 % of total expenditures, while salaries and allowances held 23,9 % share of total expenditures (MOF 2009b, p. 7).

With such apportionment, the general budget deficit deepened to 178 million Euro and represented 2,7 % of GDP. The central budget deficit on the other hand resulted in 156 million Euro, i.e. was 2,4 % of GDP. This in fact matched with the projections from the Pre-Accession Programme (PEP) for period of 2009-2011, where central budget deficit fluctuation was foreseen to be between 2 - 2,4 % of GDP (MOF 2009d, p. 33).

The general budget revenues in **2010** were 2.148 million Euro, while the general budget expenditures reached 2.320 million Euro (MOF, n.d.).

In 2010, the economy seemed to show higher activity. As for the central budget revenues, they enlarged and amounted in 1.323 million Euro outperforming the previous year by 3,7 % growth (MOF 2011c, p. 9). In accordance with MOF (2011d, p. 9-11), all categories of revenues showed better results except for the profit taxes, which declined by 16,8 % compared to 2009.[12] The tax revenues, which were the largest contributors of budget revenues participated with 88,6 % share in total revenues. This was a significant increase in the tax collection if taken into account the same value in 2009 which reached only 80,7 % of total revenues. Out of tax revenues, the share of VAT reached 52,2 % of total tax revenues, while the share of profit taxes resulted in 5,1 % of total tax revenues.

The central budget expenditures accounted for 1.463 million Euro (MOF 2011d, p. 10). Even though total expenditures increased by 2,2 % from 2009, their increase was not an unexpected move. Per envisaged PEP for period 2010-2012, the Government anticipated expenditures to grow. According to MOF (2010a, p. 25) a particular increase was planned for the capital expenditures, which would be higher by approximately 18 % compared to 2009.

As for the current expenditures, their structure remained similar to the years before. Transfers on social contributions and pensions, as well as subsidies towards the public and private enterprises traditionally accounted for largest share of current expenditures. They represented 50,4 % of total expenditures, while the salaries and allowances participated with 23,6 % in total expenditures (MOF 2011d, p. 10).

With above figures, general government deficit deepened to 171 million Euro or 2,5 % of GDP. The central budget had deficit of 140 million Euro, representing 2 % of GDP. The positive conclusion with both budget deficits was however, the fact that they were not exceeding projected plans. According to PEP for period of 2010-2012, in both cases predicted ceilings were set up at max 2,5 % of GDP and between 1,6 - 2 % of GDP respectively.

[12] In 2009, the advanced payments were collected on profits executed in 2007, while in 2010, because of changes in the regulations, these profits were paid only on non-exempted expenditures determined in the 2008 tax balances (MOF 2011d, p. 10).

7 Public Debt of Macedonia

The following chapter will be discussing the public debt of the Republic of Macedonia. In the first subchapter the discussion will focus on Macedonian public debt origins, while the following subchapter will provide with an analysis and research on Macedonian public debt level and its development over the years 2006 to 2010. The emphasis of the last subchapter will be on public debt solutions that Macedonian authorities applied for its effective management.

7.1 Public debt origins

Before gaining the independence in September 1991, the public finance system of the Republic of Macedonia including its public debt management was within the frame of Yugoslavia. However, Yugoslavian public system, as well as the methodologies it used significantly varied from Western countries.

The public finance methodology system was not the only attribute that Macedonia inherited from Yugoslavia. The country also undertook part of Yugoslavian federal public debt, making today‘s Macedonian public debt portfolio to comprise part of Yugoslavian inherited debt, as well as other borrowings from international financial institutions and markets (CEA 2007, p. 10). Significantly to mention in this regard is the fact that after the breakup from Yugoslavia, the Republic of Macedonia was mainly facing problems with the extension of its external debt rather than the domestic debt.

The total Yugoslavian debt towards number of creditors resulted in 15.9 million USD by the end of 1991, out of which the Republic of Macedonia inherited 850 million USD (Stanič 2001, p. 758). Among Macedonian largest creditors were international organizations and institution such as IMF, the London Club of Creditors, the Paris Club of Creditors and World Bank.

Slicing down public debt by creditors, the total Yugoslavian debt towards **IMF** equaled 683 million USD from which Macedonia was appointed to reimburse 5,4 %, i.e. 36,9 million USD of it (Stanič 2001, p. 759). Besides that, a large debt burden was inherited from Paris and London Club of Creditors.

Until 2006, the **London Club of Creditors** accounted for Macedonian largest single creditor. Yugoslavian public debt towards London Club of Creditors amounted in 4.4 million USD (Mrak 1998, p. 18). In 1997, the Republic of Macedonia made however an agreement with London Club of Creditors to take under its responsibility about 5 % of Yugoslavian public debt towards this institution (IMF 1998, p. 179). The same year upon an agreement reached, the Republic of Macedonia issued bonds in total amount of 228,7 million USD (Mrak 1998, p. 27). Until year 2000, Macedonian public debt towards London Club of Creditors was constantly increasing. This was due to additional borrowings made by the country from this institution. In 2006, Macedonian public debt towards London Club of Creditors reached the highest point of 253 million USD (MOF 2006, p. 22), but the same year it was early redeemed by the country.

Concerning the **Paris Club of Creditors**, the total public debt Yugoslavia had towards it was 4.2 million USD in 1991 (Stanič 200, p. 760). In 1995, after several years of arrangements going on, the Republic of Macedonia reached an agreement to take 323 million USD of this public debt on its behalf (Mrak 1998, p. 26).

Yugoslavia had also debt towards the **World Bank**. According to Mrak (1998, p. 16), this debt resulted in 2 billion USD. In 1994, the Republic of Macedonia inherited 7,5 % of it, i.e. 153,9 million USD.

The other concepts that were having an inevitable impact on Macedonian public debt portfolio were budget deficits, especially the „chronic" ones from early years of Yugoslav independence. The Republic of Macedonia leaving the former federation with the poorest economic evolution among all six federal states had to confront its small, underdeveloped, and closed market. Consequently, it had to face problems with its government budget balances being unstable starting from 1991. For instance, there was a large positive fluctuation of budget deficit of 13,4 % of GDP in 1993 towards budget deficit of 2,9 % of GDP in 1994; and a negative downslope from budget surplus of 1,8 % of GDP in 2000 to budget deficit of 7,2 % of GDP in 2001 (MOF 2005a, p. 96).

The first positive slump was because of disinflation in the economy in 1994. The failure in 2001, came out of a crisis that occurred between Macedonian and Albanian ethnic groups and induced large budget expenditures on security and military equipment.

Some other issues having overall impact on Macedonian economy also accompanied the period between years 1994 and 2000. In 1995, Greece imposed a yearlong trade embargo against Serbia, which at the end considerably slowed down Macedonian market economy that was still in its early transition stages and was very dependent on trade interactions with Serbia (USAID 1997, p. 3).

In 1998, Macedonian Government faced another issue striking that time its largest commercial bank “Stopanska banka”. During the second half of 1998, the bank failed to fulfil minimum reserve requirements and by such forced Macedonian Government to take a decision of its recapitalization. The same year were issued the euro-denominates bonds in total amount of 133,6 million USD[13] that additionally enlarged Macedonian public debt (Drummond 2000, p. 26).

The total external debt due the above-mentioned major reasons was ranging in years 1993 to 2005 between its highest point of 45,4 % of GDP in 1993, and its lowest point of 26,5 % of GDP in 1996 (NBRM, 2012a). As for the situation with the domestic debt over the same period, it started increasing in relation to the external debt since 1999. This improvement was reached mainly due to development of the domestic financial market, which has been one of MOF’s targets since 1991.

7.2 Public debt developement

The Public debt Law of the Republic of Macedonian defines the public debt as a sum of „*government debt and all financial liabilities created by municipalities borrowings, as well as borrowings by the city of Skopje, public enterprises and companies being fully or predominantly owned by the state*” (Public Debt Law 2005, art. 2, § 2). This public debt definition is assumed as a national methodology. It omits the debt of NBRM as

[13] In the original source the amount is 235 million Deutsche Mark.

part of Macedonian public debt. However, Public Debt Law was revised in years 2008 and 2011 in order to become in accordance with the IMF GFSM methodology. Since then, the debt of NBRM has also become part of public debt, but the national methodology has been still kept and used in the Macedonian reports. In the below section, the figures will be presented solely per the IMF GFSM methodology.

For better view on the situation of Macedonian public debt development through years 2006 to 2010, below there is an illustrative table with the most significant numbers:

Table 3 Public debt development

Public Debt in million Euro	2006	2007	2008	2009	2010
Total Public Debt	2.029,5	1.927,8	1.869,8	2.128,8	2.458
% of GDP	40,4	35,3	28,2	32,1	35,2
General Government Debt	1.673,6	1.430	1.386,7	1.597,2	1.710,8
% of GDP	33,3	26,2	20,9	24,4	24,6
External Debt	1.223	1.027,9	1.115,7	1.373,7	1.484,3
% of total debt	60,3	68	59,6	64,5	60,4
Domestic Debt	806,5	899,9	754,1	755	973,7
% of total debt	39,7	32	40,4	35,5	39,6

Source: MOF, 2007f; MOF, 2008a; MOF, 2008a; MOF, 2008c; MOF,2009a; MOF, 2010c; MOF, 2011d; Government Report, 2011.

In year **2006**, as per MOF (2007f, p. 32) the **total public debt** amounted in 2.029,5 million Euro, i.e. 40,4 % of GDP, while the **general government debt** was 1.673,6 million Euro and equalled 33,3 % of GDP.

The structure of Macedonian public debt by creditors was divided mostly among multilateral creditors that were participating in more than half of the public debt and included such institutions as IMF, EBRD and IDA. The private and bilateral creditors had significantly lower participation in Macedonian public debt. Such structure by creditors stayed unchanged over all examined years.

The **external debt** amounted in 1.223 million Euro and represented 60,3 % of the total debt, while the **domestic debt** was 806,5 million Euro being respectively 39,7 % of the total debt (MOF 2007f, p. 32). Such apportioning increased the share of domestic debt towards the external debt compared to 2005, however not by huge deal. While on one hand, there was a promotional issuance of treasury bills for monetary purposes by the NBRM issued in MKD currency, authorities also issued the 5th sequence of

Denationalization bonds (the first was in 2002). These Denationalization bonds were in total amount of 34 million Euro (MSE, 2011).

Both **interest and currency rate structures** of public debt were changed positively compared to 2005. Great deal for reaching better results played the fact that in 2006, the Republic of Macedonia managed to lower part of its euro-denominated debt that had variable interest rate. This occurred through an early debt redemption executed towards the London Club of Creditors. The full instalment amounted in 184,3 million Euro (MOF 2007a, p. 3). This also meant cleaning of the old debt inherited from Yugoslavia towards the largest creditor. As per MOF (2007a, p. 38), the share of public debt with fixed interest rate was covering 60 % of total public debt in 2006. As for the debt currency structure, the euro-denominated debt was rectified from 55 % to 58 % in 2006, while the denar-denominated debt held 11 % share of total public debt.

As for the **borrowings** in 2006, their gross (external and domestic) amount accounted for 153,2 million Euro (MOF 2007a, p. 40), while the projected target was estimated at 180 million Euro (MOF 2007f, p. 12). Borrowings were mostly done from commercial creditors IMF, EBRD, EIB and IBRD.

In year **2007**, as per MOF (2008a, p. 57-61) the **total public debt** resulted in 1.927,8 million Euro representing 35,3 % of GDP. Compared to 2006, this was a decline of 5,1 % of GDP. The **general government debt** accounted for 1.430 million Euro and participated with 26,2 % of GDP, which was a decline of 7,1 % of GDP compared to 2006. For public debt decrease mostly contributed the early repayment of so called Italian debt that the Republic of Macedonia inherited from Yugoslavia, and which was part of the debt towards Paris Club of Creditors. The total redemption of it amounted in 9,2 million Euro.

Other actions that helped public debt to decrease were the early repayments done in favor of IMF amounting in total of 32,8 million Euro; as well as repayments executed towards IBRD amounting in total of 96,1 million Euro (MOF 2007b, p. 27).

In 2007, the **external debt** reached 1,027.9 million Euro (MOF 2008c, p. 10) staying mostly comprised of official creditors WB, EIB and EBRD. Even though it decreased by 195,1 million Euro compared to 2006, its share increased and accounted for 68 % of total public debt. The major factor behind its increase was the issuance of the 6th Denationalization bond in total amount of 18 million Euro (MSE 2011, p. 37). This amount was lower than the one of the 5th Denationalization bond (of 34 million Euro) in 2006, but was yet significant for such weak and underdeveloped economy as Macedonian was. The **domestic debt** reached 899,9 million Euro and declined its share to 32 % of the total debt (MOF 2008c, p. 16-21).

The **interest rate structure** slightly changed in favor of improving of the debt share towards the fixed interest rate. This was as result of an early redemption of Stopanska Banka rehabilitation bond of 23,9 million Euro that had variable interest rate (MOF 2007g, p. 2). However, the interest rate structure did not change positively to a huge extend as Macedonian authorities unfortunately did not manage to agree upon prevailing of fixed interest rates on the majority of government securities issued in 2007. As per the reports end of 2007, the fixed interest rate debt share encompassed 62 % of total public debt, while the share of the debt with variable interest rate constituted the rest 38 % of total public debt (MOF 2009a, p. 60). As for the **currency rate structure**, the denar-denominated debt remained with the same share of 11 % in total public debt , while the euro-denominated structure grew and ended up at 66 % of total debt (MOF 2009a, p. 60).

The new **borrowings** executed in 2007 were much lower than in 2006 and reached 90.2 million Euro vis-à-vis the projected ceiling for borrowing of 203 million (MOF 2008c, p. 21) The largest borrowing was coming from the WB on the basis of Second Programmatic Development Policy Loan which amounted in 23,3 million Euro (MOF 2008c, p. 12). The rest of the borrowing were smaller and were intended for different projects, where the amount of each was not exceeding 10-15 million Euro.

In **2008,** as per MOF (2009a, p. 59) the **total public debt** was measured at 1.869,8 million Euro and accounted for 28,2 % of GDP. This was a successful decrease of 7,1 % of GDP from 2007. The **general government debt** was at 1.386,7 million Euro, i.e. was 20,9 % of GDP.

The shrinkage of the total public debt was as a result of the politics led for borrowings‘ reduction. They especially intensified towards to end of 2008 when the global financial crisis started suppressing the economic activity. Macedonian public debt also lowered due to the NBRM debt decrease from 344,3 to 285,2 million Euro; as well as due to the final redemption of treasury bills for monetary purposes originaly denominated in MKD currency, however expressed in Euro accounted for 75,5 million Euro by the end of 2007 (MOF 2009a, p. 59).

Out of total public debt, the **external debt** represented 59,6 % and increased to 1.115,7 million Euro, while the **domestic debt** represented 40,4 % of total public debt and decreased to 754,1 million Euro (MOF 2009a, p. 59). The ratio change of the external debt share towards the domestic debt share was mostly replicated by the final redemption done on the treasury bills for monetary purposes.

Concerning the **interest rate structure**, there was a significant increase of the variable interest rate in the total public debt portfolio. The debt share with variable interest rate resulted in 49 % of total public debt in 2008 (MOF 2010c, p. 11). Even though the fixed interest rate share was retaining its bigger part in the total debt, it accounted for 51 % of the total debt, the overall outcome showed an unfavorable progress since 2007. The reason for that was mainly the fact that the NBRM was issuing bank bills predominantly with variable interest rates that were varying between 4,7 and 8 % (NBRM, 2012b).

The **currency structure** improved for both MKD (denar) and Euro currencies compared to 2007. While the denar-denominated debt share accounted for 23 % of total public debt, the euro-denominated debt share was 57 % of total public debt (MOF 2009a, p. 60). The prevailing euro currency in the public debt was maintained due to majority of the borrowings done in Euro. However, the improved denar-denominated debt structure compared to 2007, besides other factors, was as a result of MOF managing to issue two Continuous Government bonds in total amount of 210,2 million MKD in 2008, i.e. 3,4 million Euro (MSE, 2011).

The **new borrowings** amounted in 183,2 million Euro, while the initially projected borrowings were planned at 530 million Euro (MOF 2009e, p. 18). Among most significant borrowing was the Third Programmatic Development Policy Loan that amounted in 16,7 million Euro and was obtained from WB (WB 2008, p. 1). Another large borrowing in 2008 was the Regional and Local Roads Program Support Project, which was USD denominated and amounted in 105,2 million USD (WB, n.d.).

In **2009**, as per MOF (2010c, p. 11) the **total public debt** resulted in 2.128,8 million Euro, i.e. 32,1 % of GDP. The **general government debt** increased by 210,5 million Euro, and measured 1.597,2 million Euro, which was representing 24,1 % of GDP.

For the significant public debt increase in comparison to the previous years were mostly responsible the issuance of the Eurobond of 175 million Euro (IMF 2012, p. 3), as well as the issuance of the 8th Denationalization bond of 23 million Euro (MSE, 2011). Moreover, in 2009 was imposed a restriction on the general allocation of special drawing rights in IMF, causing public debt to increase for additional 258,1 million Euro (MOF 2010d, p. 8).

The **external debt** amounted in 1.373,7 million Euro and accounted for 64,5 % of the total pulic debt (MOF 2010c, p. 34-37). Its increase was directly related to the Eurobond‘s issuance. The **domestic debt** accounted for 755 million Euro (MOF 2010c, p. 39), remaining almost unchanged from year 2008.

The fixed and the variable **interest rates** kept relatively equal ratio in the debt’s interest rate structure. By the end of 2009, the share of the debt with fixed interest rate accounted for 51 % of total public debt, while the debt that had variable interest rate was 49 % of total public debt (MOF 2010c, p. 11).

The **currency structure** of the debt in 2009 revealed that there was 65 % participation of the euro-denominated debt keeping its dominant share in the total debt, while the denar-denominated debt participated with only 14 % of total debt (MOF 2010c, p. 35). This was lower result compared to 2008 by 9 %. The decline of the denar-denominated debt structure was mainly related to the issuance of the euro-denominated Denationalization bond and Eurobond, which was mentioned in the previous paragraph.

The **new borrowings** in 2009 were summed up to 96,8 million Euro, including projects on roads and railways infrastructure, municipal services improvements, as well as other projects for social and municipal development (MOF 2010c, p. 17-18).

As per MOF (2011d, p. 48), the **2010 total public debt** was 2.458 million Euro and equaled 35,2 % of GDP. The **general government debt** for the same fiscal period resulted in 1.710,8 million Euro representing 24,6 % of GDP.

According to the Government report (2011, p. 32-34), the **external debt** increased and amounted in 1.484,3 million Euro. Its share in total public debt was 60,4 %. The **domestic debt** also increased. While in 2009 it reached 755 million Euro, in 2010 it grew to 973,7 million Euro that was equaling 39,6 % of the total debt.

The increase of the public debt was mainly coming from the increase of the NBRM debt, which almost doubled in 2010. While in 2009 it accounted for 260,4 million Euro, in 2010 it increased to 422,5 million Euro (Government report 2011, p. 34). Generally, the main reason for public debt increase in 2010 was on the side of the domestic debt, more specifically due to the NBRM continuous government bonds increasing. These included both treasury bills and treasury bonds volume expansions.

The debt structure by **interest rate** constituted 44,6 % of fixed interest rate share and 55,4 % of variable interest rate share in total public debt (Government report 2011, p. 30). The decline of the fixed interest rate share by 6,4 % compared to 2009 was mostly influenced by the issued bonds, as well as the money borrowed for projects that were predominantly agreed upon variable interest rates.

Concerning the debt **currency structure**, the prevailing share was again on the side of euro-denominated debt. It represented 58 % of total debt portfolio, while the denar-denominated debt represented 22 % of total debt (Government report 2011, p. 31). This was a positive outcome, if taken into account the fact that in 2010 was issued the 10th Denationalization bond amounting in 30 million Euro (Eurobroker, n.d.).

In 2010, the **new borrowings** resulted in 162,4 million Euro versus 350 million Euro which were previously projected (Government report 2011, p. 23). They were used for reconstruction of buildings, including reconstruction of medical centers and improvement of the roads, as well as investments done in the energy sector sphere and in projects for processing MOF‘s reforms (MOF 2011d, p. 48).

7.3 Public debt solutions

Taking a retrospective look at the previous chapters where firstly was examined government budget followed by the chapter dealing with public debt development, one can notice that the Republic of Macedonia managed to maintain both macroeconomic areas not to reach large fluctuations. Moreover, both areas were sustained within the frame of proposed Maastricht criteria. This especially applied in relation to the low public debt that made the Republic of Macedonia remain among countries with moderate indebtedness. That public debt was kept stable, had been even proving recently performed stress tests on it.

Over the last half decade, Macedonian state authorities have taken number of measures on maintaining low level of public debt; but even more, they have been concentrating on diminishing its overall risk. For reaching such improvements, as well as for purpose of following the EC recommendations, MOF started releasing annual public debt plans and projections in a form of Fiscal Policies and Public Debt Management (PDM) documents. As for the PDM, its annual publishing started in 2005. A particular focus, besides maintenance of macroeconomic and fiscal sustainability was set to predetermine and withhold the public debt to GDP ratios. Moreover, as per the Debt Strategy (2010d, p. 3), all released PDM documents have been set in accordance with the following principles of:

- establishing of optimal debt portfolio structure and its harmonization with the national macroeconomic policies;
- harmonizing the debt portfolio costs with the state budget on yearly and mid-term basis;
- restriction and elimination of risk effects on public debt sustainability on mid-tem and the long-term basis.

Going onwards, as a part of the Fiscal strategy for year 2012, MOF envisaged the fiscal deficit to be reaching maximum of 2,5 % GDP (MOF 2012a, p. 37). This projection was later examined by the IMF experts that approved it as an attainable, however suggested to decrease the deficit ceiling in order not to jeopardize the debt sustainability in the upcoming period (MINA, 2011).

With regular proposals and help from the experts of the international financial organizations and institutions, Macedonian state authorities have been continuously working on lowering the interest rates on the items borrowed or issued, as well as trying to create more favorable interest rate structure which would have fixed interest rates prevailing. This trend has not been yet stabilized concerning Macedonian public debt, but some steps have been already processed partly.

Starting from 2002 and all the way to 2009, MOF issued eight Denationalization bonds in total amount of 250,6 million Euro which were agreed upon annual fixed interest rate of 2 %. This incrementation of public debt portion with fixed interest rates should help the Republic of Macedonia avoid the risk of interest rates fluctuations in the future.

Besides that, there have been done attempts towards the extension of the maturity period on government issued bonds. With eight issuances of Denationalization bonds, MOF managed to reach 10 years maturity date on each bond. Moreover, this direction was applied towards Yugoslavian public debt handling. A good example is the case when Macedonian state authorities at some point agreed with both London and Paris Club of Creditors on a postponement of the debt repayment towards them.

The currency structure of Macedonian public debt has also been taken in consideration. In this regard, state authorities have been striving to keep the public debt prevalently in MKD currency, while the euro denomination have been second most preferred choice. For that purpose, the Republic of Macedonia has enlarged the issuance of government bonds and treasury bills for monetary purposes in Denar (MKD) denomination over the last several years. In 2006, the Compensation bond of NBRM selective credits was issued in total amount of 1.039 million MKD, i.e. 17 million Euro, followed the same year by the Rehabilitation bond of Stopanska Banka, which was also over 1 billion MKD, i.e. around 16,3 million Euro (MOF 2005b, p. 10). In 2008, according to the Government report (2011, p. 10) and MSE (2011) this trend was continued by issuing of two Continuous Government bonds No.2 and No.3 amounting together in 210,2 million MKD, i.e. 3,4 million Euro. In addition to them, in 2010, the NBRM kept on issuing treasury bills in Denar denomination to even greater extend. Unfortunately, in all these cases were not reached agreements on fixed interest rates.

As for the Euro-denomination debt, the Republic Macedonia has processed its first issuance of Eurobond in December 2005 and the second one in 2009 (IMF 2012, p. 12). State authorities also planned on issuing another Eurobond; however, this plan was cancelled in 2010 due to the turmoil in the international markets, as well as due to Greek financial problems.

Many discussions were been going on about the Eurobond topic. At some instance, Macedonian Minister of finance was even criticized by the local observers who were suggesting that instead of Eurobonds, the Republic Macedonia should obtain loans from IMF that have more favorable interest rates (Marusic, 2010). On the other hand, IMF evaluated Macedonian public debt strategy towards Eurobond markets as an „*appropriate on balance*“, although suggesting in order to sustain low public debt level, the country should focus on expanding of its domestic debt market, as well as focus on sustaining of more balanced budget policy, i.e. lowering the fiscal deficit (IMF 2011, p. 18). Moreover, IMF experts believed that the expansion of Macedonian domestic debt market should help country reduce its external financing vulnerabilities and achieve greater availability of domestic financing sources, which would eventually diminish the reliance on external funding (IMF 2011, p. 65-83). This is particularly related to the third principle of public debt strategy, which targets were to restrict or eliminate the risk effects on the public debt sustainability.

The foreign sector is another significant working point Macedonian authorities have been focusing on for to improve the public debt condition. The stimulation and improvement of country's trade balance, i.e. the growth of its exports should help country decrease its external debt. In this regard, Macedonian state authorities have been expecting increase of both exports and FDIs in the upcoming four years. Particularly for the export, its growth has been expected to vary between from 8 % to 10 % of GDP (Government, n.d.).

The continuous improvement on public debt portfolio structure has been also part of Macedonian public debt strategy over past several years. This has been particularly emphasized in attempts to avoid accumulation of an external debt. The sequence of successful managing of this issue has been however still fluctuating in the country. Representing around 40 % share of total public debt is an average condition that domestic debt reaches. The year 2008 was the most successful in this regard, as the domestic debt reached 40,4 % share of total public debt.

Macedonian authorities have been in addition constantly seeking for advantages of early debt redemptions. An example was the year 2006, when the Republic of Macedonia managed to achieve early repayment of the debt towards its largest foreign creditor, the London Club of Creditors (MOF 2009e, p. 29). The next year, a significant share of the debt was repaid towards the Paris Club of Creditors, with so-called Italian debt. Such actions were done in order to ensure a smooth temporary repayment profile and to reduce the overall public debt risk. Moreover, these approaches helped create a reduction of the external debt share, an indebtedness that cannot be forfeited.

8 Conclusion

Besides the goal of gaining additional theoretical knowledge on the public finance areas such as the government budget and public debt, the main goal of the diploma thesis was to analyze the level and development of the government budget deficits and public debt formations in the Republic of Macedonia. Finding answers on the reasons laying behind Macedonian government budget and public debt formation was the second goal of the diploma thesis. Thesis‘ last goal involved identification of the proposed solutions and actions taken by Macedonian state authorities for public debt level maintenance and its eventual reduction.

While the first part of diploma thesis aimed to provide with a theoretical view on government budget and public debt formation along with other macroeconomic areas related to this subject such as fiscal policy, revenues-expenditure structures and government budget process; the second part applied these theoretical assumptions into a real environment by analysing and examination the situation of government budget and public debt in the Republic of Macedonia between years 2006 to 2010.

The main reason for selecting year 2006 for the first year for analysis was the fact that Republic of Macedonia gained EU candidate status in December 2005 and started introducing number of reforms to improve the reliability and stability of reporting of its macroeconomic data. These reforms mainly involved implementation and adoption of the GFSM2001 and ESA95 methodologies that have been commonly used in the developed countries. On the other hand, year 2010 closed the analysis of the diploma thesis, since it was the most recent year for which all consolidated reports and other data for the subject of the diploma thesis were available. The analysis of the macroeconomic data during this period additionally revealed that the level of reporting was rather challenging, since calculation and interpretation methods were sometimes missing unification due to a gradual implementation of the adopted methodologies. This forced the author to use large number of sources for being able to analyze and compare reported data, as well as to minimize the risk of data inadequacy.

The findings on the levels and development of government budget deficits and public debt formation in the Republic of Macedonia showed that country managed to fulfill the

Maastricht criteria over the examined years 2006 to 2010, i.e. it succeeded maintaining its budget deficit below 3 % of GDP and public debt below 60 % of GDP. As for the government budget, in year 2007, it was recorded even reaching surplus 0,6 % of GDP. On the other hand, except for 2007, the outcome of analysis of other years revealed that the Republic of Macedonia suffered from fiscal imbalances. While the overall trend of government budget balances stayed in deficit with reaching its highest level of 2,7 % of GDP in 2009, the most moderate budget deficit was seen in year 2006, reaching 0,5 % of GDP.

The analysis and comparisons performed over the public debt revealed that its level was staying rather moderate but has had a growing tendency. Its highest level of 40,4 % of GDP was achieved in 2006, while the lowest level was in 2008, when it accounted for only 28,2 % of GDP. While the low level of public debt can be viewed positively, on the other hand, such results can also be explained by the presence of low and sluggish economic activity, as well as the conservative approach of state authorities in regard to state borrowings, since the planned versus executed borrowings were showing positive gaps in each of the examined years.

The second goal of the thesis, i.e. the reasons and factors for public debt and associated with it government budget deficit formation in the Republic of Macedonia could be viewed from various perspectives. Based on the research done, for most significant reasons accounted the unstable economic activity and growth, little experience in leading public finances, existence of an underdeveloped domestic market, as well as the expansionary and contracyclical fiscal policies Government was imposing. The global financial crisis in 2008 was another major factor that had negative impact on the government budget deficit and public debt. It started curbing Macedonian economy in 2009, and contributed for public debt level to be constantly increased ever since. Besides that, the research performed on the origins of Macedonian public debt provided with additional valuable answers about Macedonian public debt accumulation. In fact, after the separation from Yugoslavia in 1991, the Republic of Macedonia was forced to inherit part of Yugoslavian public debt which amounted in 850 million USD. Moreover, the inherited structure and interest rates were not always favorable. As for the inherited debt structure, its largest share was towards foreign creditors, such as the Paris and

London Club of Creditors, IMF and WB. On the other hand, the interest rates of the public debt had in most cases variable interest rates.

The last goal of the diploma thesis strived to reveal how Macedonian authorities were managing above mentioned negative issues. Although Macedonian history of public finance is rather short as the country has been independent for about 20 years, certain actions for improvement of government budget deficit and public debt level have already been taken. One of those actions included Macedonian state authorities making a commitment to EC representatives to periodically prepare the macroeconomic data and present it annually. This was previously executed on an ad-hock basis. Besides that, Macedonian authorities have been striving for continuous improvement of country‘s economic activity and for reaching higher economic growth. Such arrangements predominantly involved focusing on development of the domestic market and strengthening of capital investments in order to reach better infrastructure and higher physical capital in the country. Even though Government has been managing to issue government bonds on a yearly basis, the domestic market persists being weak and still seeks for an increase of its activity and liquidity. Efforts have been also made to keep the price level and the Macedonian Denar exchange rate stable. Furthermore, attention has been paid on refining of the legal and judicial systems. Such amendments have been taken with a consideration to cut the costs for doing business in Macedonia, to attract additional FDIs inflow, and by such to support the creation of new jobs in the country.

Nevertheless, for a successful decrease of government budget deficits and public debt in the Republic of Macedonia, there has not been paid enough attention on decreasing of public expenditures and at the same time increasing of public revenues. This can be explained by the contradictory fact that while on one hand side Government processed number of reforms that have been envisaged to enhance the social system and consequently reduce the public expenditures; on the other hand, Government imposed decrease of profit taxes and VAT in years 2007 and 2008. Though the last Government action was with an intention to improve the economic activity and support the economy especially during the recession in 2009, the decrease of tax rates also decreased the inflow of public revenues. Similar are the suggestions concerning the structure of the public debt, where there is a noticeable prevalence of the foreign debt share, foreign currency denominated debt, as well as a prevalence of variable interest rates in the total public debt. To succeed in maintaining or even decreasing of the public debt, state authorities of the Republic of Macedonia should constantly work on lowering of values of the above mentioned measures, as well as work on achieving more favorable agreements and conditions on the government borrowing.

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Annexes

Appenex 1 GFSM 2001 - Classification of Revenue

Revenue	
11	**Taxes**
111	Taxes on income, profits, and capital gains
1111	Payable by individuals
1112	Payable by corporations and other enterprises
1113	Unallocable
112	Taxes on payroll and workforce
113	Taxes on property
1131	Recurrent taxes on immovable property
1132	Recurrent taxes on net wealth
1133	Estate, inheritance, and gift taxes
1134	Taxes on financial and capital transactions
1135	Other nonrecurrent taxes on property
1136	Other recurrent taxes on property
114	Taxes on goods and services
1141	General taxes on goods and services
11411	Value-added taxes
11412	Sales taxes
11413	Turnover and other general taxes on goods and services
1142	Excises
1143	Profits of fiscal monopolies
1144	Taxes on specific services
1145	Taxes on use of goods and on permission to use goods or perform activities
11451	Motor vehicle taxes
11452	Other taxes on use of goods and on permission to use goods or perform activities
1146	Other taxes on goods and services
115	Taxes on international trade and transactions
1151	Customs and other import duties
1152	Taxes on exports
1153	Profits of export or import monopolies
1154	Exchange profits
1155	Exchange taxes
1156	Other taxes on international trade and transactions
116	Other taxes
1161	Payable solely by business
1162	Payable by other than business or unidentifiable
12	**Social contributions**
121	Social security contributions
1211	Employee contributions
1212	Employer contributions
1213	Self-employed or nonemployed contributions
1214	Unallocable contributions
122	Other social contributions
1221	Employee contributions
1222	Employer contributions
1223	Imputed contributions
13	**Grants**
131	From foreign governments
1311	Current
1312	Capital
132	From international organizations
1321	Current
1322	Capital
133	From other general government units
1331	Current
1332	Capital
14	**Other revenue**
141	Property income
1411	Interest
1412	Dividends
1413	Withdrawals from income of quasi-corporations
1414	Property income attributed to insurance policyholders
1415	Rent
142	Sales of goods and services
1421	Sales by market establishments
1422	Administrative fees
1423	Incidental sales by nonmarket establishments
1424	Imputed sales of goods and services
143	Fines, penalties, and forfeits
144	Voluntary transfers other than grants
1441	Current
1442	Capital
145	Miscellaneous and unidentified revenue

Source: Jacobs 2009, p.16.

Appenex 2 GFSM 2001 - Economic Classification of Expense

Expense			
21	**Compensation of employees**	**27**	**Social benefits**
211	Wages and salaries	271	Social security benefits
2111	Wages and salaries in cash	2711	Social security benefits in cash
2112	Wages and salaries in kind	2712	Social security benefits in kind
212	Social contributions	272	Social assistance benefits
2121	Actual social contributions	2721	Social assistance benefits in cash
2122	Imputed social contributions	2722	Social assistance benefits in kind
22	**Use of goods and services**	273	Employer social benefits
23	**Consumption of fixed capital**	2731	Employer social benefits in cash
24	**Interest**	2732	Employer social benefits in kind
241	To nonresidents	**28**	**Other expense**
242	To residents other than general government	281	Property expense other than interest
243	To other general government units	2811	Dividends (public corporations only)
25	**Subsidies**	2812	Withdrawals from income of quasi-corporations (public corporations only)
251	To public corporations	2813	Property expense attributed to insurance policyholders
2511	To nonfinancial public corporations	2814	Rent
2512	To financial public corporations	282	Miscellaneous other expense
252	To private enterprises	2821	Current
2521	To nonfinancial private enterprises	2822	Capital
2522	To financial private enterprises		
26	**Grants**		
261	To foreign governments		
2611	Current		
2612	Capital		
262	To international organizations		
2621	Current		
2622	Capital		
263	To other general government units		
2631	Current		
2632	Capital		

Source: Jacobs 2009, p.17.

Appenex 3 GFSM 2001 - Functional Classification of Expense

Total outlays	
701	General public services
7011	Executive and legislative organs, financial and fiscal affairs, external affairs
7012	Foreign economic aid
7013	General services
7014	Basic research
7015	R&D[1] General public services
7016	General public services n.e.c.[2]
7017	Public debt transactions
7018	Transfers of a general character between different levels of government
702	**Defense**
7021	Military defense
7022	Civil defense
7023	Foreign military aid
7024	R&D Defense
7025	Defense n.e.c.
703	**Public order and safety**
7031	Police services
7032	Fire protection services
7033	Law courts
7034	Prisons
7035	R&D Public order and safety
7036	Public order and safety n.e.c.
704	**Economic affairs**
7041	General economic, commercial, and labor affairs
7042	Agriculture, forestry, fishing, and hunting
7043	Fuel and energy
7044	Mining, manufacturing, and construction
7045	Transport
7046	Communication
7047	Other industries
7048	R&D Economic affairs
7049	Economic affairs n.e.c.
705	Environmental protection
7051	Waste management
7052	Waste water management
7053	Pollution abatement
7054	Protection of biodiversity and landscape
7055	R&D Environmental protection
7056	Environmental protection n.e.c.
706	Housing and community amenities
7061	Housing development
7062	Community development
7063	Water supply
7064	Street lighting
7065	R&D Housing and community amenities
7066	Housing and community amenities n.e.c.
707	**Health**
7071	Medical products, appliances, and equipment
7072	Outpatient services
7073	Hospital services
7074	Public health services
7075	R&D Health
7076	Health n.e.c.
708	**Recreation, culture, and religion**
7081	Recreational and sporting services
7082	Cultural services
7083	Broadcasting and publishing services
7084	Religious and other community services
7085	R&D Recreation, culture, and religion
7086	Recreation, culture, and religion n.e.c.
709	**Education**
7091	Pre-primary and primary education
7092	Secondary education
7093	Postsecondary nontertiary education
7094	Tertiary education
7095	Education not definable by level
7096	Subsidiary services to education
7097	R&D Education
7098	Education n.e.c.
710	**Social protection**
7101	Sickness and disability
7102	Old age
7103	Survivors
7104	Family and children
7105	Unemployment
7106	Housing
7107	Social exclusion n.e.c.
7108	R&D Social protection
7109	Social protection n.e.c.

Source: Jacobs 2009, p.18.