



**REPUBLIC OF MACEDONIA  
GOVERNMENT OF THE REPUBLIC OF MACEDONIA**

# **2019-2021 FISCAL STRATEGY OF THE REPUBLIC OF MACEDONIA**

**Skopje, May 2018**

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Pursuant to Paragraph 2, Article 16 of the Budget Law („Official Gazette of the Republic of Macedonia“, no. 64/2005, 04/2008, 103/2008, 156/2009, 95/2010, 180/2011, 171/2012, 192/2015 and 167/2016), Government of the Republic Of Macedonia, at its session held on 22 May 2018, adopted the 2019-2021 Fiscal Strategy of the Republic of Macedonia.

## Introduction

The definition of medium-term economic and fiscal policy guidelines is the key tool in the overall complex process of budget planning, since they provide fiscal assumptions on which the preparation of the next budgets of the Republic of Macedonia is based. The 2019-2021 Fiscal Strategy of the Republic of Macedonia is prepared in line with the legal regulations, the practice and the methodology of the developed countries, and it is a necessary tool when determining the initial framework for conducting fiscal policy in the following medium-term period.

The Medium-Term Fiscal Strategy is the key document in determining the medium-term fiscal goals of the Government of the Republic of Macedonia and their connection with the strategic priorities of the Government, as well as a tool to monitor the dynamics of revenues and expenditures in relation to the fiscal goals. The medium-term expenditure framework, as part of the Fiscal Strategy, is aimed at integrating the policies with the decisions on allocation of resources, in a multi-year context, thus contributing to better efficiency when using the public finances and adopting better policy decisions. In short, the Medium-term expenditure framework is a strategic allocation of resources towards the achievement of the government priorities.

The Government of the Republic of Macedonia has identified the most important strategic priorities in the Decision on Determining Strategic Priorities, as follows:

- Economic growth, increased productive employment and improved living standard of the citizens;
- The Republic of Macedonia - NATO and EU member;
- Decisive and non-selective fight against organised crime and corruption;
- Strengthened rule of law by impartial and non-discriminatory implementation of the laws, building independent institutions and functioning local government system;
- Education reforms and investments in innovations and information technology;
- Judiciary reforms;
- Full implementation of the Ohrid Framework Agreement and building of a civic state and ethnic cohesion.

Further, the public debt management policy sets the framework for the Government of the Republic of Macedonia to act towards prudent public debt management in the medium term. The main principles taken into account when managing the public debt portfolio, i.e. when preparing and implementing the public debt management policy, are the following:

- Determining the optimal structure of debt portfolio and its harmonisation with the national macroeconomic policy;
- Aligning the debt portfolio-related costs with the costs set in the budget for each year separately and in the medium term, and
- Limiting and eliminating the effect of the risks on public debt sustainability in both the medium and the long run.

In order to strengthen fiscal discipline, the Medium-Term Fiscal Strategy introduces budget expenditure ceilings, i.e. both total ceilings and ceilings by budget user. Related to this, the annual growth rate of total budget expenditures of the central government budget (Budget of the Republic of Macedonia) will gradually drop from 7.7% in 2018 to 6.3% in 2019, 5.1% in 2020 and 4.2% in 2021. Combined with the expected revenue collection, this will result a gradual narrowing of the overall budget deficit from 2.7% of GDP in 2018 to 2.5% in 2019, 2.3% in 2020 and 2% of GDP in 2021. The primary budget deficit will also drop from 1.4% of GDP in 2018 to 1.1% in 2019, further declining to 0.7% and 0.2% respectively in 2020 and 2021, i.e. the primary budget in the medium term will be almost balanced. The disciplined fiscal policy will ensure a stable public debt path, reaching, in the medium run, 54.8% of GDP in 2020 as a result of the intensified capital projects, and then dropping to 53.8% of GDP in 2021. Consequently, the public debt will be significantly below the medium- and long-run limit set at 60% of GDP.

## **1. Macroeconomic Projections**

### **1.1 International Economic Trends and Forecasts<sup>1</sup>**

The world economy in 2017 featured stronger economic growth, reaching 3.8%. Growth was mainly driven by investment recovery in the advanced countries, continued strong growth in emerging Asia, a notable upswing in emerging Europe, as well as signs of recovery in several commodity exporters. Financial conditions had a positive effect on growth strengthening, despite the signs of increased uncertainty on the capital markets and increased bond yields following signs of upward inflation in advanced economies.

Growth in highly developed countries of 2.3% in 2017 picked up by 0.6 percentage points (p.p.) compared to the previous year, which can be explained almost entirely by increased investment spending, which remained weak in the period following the global financial crisis and was particularly subdued in 2016. The European economy grew by 2.7%, with Germany, as the largest economy in the European Union, growing by 2.5%. Such growth was mainly due to the increased exports, especially in Germany and the United Kingdom, employment increase and stabilisation of the inflation rate following the several-year period of very low inflation rates, as well as favourable financial conditions, accommodative monetary policy and neutral fiscal policy.

During 2018 and 2019, global economy is expected to continue growing with a strong intensity, in circumstances of moderate expansionary fiscal policy, accommodative monetary policy and favourable financial conditions, with the projected rate of economic growth in both years of 3.9% each. Positive trends are also expected in the European economy, as a result of the favourable prospects for external demand growth, increased private investments and continued loosening of the credit conditions in the Eurozone. However, the medium-term growth in the euro area may be held back by low productivity and weak reforms related to unfavourable demographic trends. These conditions are expected to contribute to attaining 2.5% growth of the European economy in 2018 and 2.1% in 2019, with similar expectation for the German economy of 2.5% growth in 2018 and 2.0% in 2019.

### **1.2 Economic Trends in the Republic of Macedonia**

Economic activity stagnated in 2017, amid increased political uncertainty in the country in the first half of the year, when the economic activity dropped by 0.7%. On the other hand, economic growth moved to the positive zone, accounting for 0.7% in the second half of the year, thus fully neutralizing the decline in the first half of the year (Figure 1).

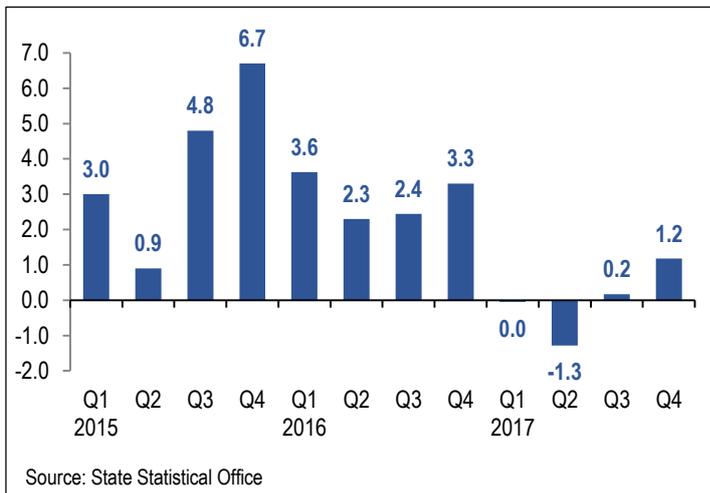
Exports of goods and services continued to grow with an intensified pace in 2017, reaching 9.2% in real terms. Export growth is mainly a result of the intensified activity of the production capacities in the free economic zones, with an additional positive contribution of domestic exporters, amid solid economic growth in the EU and favourable trends in the price of metals on the international markets. Imports of goods and services grew by 7.3% in real terms.

Consumption remained resilient to the domestic political development, experiencing real growth of 2% in 2017, as a result of the increased private consumption of 2.9%, mostly due to the growth of the household disposable income in conditions of increased employment and wages in the economy. Private consumption was also supported by crediting to households. Government consumption declined by 1.5% in real terms amid decreased public expenditures for goods and services. Gross investments were most affected by the increased uncertainty, dropping by 4.6% in real terms, mainly as a result of lower investments in construction works.

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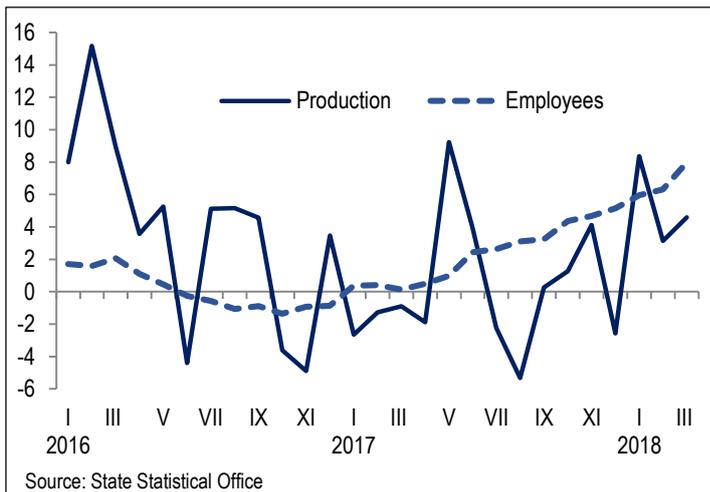
<sup>1</sup> The analysis in this section is based on the "World Economic Outlook" of the International Monetary Fund, published in April 2018.

Figure 1. Year-on-year real GDP growth (%)



Analysed by sectors, construction activity in 2017 declined by 13.7% in real terms. Industrial sector activity dropped by 2.5%, showing signs of recovery at the end of the year, in conditions of favourable developments at Manufacturing. In 2017, services sector grew by 1.7% as a result of increased activity in Trade, transport and catering and Information and communications, while the agricultural sector grew by around 4% in real terms. Industrial production grew by 5.2% in the first three months of 2018, as a result of the increased production in Manufacturing by 7.4% (Figure 2). Positive trends in the Trade sector also continued in the first three months of 2018, i.e. the total turnover in the country grew by 7.3% in nominal terms, amid increased turnover in all segments.

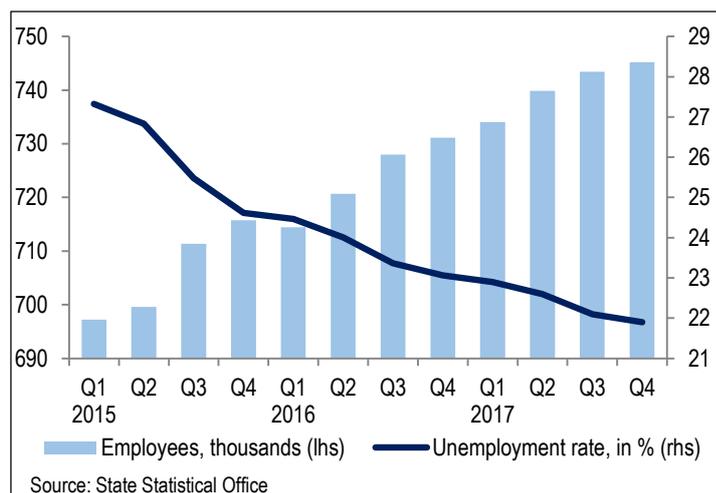
Figure 2. Year-on-year growth of industrial production and employees (in %)



Positive trends on the labour market continued in 2017 (Figure 3). According to the Labour Force Survey, the unemployment rate in the fourth quarter declined to 21.9%, i.e. by 1.2 percentage points compared to the same quarter in 2016, whereby youth unemployment also experienced a drop. The employment rate reached 44.3%, being 0.8 p.p. higher in relation to the same quarter in 2016.

The number of employees in 2017 increased by 2.4%, i.e. by around 17 thousand persons compared to 2016, whereby the largest increase of employment was registered in the services sector, in particular Trade and catering, with industrial and construction sectors also registering higher employment, while the number of employees in the agricultural sector remained unchanged. Favourable trends in the industry at the beginning of 2018 are accompanied by an increased number of workers, which surged by 6.7% in the first three months, driven by the employment growth by 7.6% in Manufacturing.

Figure 3. Number of employees and unemployment rate



The average net wage in 2017 grew by 2.6% in nominal terms and by 1.2% in real terms, with a tendency for a higher growth in the last quarter of the year, mostly as a result of the increased minimum wage. The average net wage in the period January - February 2018 grew by 4.6% in nominal terms and by 3.1% in real terms (year-on-year), thus accelerating in relation to the previous year.

Developments in the current account of the balance of payments in 2017 resulted in a low deficit of 1.3% of GDP, which is halved compared to 2016, as a result of the reduced trade deficit, increased surplus on the services account and higher transfers from abroad. The current account deficit was financed with FDI inflows, which were significant in the last quarter of the year, and accounting for 2.3% of GDP throughout 2017.

Gross foreign exchange reserves amounted to EUR 2.34 billion at the end of 2017, providing for 4-month coverage of imports of goods and services in the 12-months, thus being at an adequate level to manage possible shocks.

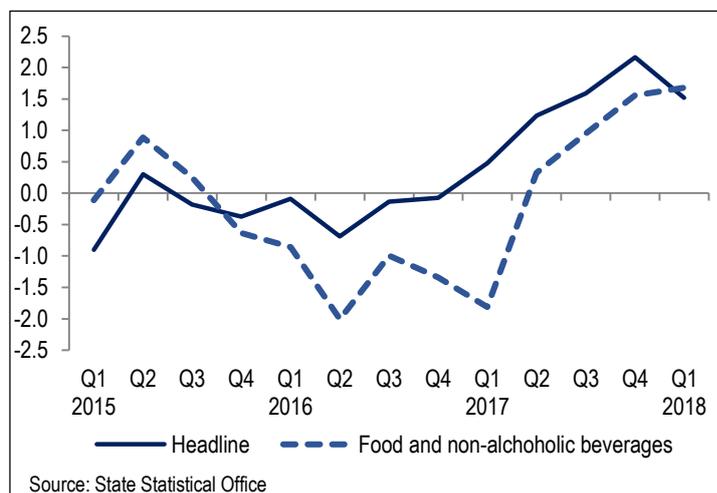
Strong exports of goods continued in the first three months in 2018, with a 13.1% growth, driven by the increased exports of machinery and transport equipment (22.5%) and chemical products (11.8%). Imports of goods in this period increased by 12.5%, mainly as a result of the higher imports of intermediary goods. Trade deficit in this period accounted for 4.5% of the projected GDP.

The inflation rate amounted to 1.4% in 2017, following the slight reduction of consumer prices in the previous three years (Figure 4). Inflation in 2017 mainly reflected the higher fuel prices, reflecting the trends on the global market, increased prices of tobacco and communications, while prices of food products remained the same. The inflation rate in the period January - March 2018 amounted to 1.5%. The quarterly dynamics showed certain inflation slowdown compared to the previous three-month period, mostly as a result of the slowed-down growth of core inflation.<sup>2</sup>

In the course of 2017, the National Bank of the Republic of Macedonia (NBRM) reduced the interest rate on Central bank bills on two occasions (by 0.25 p.p. each), from 3.75% to 3.25%. Such changes reflect the continuous stabilisation of the expectations and the confidence of the economic agents, as well as the continuous exhaustion of the effects of the political crisis on the economy. In March 2018, NBRM additionally reduced the reference interest rate to 3%, reflecting the sound economic fundamentals, in conditions of further stabilisation of the confidence of the economic agents.

<sup>2</sup> Inflation without the food and energy components.

Figure 4. Year-on-year inflation rate



Banks kept their stability and safety in conditions of political instability in the country. Total deposits in the banking system in December 2017 were higher by 5.4% year-on-year, mostly due to the increased Denar deposits. In December 2017, credit activity was higher by 5.7% year-on-year, primarily as a result of the increased crediting to households by 9.2%. In March 2018, credits to private sector grew by 5.8% year-on-year, in conditions of increased household credits by 9.4% and corporate credits by 2.5%.

### 1.3 Medium-Term Macroeconomic Projections

Fiscal policy of the Republic of Macedonia is aimed at developing the economy and raising the living standard of citizens, by supporting domestic enterprises, above all small- and medium-sized enterprises, increasing employment through the active employment measures, increasing the level of wages, as well as strengthening the social protection system.

Positive shifts at the end of 2017 and the beginning of 2018 are within the expectations and, accompanied by the government measures to stimulate the domestic demand, in particular the investments, they point out to intensified economic activity in 2018, projected to grow by 3.2%.

Political stability and the recovery of investor confidence are expected to contribute to the growth of private investments, both foreign and domestic, in the following medium-term period. The increase of wages and employment in the private sector, supported by the government measures, accompanied by the expectations for low and stable inflation in the country, will contribute to increased private consumption. Continuous solid exports by the new production capacities, as well as the recovery of the traditional exporting sectors as a result of the strengthened economic activity in the trading partner countries, will contribute to increased exports from Macedonia and greater utilisation of the industrial capacities.

Therefore, real GDP growth is expected to increase to 3.5% in 2019, and to further intensify in the following two years, i.e. it is expected to reach 4% in 2020 and 5% in 2021 (Table 1). Private consumption is projected to significantly contribute to economic growth in this medium-term period, with a 2.8% growth in real terms (Figure 5). Growth of private consumption is related to the expected growth of employment in the private sector, the gradual increase of the minimum wage, reflecting on the growth of average wage in the country, as well as the measures aimed at strengthening the social protection, which will result in increase of the household disposable income. Private consumption is expected to also be supported by the projected increase of credits to households. The real growth of government consumption in this period is projected at 1% in average.

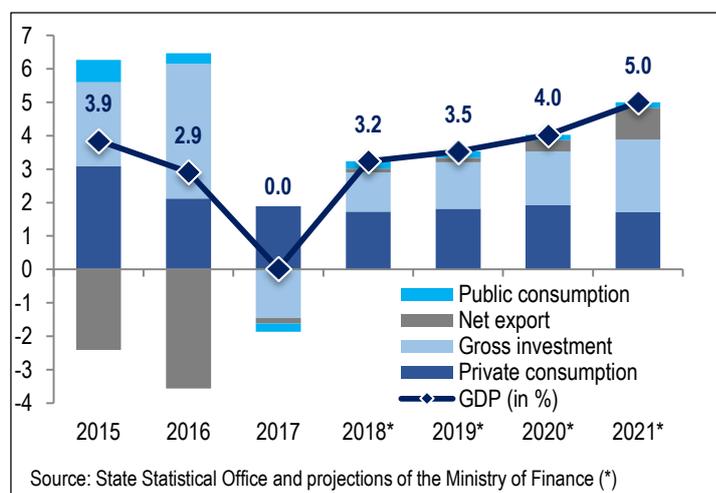
Table 1. Comparison of GDP growth and inflation projections for Macedonia

Institution	Real GDP growth (%)				Inflation rate (%)			
	2018	2019	2020	2021	2018	2019	2020	2021
IMF	2.8	3.0	3.2	3.4	1.8	1.9	2.0	2.0
World Bank	2.3	2.7	3.0	/	1.6	2.0	2.0	/
EBRD	2.5	3.0	/	/	/	/	/	/
European Commission	3.1	3.3	/	/	1.9	2.0	/	/
Vienna Institute for International Economic Studies	3.4	3.4	3.2	/	1.5	2.0	2.0	/
NBRM	3.2	3.5	/	/	2.0	2.0	/	
Ministry of Finance	3.2	3.5	4.0	5.0	1.7	2.0	2.0	2.2

Source: IMF (World Economic Outlook Database, April 2018), World Bank (Western Balkans Regular Economic Report No. 13, April 2018), EBRD (Regional Economic Prospects, May 2018), European Commission (European Economic Forecast, May 2018), WIW The Vienna Institute for International Economic Studies (Forecast Report, March 2018) and NBRM (Quarterly report, May 2018).

The growth of gross investments in the 2019 - 2021 period is projected at around 5.5% in real terms on average. Planned investments of the public sector, as well as the support to investment activity of the domestic and the foreign companies, are expected to have positive contribution to investment growth. The improved confidence of the economic agents, the improved business climate and the government measures for stimulating investments are a significant factor to attaining the projected growth of gross-investments (Figure 5).

Figure 5. GDP growth (in %) and contribution by expenditure components (in percentage points)



Net exports in the following medium term are expected to have a positive contribution to the growth of the economic activity. Exports of goods and services are envisaged to have a 8.8% real growth in average, as a result of the expectations for increased export potential of the country, in conditions of expected increase and expansion of the export capacities in the country, government support to exports stimulation, as well as the expected growth of foreign demand, especially for higher value-added products, the share of which in the domestic industry is increasing. Favourable effects on exports are also expected from the envisaged increase of prices of base metals on the medium term. Projected growth of domestic demand and export activity provides for growth of imports of goods and services which, in this period, are expected to have a 6.8% real growth on average.

The projected increase of the economic activity in the coming medium-term period is expected to be accompanied by employment increase, boosted by the active employment measures and programmes, the support to the domestic and the foreign companies for job creation, as well as other measures aimed at unemployment reduction.

According to the projections, the number of employed persons is expected to increase by 2.3% on average annually in the period 2019 - 2021. The increase of demand in this period is expected to also reflect on the labour supply, projected to increase by 1% annually in average. Such trends on the labour market will provide for the average unemployment rate to drop to 18.5% in 2021. The increase of the average net-wage in this period is expected to be 4.2% annually in nominal terms (Table 2).

Table 2. Actual and Projected Main Macroeconomic Indicators for Macedonia

	2017	2018*	2019*	2020*	2021*
GDP, real growth rate (%)	0.0	3.2	3.5	4.0	5.0
Inflation rate (average)	1.4	1.7	2.0	2.0	2.2
Export of goods (nominal growth, %)	15.7	10.1	9.0	9.6	10.9
Import of goods (nominal growth, %)	11.8	7.4	8.1	8.5	9.1
Trade balance (% of GDP)	-18.1	-16.9	-16.8	-16.6	-15.9
Current account balance (% of GDP)	-1.3	-1.9	-1.7	-1.6	-1.4
Net wage - nominal growth (%)	2.6	4.0	4.4	4.4	3.7
Net wage - real growth (%)	1.2	2.3	2.4	2.4	1.5
Unemployment rate (average)	22.4	21.5	20.5	19.6	18.5
Employment rate (average)	44.1	44.9	45.8	46.8	47.9

Source: State Statistical Office and forecast of the Ministry of Finance (\*)

Recent and expected price movements of primary products in international markets in the coming period result in an expected inflation rate of 1.7% in 2018. In the period 2019-2021, the inflation rate is expected to be low and stable. The inflation dynamics will be influenced by the trends of global prices of primary products, and partially by the trends of the economic activity in the national economy. Thus, the inflation rate in 2019 and 2020 is expected to be 2%, while it is projected at 2.2% in 2021.

The current account deficit is expected to remain relatively low and to gradually narrow in the period 2019 - 2021, i.e. it is expected to decline to 1.4% of GDP in 2021. This tendency is a result of the envisaged reduction of the trade deficit level and the stable level of private transfers. The current account deficit will be financed with the expected FDI inflow, which will result in keeping the foreign reserves at an adequate level. The stable Denar exchange rate in relation to the euro will be retained in this period, aimed at maintaining price stability as the ultimate goal of macroeconomic policy.

Baseline macroeconomic projections are accompanied by certain risks<sup>3</sup>, which are related to both the international and the domestic environment. As regards the risks related to the international environment, they are mainly associated with the economic trends and the growth dynamics of the EU economy, as the main trading partner of Macedonia. Hence, possible weaker economic performance in the EU and the other trading partners to the country than the projected ones in the coming medium-term period may deteriorate the prospects for growth of the economic activity in Macedonia, through weaker growth of exports and industrial production, as well as the reduced inflow of foreign capital. The lower than expected growth or possibly the fall of prices of base metals on the global market is an additional risk.

As regards the domestic environment, risks are significantly reduced in circumstances of stabilisation of the political situation in the country and prospects for increased growth of the domestic economy. Related to this, the projected growth of the domestic demand over the medium term, which is expected to significantly contribute to boosting the economic activity, is related to risks, which are assessed as moderate and refer primarily to the increase of gross investments, i.e. the realisation of infrastructure projects, as well as the effects from the support to the investment activity of domestic and foreign companies on the economy. Further, improved Euro-Atlantic perspectives point to potential upside risks to the baseline macroeconomic forecast.

<sup>3</sup> Possible effects of the macroeconomic and the other risks on the fiscal variables are shown in Section 6.

## **2. Fiscal Projections**

### **2.1 Central government budget (Budget of the Republic of Macedonia)**

#### **2.1.1 Revenues and Expenditures in the Period January - April 2018**

Performance of revenues and inflows to the Budget of the Republic of Macedonia is within the expectations for this period of the year, while expenditure execution is realised on regular and timely manner (Table 3). In the period January - April 2018, total revenues were collected in the amount of Denar 60,466 million or around 31% of the 2018 Budget, i.e. their collection was higher by 4.6% compared to the revenues collected in the same period last year. Denar 36,660 million out of this amount was tax revenues, being higher by Denar 2,511 million or by 7.4% compared to last year. VAT revenues were collected in the amount of Denar 15,607 million, accounting for most of tax revenues with 42.6%. Profit tax revenues were collected in the amount of Denar 5,976 million. Collection of excise revenues was also higher than the projections. They were collected in the amount of Denar 7,586 million in the first four months of 2018.

Revenues collected on the basis of social contributions amounted to Denar 17,752 million. This amount was by Denar 1,008 or by 6% more in relation to the respective period in 2017. Denar 11,928 million was collected on the basis of pension insurance, while revenues collected on the basis of health insurance contributions amounted to Denar 5,063 million.

Non-tax revenues were collected in the amount of Denar 4,115 million in the period January - April 2018. The largest share reflects non-tax revenues of budget users on their special revenue accounts, collected in the amount of Denar 2,336 million. Capital revenues were collected in the amount of Denar 689 million, while budget users generated Denar 1,250 million on the basis of donations from international multilateral and bilateral cooperation.

In the period January - April 2018, expenditures were executed in the amount of Denar 63,006 million, i.e. execution was higher by Denar 1,623 million or by 2.6% in relation to the same period last year. All liabilities of the budget users, legal rights of the citizens and the due liabilities towards domestic and foreign creditors were settled on time and on regular basis during this period.

Current expenditures were executed in the amount of Denar 60,371 million. During this period, Denar 8,703 million was paid for wages and allowances to the employees of the budget users, while expenditures related to goods and services were executed in the amount of 4,865 million.

Transfers-related expenditures accounted for the most of the current expenditures, amounting to Denar 45,136 million in this period. Government liabilities on the basis of payments related to exercising the rights to guaranteed social protection of the citizens (pecuniary allowances to vulnerable categories of citizens, as well as child allowances and parenting payments) were settled on regular basis, accounting for Denar 2,533 million. As regards regular payment of pensions, Denar 17,811 million was allocated therefore. With respect to financing health services and benefits, Denar 9,431 million was paid, while Denar 358 million was allocated for payment of unemployment benefits through the Employment Agency. Denar 5,254 million was transferred from the central government budget (Budget of the Republic of Macedonia) to the municipalities as block grants for financing the transferred competences, as well as earmarked grants for financing the operating costs in local public institutions. In addition, Denar 736 million was transferred on the basis of VAT revenues. During this period, agricultural subsidies were paid on continuous basis and in a timely manner, aimed at improving the quality and the competitiveness of the sector. Denar 1,667 million was allocated for regular servicing of liabilities on the basis of interest, according to the repayment schedules on domestic and foreign borrowing. Denar 634 million out of this amount was allocated for payment of interest on foreign borrowing.

In the period January - April 2018, capital expenditures were executed in the amount of Denar 2,635 million.

During this period, central government budget deficit amounted to Denar 2,540 million, being by Denar 1,056 million lower compared to the respective deficit in 2017. Inflows to the Budget provided for regular repayment of principal on the basis of incurred liabilities, amounting to Denar 20,015 million.

Table 3. 2018 Central Government Budget (Budget of the Republic of Macedonia) and its execution in the period January - April 2018

	<b>Budget 2018 (denar million)</b>	<b>Execution January – April 2018 (denar million)</b>	<b>Execution January – April 2018 / Budget 2018 (%)</b>	<b>Execution January - April 2018 / January - April 2017 (%)</b>
<b>Total revenues</b>	<b>193,512</b>	<b>60,466</b>	<b>31.2</b>	<b>4.6</b>
<b>Tax revenues and contributions</b>	<b>170,200</b>	<b>54,412</b>	<b>32.0</b>	<b>6.9</b>
Tax revenues	114,797	36,660	31.9	7.4
Contributions	55,403	17,752	32.0	6.0
<b>Non-tax revenues</b>	<b>17,201</b>	<b>4,115</b>	<b>23.9</b>	<b>-20.4</b>
<b>Capital revenues</b>	<b>1,510</b>	<b>689</b>	<b>45.6</b>	<b>249.7</b>
<b>Donations</b>	<b>4,601</b>	<b>1,250</b>	<b>27.2</b>	<b>-18.3</b>
<b>Total expenditures</b>	<b>211,745</b>	<b>63,006</b>	<b>29.8</b>	<b>2.6</b>
<b>Current expenditures</b>	<b>187,601</b>	<b>60,371</b>	<b>32.2</b>	<b>9.8</b>
Wages and allowances	27,126	8,703	32.1	-0.5
Goods and services	17,558	4,865	27.7	-4.5
Transfers to LGUs	18,147	5,990	33.0	4.1
Subsidies and transfers	17,292	6,713	38.8	152.1
Social transfers	98,794	32,433	32.8	4.9
Interests	8,684	1,667	19.2	-6.8
<b>Capital expenditures</b>	<b>24,144</b>	<b>2,635</b>	<b>10.9</b>	<b>-58.9</b>
<b>Deficit</b>	<b>-18,233</b>	<b>-2,540</b>	<b>13.9</b>	<b>-29.4</b>
<b>Deficit financing</b>	<b>18,233</b>	<b>2,540</b>		
<b>Inflows</b>	<b>40,897</b>	<b>22,555</b>		
Domestic sources	17,700	8,396		
External sources	34,839	31,185		
Deposits (“-“ is accumulation on the account)	-11,642	-17,026		
<b>Outflows</b>	<b>22,664</b>	<b>20,015</b>		
Repayment upon domestic borrowing	12,246	6,654		
Repayment upon foreign borrowing	10,418	13,361		

Source: Ministry of Finance

### 2.1.2 Medium-Term Framework of the Central Government Budget (Budget of the Republic of Macedonia)

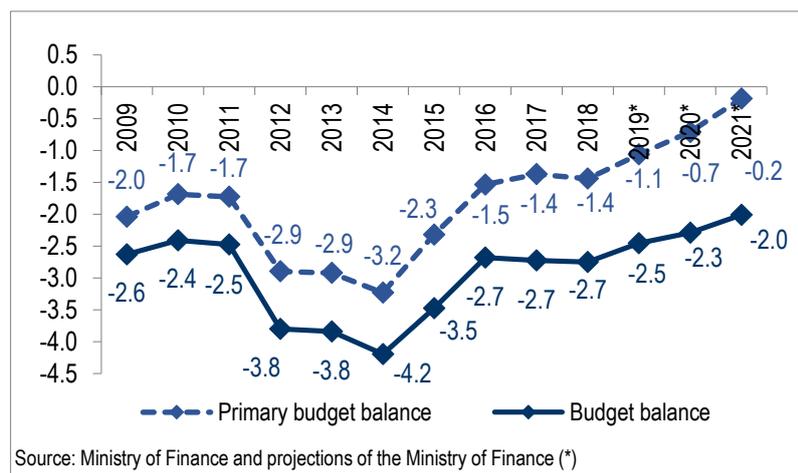
Fiscal policy in the period 2019 - 2021 will reflect further strengthening of Budget management and fiscal discipline, that will result in maintaining macroeconomic stability, gradual fiscal consolidation and maintaining low budget deficit (Table 4).

The focus will be placed on creating a favourable business climate, supporting domestic companies and innovative activity, as well as supporting the economy with significant investments in infrastructure projects. Further modernisation and strengthening of revenue collection, by strengthening the institutional capacity of the tax administration, as well as enhancing the control and efficient budget spending, are also one of the priorities in the period to come.

In order to strengthen the fiscal discipline, the Medium-Term Fiscal Strategy introduces budget expenditure ceilings, both total ceilings and ceilings by budget users (Appendix 1). Related to this, the annual growth rate of total budget expenditures of the central government (Budget of the Republic of Macedonia) will gradually drop from 7.7% in 2018 to 6.3% in 2019, 5.1% in 2020 and 4.2% in 2021. In conditions of prudent public financial management as per the planned policies, fiscal policy in the coming period will provide for a gradual decline of the level of overall budget deficit from 2.7% of GDP in 2018 to 2.5% of GDP in 2019, 2.3% of GDP in 2020 and 2% of GDP in 2021. Furthermore, the primary budget deficit (total budget deficit without the interest-related costs) will also fall from 1.4% of GDP in 2018, to 1.1% of GDP in 2019, and further to 0.7% and 0.2%

respectively in 2019 and 2020, i.e. the primary budget at the end of the medium-term period will be almost balanced (Figure 6).

Figure 6. Overall and primary budget deficit (% of GDP)



Total own revenues of the central government (Budget of the Republic of Macedonia) for the period 2018-2021 are projected to around 29% of GDP. Revenue projections are based upon the anticipated tax reforms as regards personal income tax, as well as the existing legal solutions regarding the other public duties. Tax reform, envisaged to start with implementation from 2019, as per the medium-term projections is expected to provide for a fiscal effect of around Denar 1.8 billion per year. This reform envisages introduction of a moderate progressive taxation as regards the personal income tax, i.e. an additional marginal tax rate for persons with the highest income, in line with the developed European tax systems. The goal of the reform is, above all, to reduce inequality in the society, as well as to ensure additional budget funds to be used for higher public investments and to improve the quality of the services in education, health and social protection sectors.

Tax revenues account for 59.3% of the projected revenues, followed by revenues on the basis of social contributions accounting for 28.5%, non-tax revenues and capital revenues accounting for 9.2%, while the rest of the revenues are expected to be generated from IPA Funds and other donations. With respect to tax revenues, most revenues will be generated on the basis of VAT, personal income tax and excises.

In the next medium-term period, projections for social contributions, which are genuine revenues of the Pension and Disability Insurance Fund, Health Insurance Fund and the Employment Agency, are based on keeping the existing mandatory social insurance rates and the other respective parameters, as well as the expected positive economic trends, which will accordingly reflect on the growth rates of both employment and wages. Thereby, possible future changes in some of the parameters of the social insurance system would accordingly affect the fiscal projections.

Non-tax revenues in the next medium-term period account for around 8.6% of the total revenues, wherein revenues on the basis of administrative fees and other non-tax revenues, which the budget users generate on their own accounts, account for the highest share.

In the coming period, budget revenue projections with regard to foreign donations include the donations the budget users will realise for specific projects, as well as disbursements from the EU pre-accession funds.

Table 4. 2017 - 2021 Central Government Budget (Budget of the Republic of Macedonia), Denar million

	Execution 2017	Budget 2018	2019*	2020*	2021*
<b>Total revenues</b>	<b>179,673</b>	<b>193,512</b>	<b>207,904</b>	<b>219,452</b>	<b>230,530</b>
<b>Tax revenues and contributions</b>	<b>157,537</b>	<b>170,200</b>	<b>181,693</b>	<b>191,942</b>	<b>203,216</b>
Tax revenues	104,647	114,797	122,994	129,753	137,026
Contributions	52,890	55,403	58,699	62,189	66,190
<b>Non-tax revenues</b>	<b>13,396</b>	<b>17,201</b>	<b>16,949</b>	<b>19,016</b>	<b>19,597</b>
<b>Capital revenues</b>	<b>1,316</b>	<b>1,510</b>	<b>1,403</b>	<b>1,403</b>	<b>1,403</b>
<b>Donations</b>	<b>7,424</b>	<b>4,601</b>	<b>7,859</b>	<b>7,091</b>	<b>6,314</b>
<b>Total expenditures</b>	<b>196,561</b>	<b>211,745</b>	<b>225,169</b>	<b>236,614</b>	<b>246,636</b>
<b>Current expenditures</b>	<b>176,698</b>	<b>187,601</b>	<b>197,754</b>	<b>206,505</b>	<b>215,715</b>
Wages and allowances	26,204	27,126	27,244	27,410	27,565
Goods and services	15,344	17,558	18,838	19,204	19,548
Transfers to LGUs	17,014	18,147	19,311	19,937	20,583
Subsidies and transfers	15,058	17,292	18,195	18,089	18,470
Social transfers	94,690	98,794	104,353	110,007	114,923
Interest payments	8,388	8,684	9,813	11,858	14,626
Domestic	2,845	3,165	3,470	5,217	7,546
Foreign	5,543	5,519	6,343	6,641	7,080
<b>Capital expenditures</b>	<b>19,863</b>	<b>24,144</b>	<b>27,415</b>	<b>30,109</b>	<b>30,921</b>
<b>Budget Balance</b>	<b>-16,888</b>	<b>-18,233</b>	<b>-17,265</b>	<b>-17,162</b>	<b>-16,105</b>
<b>Primary budget balance</b>	<b>-8,500</b>	<b>-9,549</b>	<b>-7,452</b>	<b>-5,304</b>	<b>-1,479</b>
<b>Total revenues, % of GDP</b>	<b>29.0</b>	<b>29.2</b>	<b>29.6</b>	<b>29.3</b>	<b>28.8</b>
<b>Total expenditures, % of GDP</b>	<b>31.7</b>	<b>31.9</b>	<b>32.0</b>	<b>31.6</b>	<b>30.8</b>
<b>Budget balance, % of GDP</b>	<b>-2.7</b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.3</b>	<b>-2.0</b>
<b>Primary budget balance, % of GDP</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.1</b>	<b>-0.7</b>	<b>-0.2</b>

Source: Ministry of Finance and projections of the Ministry of Finance (\*)

The expenditure side of the central government budget (Budget of the Republic of Macedonia) in the next period is fully created in the function of achieving the strategic priorities of the Government of the Republic of Macedonia, i.e. accelerating the economic growth and the EU and NATO integration processes. The average share of expenditures in the central government budget in the period 2018-2021 is around 31.6% of GDP. Expenditure projections in the budget for the next medium-term period are prepared on the basis of three key foundations:

- Harmonisation of the revenue projections with the planned economic activities;
- Total budget expenditure projections ensure continuous fiscal consolidation, and
- Projected expenditures provide for regular and smooth fulfilment of all legal obligations.

In addition to the ceilings on the total expenditures mentioned above, the medium-term perspective in the budget process imposes the setting of maximum amounts of expenditures (expenditure ceilings) by budget users. Although expenditure projections give aggregate information for the coming years, setting the expenditure ceilings means setting spending limits for the coming years. Therefore, taking into account the legal provisions, expenditure ceilings for the period 2019 - 2021 are presented as an appendix to the Fiscal Strategy by budget users: expenditures from the core budget and expenditures financed under loans from international financial institutions and bilateral creditors (Appendix 1).

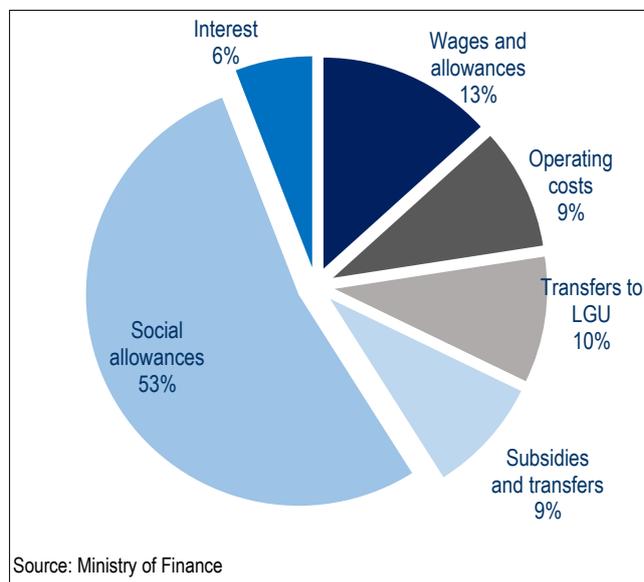
When projecting the current expenditures for the next period (Figure 7), following assumptions were taken into account:

- As regards expenditures related to wages and allowances, continuation of strict control over new employments and gradual increase of wages in certain sectors in line with the fiscal possibilities;
- Timely payment of pensions and social benefits, for the purpose of improving the well-being of the beneficiaries of these rights. Planned reforms as regards the social protection system, by improving the

social rights and streamlining the procedures to exercise such rights, will provide for improved social services to the citizens, intensified fight against poverty and social exclusion in the country;

- Ensuring substantial amounts of agricultural subsidies, aimed at strengthening and supporting this sector, boosting the exports of Macedonian agricultural products and conquering new markets;
- Boosting the economic growth and development in the Republic of Macedonia, by supporting investments in order to enhance the competitiveness of the Macedonian economy and employment, by providing substantial support to the domestic companies, export support, measures for new greenfield investments and enhancing the innovation capacities of the companies by better access to skills, knowledge and technology.

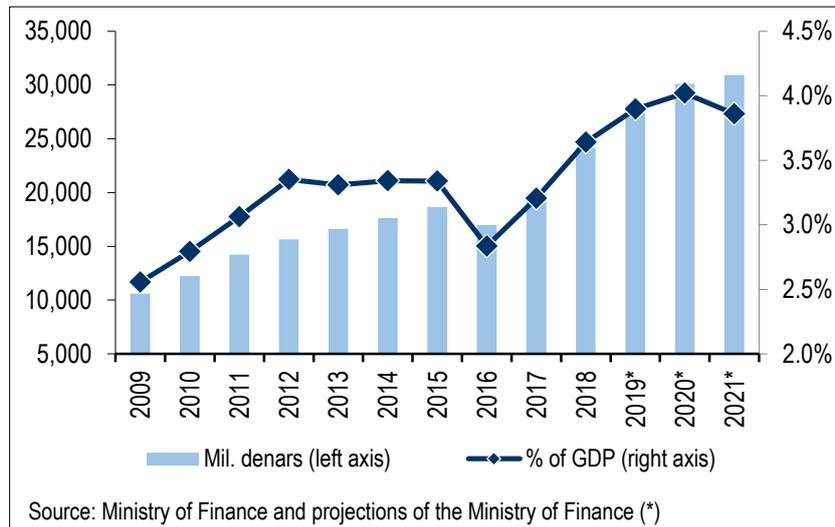
Figure 7. Structure of current expenditures (%)



In the coming medium-term period, fiscal policy remains focused on ensuring substantial public investments, which are a precondition for improvement of economic perspectives, as well as better life of the citizens. Related to this, a significant amount of capital investments is projected (Figure 8), intended for intensification of the infrastructure projects, i.e. investments in railway infrastructure, energy and utilities infrastructure, as well as capital investments aimed at improving the conditions in the health, education and social systems, agriculture, culture, sports, environment protection and judiciary.

The efficient usage of budget funds and funds provided under loans from international financial institutions and bilateral creditors will be basis for a series of investment activities and reforms, which will provide for job creation and favourable business environment.

Figure 8. Capital expenditures in the central government budget (Budget of the Republic of Macedonia)



In addition to the Budget, substantial investments in road infrastructure, financed with World Bank loans, are ongoing through the Public Enterprise for State Roads, such as: “National and Regional Roads Rehabilitation Project”, including the following road sections: Krivogastani – Obsrani – Vogani, Kocani – Delcevo and “Road Upgrading and Development Project” (Kriva Palanka - Rankovce). At the same time, construction of Miladinovci-Stip Highway and Kicevo-Ohrid Highway, financed with loans from Export - Import Bank of China are ongoing. Activities envisaged under the National Roads Programme, funded with EBRD loan, will be intensified in the coming period, envisaging construction of new road sections Stip – Kocani and Raec – Drenovo, as well as reconstruction and rehabilitation of 26 road sections in the Republic of Macedonia, total length of which is around 400 km. Stip - Radovis Road Section Project, also funded with an EBRD loan, is in the process of realisation. In the coming medium-term period, construction of Skopje-Blace Highway Section is expected to start, which will provide for positive effects on the economic, social and environmental aspects in the region and easier international transportation and trade in the region, particularly between the Republic of Macedonia and Republic of Kosovo.

As for the railway infrastructure, focus will be placed on completion of the implementation of the Project for Improvement of the Railway Corridor X, as well as intensification of the activities within the Project for Completion of Rail Corridor VIII, being aimed at connecting the Black Sea with the Adriatic Sea, which speaks about the huge strategic and economic significance of this Project.

Construction of the eastern part of Rail Corridor VIII, i.e. the part towards Bulgaria, is carried out in 3 phases. Realisation of the first phase (Kumanovo - Beljakovce section), 30.8 km long, and second phase (Beljakovce - Kriva Palanka section), 34 km long, financed with EBRD Loans and WBIF grant funds, will be intensified within the envisaged period. In addition to the WBIF grant funds for technical assistance to the Project, WBIF investment grant in the amount of EUR 70 million for financing of the second phase has been secured. Preparation of the third phase (Kriva Palanka - Deve Bair section, border towards the Republic of Bulgaria), covering 23.4 km, financed with IPA grants, is completed, and the construction is expected to be financed with loans from international financial institutions, bilateral creditors, while the possibility to ensure grant funds within the national IPA is also under consideration. In parallel to the investments in railway infrastructure, implementation of the “Macedonian Railways Fleet Renewal Project”, financed with EBRD loan in the amount of EUR 50 million, will continue.

As regards the transport infrastructure, Republic of Macedonia expressed interest in participating at the World Bank regional initiative “Western Balkans Trade and Transport Facilitation Project”. Significant project activities related to road and railway infrastructure, as well as activities aimed at improving cross-border cooperation with the countries in the region, will be realised within this initiative.

By implementing the “Project for Construction of Gas Pipeline System in the Republic of Macedonia“, business sector, public sector and households will be provided supply with cheap and environmentally friendly energy, at the same time reducing the emission of harmful gases. Construction of the sections of the national gasification system Stip - Negotino – Bitola and Skopje – Tetovo – Gostivar, which is ongoing, is financed with a loan from Deutsche Bank and Erste Group Bank. During the following period, the Government will focus on

preparation and realisation of a new Municipal Gas Distribution Network Project in the Republic of Macedonia, to be financed with loans from the international financial institutions.

Implementation of the "Municipal Services Improvement Project", with financial support by the World Bank, will continue in 2019 as well. World Bank loan proceeds are intended for financing infrastructure investment projects in the field of water supply and wastewater drainage, management of solid waste and other investments in municipal services, which have potential for generating revenues, i.e. making savings, or are of high priority for the municipalities. IPA funds are additionally provided for this Project, which the municipalities can use as grants by 2019 in order to finance their priority projects.

In order to improve the conditions and the quality of life, above all in the rural areas in the Republic of Macedonia, by supplying clean potable water, "Water Supply and Waste Water Collection Project", financed with EIB (European Investment Bank) loan, will continue to be implemented in the coming period. At the same time, the Government of the Republic of Macedonia plans to provide additional financing for this Project in 2019 on the basis of a new loan from the EIB, in order to respond to the needs and the demands of the municipalities in the country for investments in utility infrastructure.

Construction of the Regional Clinical Hospital in Stip, financed with a loan from the CEB, will continue in the coming period, while the Government of the Republic of Macedonia undertakes activities for preparation and creation of conditions for construction of a new Clinical Centre "Mother Theresa" at a new location in Skopje.

As regards education, implementation of the "Project for Building Physical Education Facilities in Secondary Schools", financed with CEB loan and contribution of the Republic of Macedonia, is expected to be completed in the coming period. The Project covers construction and procurement of the necessary equipment for 30 physical education facilities in secondary schools in different municipalities in the country, as well as reconstruction of several secondary schools. In addition, implementation of the "Project for Building Physical Education Facilities in Primary Schools and Rehabilitation of Primary and Secondary Schools in the Republic of Macedonia", financed with CEB loan and contribution of the Republic of Macedonia, will continue, aimed at improving the physical education, as well as the overall learning conditions in the primary and the secondary schools.

Implementation of the second and the third phases of the "Zletovica Water Basin Utilisation Improvement Project" is planned to commence with a support by EIB. The main objective of the second phase is provision of irrigation for 4,570 ha net area in the region of Probistip and Kratovo municipalities. Implementation of the third phase, which includes construction of small hydro power plants along the flow of Zletovica River, will provide for reducing electricity shortage in the region, safe, secure and quality supply of energy for the consumers and increased energy efficiency.

Second phase of the "Irrigation Programme Southern Vardar Valley", which will continue in 2019 as well, will be financed with KfW loan. EUR 4 million is provided for this Project as a grant from the German Federal Republic through KfW, aimed at supporting the envisaged investment activities, i.e. rehabilitation and modernisation of the irrigation systems in Valandovo region.

First phase of the "Water and Sewerage Programme Macedonia", financed with KfW loan and SECO grant funds, is expected to be completed, providing for sustainable supply of potable water to the population in the selected municipalities (Gostivar, Kavadarci, Radovis). At the same time, it is expected for the second phase of the Project to commence. This phase will be financed with grant funds in the amount of EUR 5 million, awarded by the German Federal Republic through KfW, for investment activities in the municipalities of Gevgelija, Radovis and Kavadarci.

An important priority where the Government of the Republic of Macedonia will focus on is the preparation and the implementation of the Project for Construction of Waste Water Treatment Plant in the City of Skopje, where loans and grants are planned to be provided from international financial institutions, bilateral creditors and EU funds.

In order to establish professionally and efficiently organised and managed houses of correction (HC) and educational correctional houses (ECH), which continuously ensure re-socialised and integrated citizens in the society, "Project for Reconstruction of Houses of Correction", financed with the Council of Europe Development Bank loan, is being implemented. First segment of the Project will be completed in 2019, envisaging activities to be performed in Kumanovo Prison, ECH for minors in Tetovo, as well as the activities within the first phase of HC Izdrizovo. At the same time, implementation of second segment of the Project will commence, covering two important houses of correction in the Republic of Macedonia, i.e. phase 2 and 3 of HC Izdrizovo and Skopje Prison.

One of the important elements in the social development policy is to increase the quality of life of low-income persons and vulnerable groups by providing for their appropriate housing. Government activities and measures as regards social policy are also supported under the "Project for Housing of Vulnerable Groups",

funded with a CEB loan, encompassing construction of flats for low-income persons. Within this sector, the Government of the Republic of Macedonia undertakes activities, in cooperation with the World Bank, for preparation and implementation of a new project to include implementation of reforms in the social protection area, as well as investment activities aimed at improving the social infrastructure, i.e. reconstruction and construction of early childhood development centres.

In order to provide fresh capital for small- and medium-sized enterprises, as well as support for new projects, job creation, increased liquidity of the economy and higher exports, fifth EIB credit line for financing small- and medium-sized enterprises, in the amount of EUR 100 million, will be realised.

### 2.1.3 Central Government Budget Deficit and Its Financing

During the 2019-2021 period, the budget deficit is envisaged to gradually fall, as follows: Denar 17.3 billion in 2019, Denar 17.2 billion in 2020 and Denar 16.1 billion in 2021. This means that gradual fiscal consolidation is projected in this medium-term period, i.e. the share of budget deficit in GDP will decrease from 2.5% in 2019 to 2.3% in 2020 and 2.0% in 2021.

The financing of the projected deficit will be provided from domestic and foreign borrowing (Table 5). Borrowing abroad may be realised on the basis of favourable loans from international financial institutions, disbursements of funds under favourable loans and credit lines intended for financing certain projects, as well as issuance of Eurobond on the international capital market. Related to this, the choice of a specific external financing source will be based on the ongoing and the expected developments on the international capital market. Furthermore, borrowing on the domestic government securities market will provide for additional financing under favourable terms and conditions, by using the relatively low interest rates and the high level of interest of investors on the domestic government securities market. For the purpose of optimising the payments and reducing the refinancing risk, main commitment of the Ministry of Finance will be to lengthen the maturity of issued securities, by issuing government bonds with longer maturities.

Table 5. Deficit and Sources for Its Financing (Denar million)

	Actual 2017	Budget 2018	2019*	2020*	2021*
<b>Budget balance</b>	<b>-16,888</b>	<b>-18,233</b>	<b>-17,265</b>	<b>-17,162</b>	<b>-16,105</b>
<b>Deficit financing</b>	<b>16,888</b>	<b>18,233</b>	<b>17,265</b>	<b>17,162</b>	<b>16,105</b>
<b>Inflows</b>	<b>34,470</b>	<b>40,897</b>	<b>33,741</b>	<b>49,229</b>	<b>61,211</b>
Domestic sources	20,086	17,700	19,001	12,855	16,664
Foreign sources	3,835	34,839	25,621	34,660	34,770
Deposits ("-" is accumulation on the account)	10,549	-11,642	-10,881	1,714	9,777
<b>Outflows</b>	<b>17,582</b>	<b>22,664</b>	<b>16,476</b>	<b>32,067</b>	<b>45,106</b>
Repayment upon domestic borrowing	9,301	12,246	10,330	5,200	7,851
Repayment upon foreign borrowing	8,281	10,418	6,146	26,867	37,255
Memorandum					
Net domestic borrowing	10,785	5,454	8,671	7,655	8,813
Net foreign borrowing	-4,446	24,421	19,475	7,793	-2,485

Source: Ministry of Finance and projections of the Ministry of Finance (\*)

## 2.2 Local Government Budget

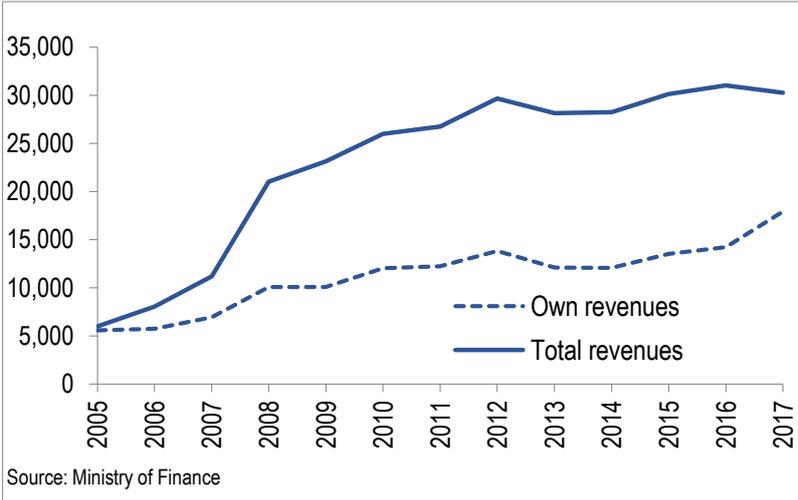
Decentralisation of the powers to local government and strengthening its capacity is one of the priorities arising from the Accession Partnership of the Republic of Macedonia with the EU and the Framework Agreement. All municipalities (except for Plasnica) finance the transferred powers with block grants since 2012, when the phased approach for transferring and managing the operating and financial resources for the transferred powers in the field of education, culture, child care and social protection ended.

Powers in several sectors assumed by the municipalities increased both the administrative and the fiscal capacities and strengthened the capacities for managing larger amount of funds. Successful administration and collection of own revenues contributes to the process of increased own revenues of municipalities and the strengthened capacities for fund management, performance of the transferred powers and management of financial and other resources necessary for their realisation. In addition, municipalities successfully administer new powers related to managing construction land, dealing with illegally built facilities with respective revenue collection. Successful implementation of fiscal decentralisation, with fully established legal and institutional framework for local government, provides for developed, responsible and functional local government units and level of local democracy, bringing the citizens closer to the local government institutions. Progress in achieving the decentralisation-related goals is assessed as successful by many international institutions, which assisted with several projects towards improvements in the public financial management system, control, transparency and coordination in managing local government reforms.

At the same time, access to the capital market has been easier, under more liberal and transparent requirements for borrowing, by which, interest of the municipalities for financing investment projects on the basis of borrowing increased. To that end, the Government has provided credit lines from international financial institutions (World Bank, EIB, KfW and EBRD), which have provided for substantial investments, especially in: reconstruction and rehabilitation of local streets, roads and bridges, construction and reconstruction of water supply and atmospheric water networks, improvement of public hygiene and increasing energy efficiency in municipal public facilities and local spatial landscaping.

As regards the level of decentralisation, the Republic of Macedonia, according to the data on 2017 expenditure execution (around 5% of GDP), belongs to the group of decentralised countries. Compared to 2005, when the process of transferring of powers and fiscal decentralisation commenced, today, municipal revenues have increased by more than five times (Denar 5.9 billion in 2005, more than Denar 30 billion in 2017). Tax revenues, which the municipalities are authorised to collect, have increased by more than twice during the same period (Figure 9).

Figure 9. Own and Total Revenues in the Period 2005 - 2017 (in Denar million)



Municipalities in the Republic of Macedonia are financed from own sources of revenues, grants from the central government budget (Budget of the Republic of Macedonia) for the powers transferred in the field of education, culture, social protection and fire fighting, revenues determined in separate laws, tax revenues collected at central level, transfers from the central government budget and other institutions, revenues collected from grants, loans and other revenues.

Own revenues of the municipalities are local taxes (tax on real estate, inheritance and gift tax, tax on sales of real estate), local fees prescribed by law (utility fees, administrative fees and other fees stipulated by law), local fees (fee for landscaping of construction land, fees for utility activities, fees for spatial and urban plans), revenues on the basis of ownership and other revenues stipulated by law. Municipalities also receive transferred revenues in the amount of 3% of the collected PIT on the basis of personal earnings from salaries of

individuals with a permanent address in the respective municipality and 100% of the PIT collected from individuals engaged in craftsmanship activity, registered in the area of the municipality.

Additional revenues are also transferred as grants from the central government budget (Budget of the Republic of Macedonia), as follows: revenues on the basis of VAT grants (4.5% of collected VAT in the previous fiscal year), earmarked and block grants for the transferred powers in the field of education, culture, social protection and fire fighting, and capital grants. Funds from these grants are distributed on the basis of criteria determined in decrees adopted by the Government of the Republic of Macedonia.

### **2.2.1 Revenues and Expenditures in the period January - April 2018**

Revenue collection and inflows in the budgets of local government units in this period were within the expectations, i.e. total revenues in the period January - April 2018 were collected in the amount of Denar 10,791 million and they grew by 7% compared to the same period last year. Denar 2,710 million out of this amount was tax revenues, being higher by 3.7% more compared to last year. Revenues collected on the basis of property taxes in this period of 2018 amounted to Denar 1,026 million, being an increase of 13.7%. As regards income taxes and fees for usage or licences for performing an activity, growth of 4.2%, i.e. 6.3%, was registered.

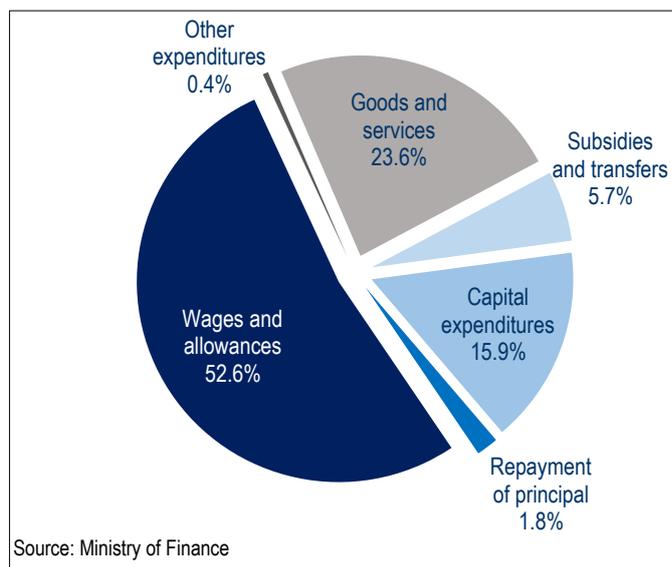
During the analyzed period in 2018, non-tax revenues were collected in the amount of Denar 433 million and, when compared to the same period in 2017, they were lower by 1.9%, i.e. by an insignificant amount of Denar 8.3 million. With respect to non-tax revenues, inflows on the basis of fees and charges predominated, amounting to Denar 336 million, registering an increase of 2.4% compared to those collected in the respective period in 2017.

In the period January - April 2018, capital revenues were collected in the amount of Denar 918 million, being significantly higher by 138.8% compared to those collected in the previous year. Capital revenues are dominated by revenues collected on the basis of sale of land and intangible. In the analysed period, revenues collected on the basis of grants amounted to Denar 5,255 million, i.e. an annual increase of 4.1%. Revenues collected on the basis of transfers in the period January - April 2018 amounted to Denar 1,102 million, being by 18.8% lower compared to the revenues in the analysed period last year. In the period January - April 2018, revenues collected on the basis of donations amounted to Denar 272 million, i.e. they were double as high compared to last year. During the same period, revenues on the basis of loans were collected in the amount of Denar 100 million, i.e. they decreased by 8.3% compared to the same period last year.

In the period January - April 2018, expenditures were executed in the amount of Denar 9,363 million, i.e. execution was lower by 2.9% in relation to the same period last year. These expenditures provided for regular settling of liabilities arising from the transferred powers to the municipalities, necessary for their ongoing operations, implementation of capital projects and principal repayment for the previously taken loans.

Expenditures related to wages and allowances accounted for the most of the expenditures with 52.6%, i.e. Denar 4,924 million (Figure 10). Most of the wages, i.e. Denar 84.7 million was intended for the employees in the institutions at local level, such as primary and secondary education, culture, kindergartens and old people's homes and fire fighting, financed with block grants. Expenditures related to goods and services amounted to Denar 2,210 million, accounting for 23.6% of total expenditures. Capital expenditures accounted for 15.9%, amounting to Denar 1,491 million, being mostly financed, i.e. 79.6%, with municipal own funds, while 11.8% was funds on the basis of donations. Expenditures related to subsidies and transfers amounted to Denar 532 million, accounting for 5.7%, while principal repayment amounted to Denar 165 million, i.e. 1.8% of total expenditures. Expenditures executed on the basis of reserves, social benefits and interest payments accounted for around 0.4%.

Figure 10. Structure of Expenditures in the period January - April 2018



### 2.2.2 Medium-Term Framework of Local Government Budget

In the course of 2018, as well as in the medium run, municipalities are expected to continue the trend of improved collection of own revenues, strengthening the capacities for development of policies for financing the municipalities and enhancing the capacities for financial management. For the purpose of realising the strategic commitments, strong commitment to encouraging sustainable local development, good local governance and creating conditions for more active, more effective and more innovative role of the local authorities in implementing national objectives for growth and development will continue in the next period as well.

Stable revenues are allocated to the municipalities from the local government budget on the basis of the VAT grant (general grant), in the amount of 4.5% of VAT collected in the previous year. As regards the grants for transferred powers, criteria for distribution of funds allocated for the transferred powers in the field of primary and secondary education, culture, child care and protection of elderly people and fire fighting will be defined in the following period. Therefore, the Government of the Republic of Macedonia has established an inter-ministerial working group, which is to prepare a detailed analysis on the situation in these areas in which block and earmarked grants are transferred, redefining the manner and the determining of the distribution criteria.

New revenues are provided by allocating funds from lease of state-owned agricultural land to the municipalities, the proportion of which is 50% for the central government budget and 50% for the municipalities and the municipalities in the City of Skopje, to be distributed from 2018, depending on the location of the agricultural land under lease, provided that collection of revenues on the basis of tax on real estate exceeds 80% in relation to the ones projected in the previous year. Municipalities also have higher revenues from the fee collected by issuing concession for usage of water resources for electricity generation (50% for the central government budget and 50% for the local authorities), depending on which area the concession activity is performed.

Increased own revenues of the municipalities, in particular revenues collected on the basis of taxes on real estate, as a result of better inclusion of the real estate of natural persons and legal entities and re-assessment of the value of real estate, will continue in the next medium-term period. At the same time, part of the municipalities generate higher revenues on the basis of property taxes as a result of the higher rate of calculation and collection of property tax within the margin set by to the Law on Property Taxes. Higher revenues are also expected by applying the improved elements of calculation in the Methodology on Determining Market Value of Real Estate, as well as the improved quality of the assessment of the value of real estate with the legal possibility to employ an expert – an evaluator or to use the services of licenced evaluators.

In the coming period, higher revenues are expected to be generated by determining the real market value of the real estate after completing the procedure related to illegally built facilities on construction and agricultural land. Further on, municipalities will continue performing the transferred powers for management of

construction land and treatment of illegally built facilities and agricultural land, the respective sources of revenues therefore being determined in the municipal budget.

The Government of the Republic of Macedonia will continue to carry out the activities aimed at equal regional development and advancement of all regions in the country in the next period as well. Implementation of the 2009-2019 Strategy for Equal Regional Development of the Republic of Macedonia in the eight planning regions (Vardar, East, Southwest, Southeast, Pelagonija, Polog, Northeast and Skopje regions), by better vertical and horizontal coordination of both the national and the local policies and the integrated development projects adjusted to the local needs and conditions, will provide for more balanced local development throughout the country. The Council for Equal Regional Development will continue to play a significant role as promoter of partnership between the regions/the municipalities and the Government, and within it the usage of funds will be coordinated from all sectoral programmes intended for the planning regions and the municipalities. Special efforts will be put in supporting the municipalities by encouraging the local development via supporting the local projects and harmonizing them with the national ones.

The 2015 - 2020 Programme on Sustainable Local Development and Decentralisation in the Republic of Macedonia is in the process of revision, as well as the 2018 - 2020 Action Plan, envisaging specific activities and projects to be implemented by the relevant institutions. The request for the Programme to be partially revised arose due to the need for it to be harmonised with the present policies, priorities, strategic documents and trends of local development and decentralisation in the country.

Implementation of a series of infrastructure projects related to the improvement of the quality of life will accordingly improve the regional development and the active integration in the economy. Related to this, projects will be implemented aimed at improving the overall road infrastructure, bridges, local streets and roads, utility infrastructure (water supply, sewage systems, wastewater treatment station collectors, pedestrian crossings, horticulture landscaping, public hygiene), as well as improving the infrastructure of villages through urbanisation, connection of inhabited areas and construction of local roads, pedestrian crossings and lighting, development and support of rural tourism and recreational centres.

As mentioned above, implementation of the "Municipal Services Improvement Project", financially supported by the World Bank, as well as of the "Water Supply and Waste Water Collection Project", financed with EIB (European Investment Bank) loan, will continue in the coming period. At the same time, pursuant to the legal regulations, in the coming period, municipalities that fulfil the legal criteria to borrow, will be able to finance their projects by borrowing on the basis of concluding loan agreements with domestic or foreign creditors or on the basis of issuing municipal bonds.

Table 6. Medium-Term Projection of Local Government Budget

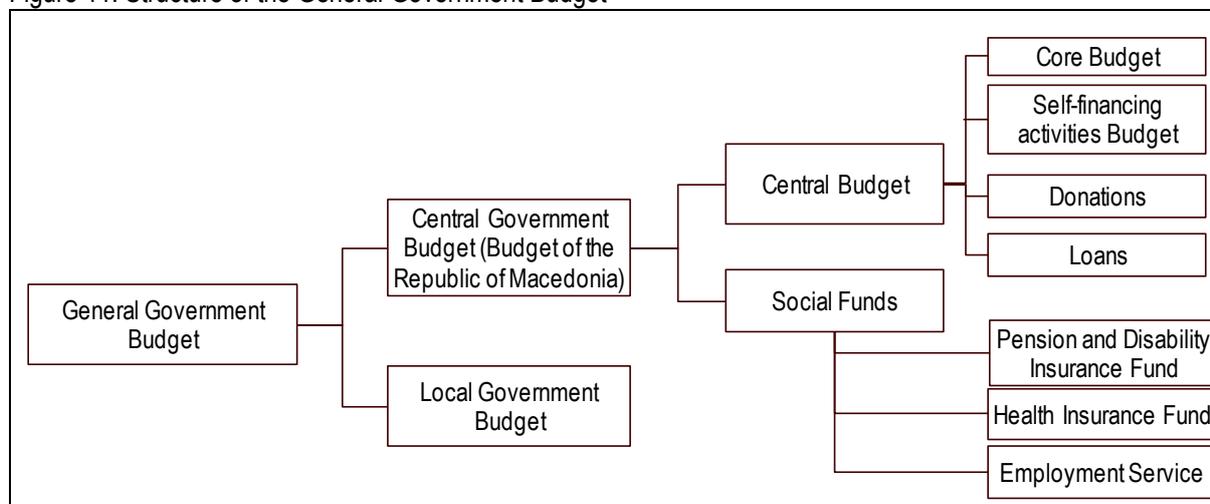
	2018*	2019*	2020*	2021*
<b>Total revenues</b>	<b>32,667</b>	<b>33,831</b>	<b>34,457</b>	<b>35,102</b>
Tax revenues	8,450	8,450	8,450	8,450
Non-tax revenues	1,450	1,450	1,450	1,450
Capital revenues	2,120	2,120	2,120	2,120
Transfers	19,847	21,011	21,637	22,283
Donations	800	800	800	800
<b>Total expenditures</b>	<b>32,667</b>	<b>33,831</b>	<b>34,457</b>	<b>35,102</b>
Wages and allowances	15,270	15,844	15,844	15,844
Goods and services	8,205	8,715	9,215	9,715
Interest payments	55	55	55	55
Subsidies and transfers	1,350	1,470	1,470	1,470
Social transfers	32	0	0	0
Capital expenditures	7,755	7,747	7,873	8,018
<b>Deficit</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Deficit financing</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

Source: Projections of the Ministry of Finance (\*)

## 2.3 General Government Budget (Consolidated central and local government budget)

The General Government Budget includes consolidated data of the central government budget (Budget of the Republic of Macedonia) and the local government budget (budgets of the municipalities). The central government budget comprises the central budget (core budget, self-financing activities budget, donation funds and loan funds) and the budgets of the Pension Insurance Fund, the Health Insurance Fund and the Employment Agency (Figure 11).

Figure 11. Structure of the General Government Budget



In the following period, revenues projected in the General Government Budget will decline as share of GDP, from 31.2% of GDP in 2018 to 30.4% in 2021 (Table 7). As a result of continuous disciplined budget policy and strengthened control over the public spending, total expenditures in the consolidated budget will also experience a decline in the 2018 - 2021 period, from 33.9% in 2018 to 32.4% in 2021.

Table 7. General Government Budget

	Denar million				% of GDP			
	2018*	2019*	2020*	2021*	2018*	2019*	2020*	2021*
<b>Central Budget</b>								
Revenues	116,545	126,463	133,859	140,252	17.6	18.0	17.9	17.5
Expenditures	134,778	143,728	151,021	156,358	20.3	20.4	20.2	19.5
Deficit	-18,233	-17,265	-17,162	-16,105	-2.7	-2.5	-2.3	-2.0
<b>Social Funds</b>								
Revenues	57,420	60,730	64,256	68,296	8.7	8.6	8.6	8.5
Expenditures	57,420	60,730	64,256	68,295	8.7	8.6	8.6	8.5
Deficit	0	0	0	0	0.0	0.0	0.0	0.0
<b>Central Government (Budget of the Republic of Macedonia)</b>								
Revenues	173,965	187,193	198,115	208,548	26.2	26.6	26.4	26.0
Expenditures	192,198	204,458	215,277	224,653	29.0	29.1	28.7	28.0
Deficit	-18,233	-17,265	-17,162	-16,105	-2.7	-2.5	-2.3	-2.0
<b>Local Government Budget</b>								
Revenues	32,667	33,831	34,457	35,102	4.9	4.8	4.6	4.4
Expenditures	32,667	33,831	34,457	35,102	4.9	4.8	4.6	4.4
Deficit	0	0	0	0	0.0	0.0	0.0	0.0
<b>General Government Budget (Consolidated Central and Local Government)</b>								
Revenues	206,632	221,024	232,572	243,650	31.2	31.4	31.0	30.4
Expenditures	224,865	238,289	249,734	259,755	33.9	33.9	33.3	32.4
Deficit	-18,233	-17,265	-17,162	-16,105	-2.7	-2.5	-2.3	-2.0

### 3. Improvement of Public Financial Management

Good governance and public financial management become a component of a fundamental importance and factor to financial safety in all countries. In order to ensure sustainability of the national budgets and the financial systems, as well as stable and sustainable economic development, strengthened public financial management is required. Public financial management has impact on the economic stance of the country and on its ability to implement the set policies in order to realise the priorities.

Public financial management is aimed at attaining the following goals:

- maintenance of fiscal discipline, aimed at controlling total budget expenditures by introducing spending limits
- allocation of funds in line with the government priorities
- efficient delivery of public services and
- transparency improvement

Therefore, an efficient public financial management system is an indispensable requirement for a sustainable economic growth and efficient delivery of public services in the country, as well as for setting the basis for implementing reforms in other areas. Commitment to improving the public financial management is embodied in the Public Financial Management Reform Programme 2018 - 2021, adopted by the Government of the Republic of Macedonia. The goal of the Programme is to improve efficiency and effectiveness of public spending, strengthen fiscal discipline, debt sustainability and efficient, transparent and modern public financial management through 7 priority reform areas:

- Priority 1: Improved Fiscal Framework
- Priority 2: Revenue Mobilisation
- Priority 3: Planning and Budgeting
- Priority 4: Budget Execution
- Priority 5: Transparent Government Reporting
- Priority 6: Internal Control
- Priority 7: External Control and Parliamentary Oversight

In 2018, the Government started implementing both the measures and the activities envisaged in the Public Financial Management Reform Programme and the adopted 2018 Action Plan. Key reform activities encompassed by the 2018 Action Plan are aimed at preparing new legal solutions in several key areas: Public Procurement Law harmonised with the latest Procurement Directives and the EU best practice, Law on Public Internal Control, Budget Law, introduction of fiscal rules and fiscal council and revision of the Public Debt Law.

In the coming period, implementation of measures and activities envisaged in the Public Financial Management Reform Programme and the annual action plans for its implementation will continue, to the end of realizing the Programme goals: improved medium-term fiscal projections, improved revenue collection in the country by both the tax and the customs administration and ensured long-term stability of the IT systems for public financial management in case of crisis, maintaining overall fiscal discipline on the medium term, improved efficiency when executing the Budget and strengthened financial discipline, improved transparency in public financial management, establishment of a sound financial management and control system and ensuring accountability in spending public funds.

Improved transparency through government reporting is one of the measures envisaged in the Programme which the Government started in 2017, when the Ministry of Finance published the Citizen's Budget for the 2017 Supplementary Budget and the Citizen's Budget for the 2018 Budget for the first time, as well as many other new fiscal information, such as reports on budget execution by budget users on monthly basis, reports on budget execution of the municipalities on quarterly basis, quarterly report on execution of the General Government Budget. In order to improve accountability and to inform the public on how citizens' funds are spent, at the same time reflecting in greater inclusion of the citizens in the creation of government programmes and policies, one of the key commitments of the Ministry of Finance in the period 2018 - 2021 will be to develop and implement transparency standards on PFM reporting.

Taking into account that no unified mechanism on recording liabilities exists as regards the liabilities of the entities using the public funds, a need has arisen for a systemic solution for recording liabilities by creating an electronic system to provide for a single recording of all liabilities. Therefore, Law on Reporting and Recording

Liabilities was adopted in 2018, regulating the reporting and the recording of undertaken liabilities not yet due for payment and unpaid liabilities that are due for payment, in order to ensure and maintain transparency and accountability and strengthen the responsibility when managing public funds.

This legal solution establishes a legal obligation for reporting the liabilities in the electronic system on monthly basis by:

- government bodies,
- local government units,
- institutions performing activities in the field of culture, education, health, child care and social protection, as well as other activities of public interest determined by law, established by the Republic of Macedonia or the local government units,
- public enterprises, state-owned companies and
- other legal entities established by the Republic of Macedonia or the local government units.

On the basis of the recorded data on reported liabilities, and in order to inform the public and improve transparency, the Ministry of Finance will publish summary reports on its website, which will fully reflect the undertaken liabilities not yet due for payment (which will become due in the future and are potential debts) and unpaid liabilities that are due for payment (which represent generated debt).

Within the efforts to further improve transparency and government finance statistics, in January 2018, Ministry of Finance for the first time submitted reports to be published in the IMF GFS Year Book in line with the latest IMF GFSM 2014. The reports cover the execution of the General Government Budget (central government budget and local government budget), prepared on cash basis, including annual data for the period from 2013 to 2016. By publishing these reports, the Republic of Macedonia joined the IMF database which provides for comparison of the data at international level. One of the priorities of the Ministry of Finance in the coming period will be further improvement of government finance statistics and alignment with the latest international standards.

For the purpose of better quality public debt management, the Ministry of Finance has initiated strengthening of its capacities in this area and has asked for a technical assistance from the IMF and the World Bank. At the beginning of 2017, the Ministry of Finance joined the World Bank Government Debt and Risk Management Programme (GDRM), which comprises several components to be worked on in the coming period, as follows:

- further development of domestic securities market
- improvement of the capacities when managing risks of the public debt portfolio and improvement of the medium-term public debt management framework
- improvement of the functions of the public debt management system.

#### **4. Use of EU Pre-Accession Assistance**

Republic of Macedonia, as a candidate country for EU membership, has funds under the EU Pre-Accession Assistance (IPA) Instrument available through two financial perspectives: IPA 2007 - 2013 Financial Perspective (IPA 1) and IPA 2014 - 2020 Financial Perspective (IPA 2).

This section of the document presents only the part of EU Pre-Accession Assistance which is implemented under the decentralised/indirect management method. IPA decentralised/indirect management method is a management method within which the European Commission entrusts tasks for implementation of certain IPA programmes to the accredited structure in the Republic of Macedonia, such as tender procedures, contracting, project monitoring and execution of payments. On the other hand, when it is a matter of centralised management, these are responsibilities of the EC.

Funds for national co-financing intended for projects implemented under the decentralised/indirect management are planned within the budget of the Ministry of Finance, organisational code 09002 - Functions of the State, except for the national co-financing necessary for financing the IPARD projects, which is planned within the budget of the Agency for Financial Support in Agriculture and Rural Development, organisational code 14004, as well as the national co-financing for payment of financial contribution to EC for participation in the Union Programmes, which is planned in the line ministries.

#### 4.1 IPA 1 - 2007 - 2013 Financial Perspective

Within IPA 1 - 2007 - 2013 Financial Perspective, Republic of Macedonia has available, through the five IPA Components, funds in the amount of EUR 614 million (Denar 37.8 billion), around EUR 467 million (Denar 28.7 billion) out of which or around 76% of the total allocations are employed through the decentralised management method (through structures that are accredited by the EC services so as for indirect management of the European funds). As regards IPA 1, national structures responsible for implementation of the projects are accredited for decentralised management of the following components: IPA Component I - Transition Assistance and Institution Building (TAIB); IPA Component III - Regional Development; IPA Component IV - Human Resources Development and IPA Component V - Rural Development.

Implementation of most of the programmes within IPA 1 finishes by the end of 2017/2018, i.e. projects which finish are the ones financed within the Annual National Programmes TAIB 2009, 2010, 2011, the Multi-Annual Programme on Regional Development, the Multi-Annual Programme on Human Resources Development and IPARD Programme. Projects financed under the Regional Development Component, in addition to contributing to modernisation of both the road and the railway traffic and improvement of the environment infrastructure, also show the best visibility of IPA funding.

As regards the transport sector, several major projects were financed:

- Project for Construction of New Motorway Section Demir Kapija – Smokvica as part of Pan-European Corridor X;
- Project for Renewal with Reconstruction of the Railway Section Bitola - Kremenica, as part of Xd of Corridor X, expected to be completed by the end of 2018;
- Project for Upgrading and Extension of Sewerage Network in Prilep.

In addition to the above-mentioned major projects, significant number of infrastructure projects were also implemented and successfully completed, as follows:

- rehabilitation of motorway sections Veles - Katlanovo, Smokvica - Gevgelija, Kumanovo - Miladinovci (right and left carriageway);
- rehabilitation and upgrading of Skopje Railway Station and of additional 10 railway stations along Corridor X;
- reconstruction and placement of traffic signs and road markings on certain interchanges along Corridor X, which is to improve the road safety system in the country;
- preparation of a detailed design for construction of new railway section Kriva Palanka - border with Republic of Bulgaria, as part of Corridor VIII.

With respect to the environment sector, sewerage networks, 110 km long in total, were built in Prilep, Kumanovo and Berovo, four waste water treatment plants were built in Prilep, Strumica, Radovis and Kicevo, project documentation for construction of new waste water treatment plants in 12 municipalities was prepared, project documentation for establishment of Integrated Waste Management System in six regions, out of total of eight planning regions, in the country was prepared, new tariff system on water services was developed and established, which started to apply from 1<sup>st</sup> January 2018, National Water Management Study was prepared, being a set of documents outlining the water management policy of the country.

Programmes within IPA 1 which remain to be implemented include the projects planned within Annual National Programme TAIB 2012 and Annual National Programme TAIB 2013.

These IPA Component I Programmes generally provide support to the state administration in order to enhance its capacities at both central and local level, undertake reforms, as well as fulfill the obligations under the membership more quickly and more efficiently.

As per National Programme TAIB 2012, contracting rate accounts for around 75%, i.e. total of 46 contract are concluded, the implementation of which is to be completed by October 2018, while the deadline to complete the final payments per the contracts expires in October 2019.

With respect to National Programme TAIB 2013, contracting rate accounts for 93%, i.e. total of 52 contracts are concluded, the implementation of which is to be completed in December 2017. In line with the requirements in the Financing Agreement, contract implementation should be completed by December 2019, i.e. final payments under the contracts are to be made by 21<sup>st</sup> December 2020 at the latest.

Projects in the following areas are financed within these two Programmes:

- Public Administration Reform: the objective is to ensure horizontal coordination as regards administration modernisation, to improve public financial management and to ensure accountability and

transparency in using public funds, to support the inclusion of the civil society in policy creation by strengthening the capacities of the institutions in charge of various sectoral policies;

- Local government: the objective is to consolidate the local government system by ensuring strong link between the decentralisation process and the inclusive processes for sustainable development with the two support processes, fiscal decentralisation and equal regional development. In addition, it is also aimed at ensuring for the policy focus to be shifted to providing equitable access to better local services for all citizens by creating legal and institutional environment;
- Justice, home affairs and fundamental rights: the objective is underpin implementation of both standards and recommendations of the international community and the European Union in the areas such as border control, fight against organised and serious crime, financial crime, fraud as regards EU funds, corruption, money laundering, judicial cooperation, IT infrastructure necessary for fulfilment of the requirements in the Shengen zone and personal data protection;
- Customs and Kafasan border crossing: the objective is to strengthen CARM institutional and administrative capacity and to meet EU measures on implementing the *acquis* in the field of customs so as to prevent illegal trading in goods, to facilitate trade and to introduce further improvements in terms of the organisation and the management by implementing the adopted strategies on further development of customs operations and procedures. In addition, the goal is to upgrade the customs clearance and inspection capacities at the Kafasan road border crossing;
- Tabanovce border crossing: the goal is to upgrade the customs clearance capacities at Tabanovce road border crossing;
- Environment and climate changes: the goal is to strengthen the administrative capacities as regards waste management, water management, air management, climate changes, and environment protection;
- Private sector development: the goal is to improve the business environment and the institutional capacities in the field of competitiveness, to boost the competitiveness index of the country, to boost the competitiveness of the market and the efficiency of the companies' production, as well as enhance market sophistication, innovations and access to finances;
- Agriculture and rural development: the goal is to develop a common sectoral access and understanding of priorities in agriculture and rural areas, which are to contribute to implementing the EU Common Agricultural Policy;
- Further harmonisation of food safety, veterinary and phytosanitary policies with EU requirements: the goal is to provide additional assistance to the Food and Veterinary Agency and the Phytosanitary Agency to the end of strengthening their overall abilities to implement the EU *acquis* and the obligations encompassed in other relevant documents, with a specific reference to improving the animal control, field inspection services, feed safety, primary control over production and plant health control systems;
- Strengthening the capacities of the National Authorities for sound and efficient management of EU funds: the goal is to strengthen the capacities of NAO, NF, CFCD (structures within the Ministry of Finance), the Operating Structure, NIPAC Office and AA for sound and efficient management and auditing of EU funds, in terms of both the new EU regulation on IPA 2 and the acceleration of the EU integration process by adhering to the new priorities identified in the new Progress Reports and the Enlargement Strategy.
- Participation in EU programmes and agencies: the goal is to co-finance the costs related to the 'entry tickets', which the beneficiary has to pay for participation in the EU programmes and agencies, thus facilitating the progressive transfer of 'know-how' and strengthening the capacities of the relevant administrative bodies benefiting from the participation in the programmes and the agencies.

Thereby, it is important to point out that significant portion of the funds is also intended for intensifying the cooperation of the Macedonian Government with the NGO sector and strengthening the capacities of the NGO sector. In fact, total of 25 grant contracts are concluded with the NGO sector under the National Programme TAIB 2013 alone.

#### **4.2 IPA 2 - 2014 - 2020 Financial Perspective**

Under IPA 2 2014 - 2020 Financial Perspective, Republic of Macedonia has EUR 664 million (Denar 40.9 billion) available, EUR 445.5 million (Denar 27.44 billion) out of which or almost 67% is programmed so far.

In addition, 2018 programming is in the final stage, and preparatory activities as regards 2019 programming are initiated. With respect to the manner of implementation, around 50% of the total allocations under IPA 2 will be earmarked for projects planned to be implemented through indirect management system, i.e. through accredited IPA structures.

Awarded assistance will be used for financing projects in the following areas: justice and home affairs, road and railway infrastructure, environment protection, education, employment, promotion of gender equality, human resources development and agriculture and rural development.

IPA funds will be employed through the following annual and multi-annual programmes:

- 2014 Action Programme for financing projects in the following areas:
  - judiciary,
  - disaster recovery system and ensuring business continuity,
  - further development of capacities for crime scene investigations,
  - entry tickets for the Union Programmes,
  - local and regional competitiveness, focusing on tourism, and
  - support to EU integration (SEA)
- 2015 Action Programme, 2016 Action Programme, 2018 Action Programme and 2019 Action Programme for financing the entry tickets for EU Programmes;
- 2017 Action Programme for financing projects in the following areas:
  - labour and education,
  - entry tickets for the Union Programmes,
- Multi-Annual Sectoral Operational Programme of the Republic of Macedonia for Transport 2014 – 2020;
- Multi-Annual Sectoral Operational Programme of the Republic of Macedonia for Environment and Climate Action 2014 – 2020;
- IPARD 2 Programme.

Around 15 contracts are envisaged to be financed within the 2014 Action Programme. As regards the financing of the projects within this Programme, IPA funds in the amount of around EUR 20 million are made available to the Republic of Macedonia. Among the more significant projects envisaged to be financed under the Programme are the following:

- construction works for rehabilitation of prisons in Bitola and Skopje,
- construction works for rehabilitation of Public Prosecutor's Office regional offices,
- grant scheme for support to NGO in the area of law,
- service contracts to support judiciary reforms,
- contract for procurement of IT equipment for the needs of the Ministry of Internal Affairs - Disaster Recovery Data Centre,
- contract for procurement of IT equipment for the judiciary bodies.

Contracting deadline is 23<sup>rd</sup> December 2018. As of December 2017 inclusive, 2 contracts were concluded in the amount of EUR 340,000. As regards the remaining projects, tender procedures are ongoing.

Financing of projects in the field of road and rail transport, as well as projects for construction of waste water treatment plants, sewerage networks and waste management and climate changes is envisaged within the Multi-Annual Sectoral Operational Programme of the Republic of Macedonia for Environment and Climate Action and Multi-Annual Sectoral Operational Programme of the Republic of Macedonia for Transport.

It is envisaged for around 40 contracts to be financed within the environment and climate action sector in the period 2014 - 2020. To than end, IPA funds in the amount of EUR 86 million are allocated to the environment and climate action sector in the period 2014 – 2019. Among the more significant projects envisaged to be financed under the Programme are the following:

- contracts for construction works related to water treatment stations in Bitola and Tetovo,
- contracts for construction works related to upgrading the sewerage network in Bitola, Tetovo and Kicevo,
- contract for construction of wastewater collection infrastructure in Skopje,
- contracts for construction works and procurement of equipment for establishing an integrated and financially sustainable system for regional solid waste management in East and North-East Regions,
- contracts for construction works related to closure of non-compliance landfills and dumpsites in East and North-East Regions.

It is envisaged for around 17 contracts to be financed within the transport sector in the period 2014 - 2020. IPA funds in the amount of EUR 108 million is allocated to the transport sector in the period 2014 – 2019. Among the more significant projects envisaged to be financed under the Programme are the following:

- contract for construction of the rail section from Kriva Palanka to the Republic of Bulgaria,
- contract for construction of Gradsko – Drenovo road section,
- contract for reconstruction of Raec – Prilep road section,
- contract for reconstruction of Kumanovo – Rankovce road section.

As of December 2017 inclusive, 3 contracts were concluded in the amount of EUR 30 million. As regards the remaining projects, tender procedures are ongoing.

With respect to 2015, 2016, 2018 and 2019 Action Programmes, under which the entry tickets for the Union Programmes are financed, payment of entry tickets for participation in the respective programmes and agencies for the 2014 - 2020 Financial Perspective will be made in a decentralised manner through the National Fund within the Ministry of Finance, whereby, IPA contribution is planned within the budget of the Ministry of Finance, while the planning of the national contribution is an obligation of the competent institutions within their.

Union Programmes cover almost every area of the social and the economic life of European citizens: education, culture, youth, media, social affairs, development of small- and medium-sized enterprises, environment, transport, public health, legal cooperation, fight against violence, crime, terrorism, information society, customs duties and taxes. All legal entities may participate in the Programmes and, in certain cases, natural persons (individuals) from the participating countries may also participate therein.

To the end of participating in the Union Programmes, Republic of Macedonia signs Memorandum of Understanding/Accession Agreement, which legally regulates the participation in the Programmes. As regards the payment of entry ticket for participation in the Union Programmes, a possibility is opened to use the EU Pre-Accession Funds therefore. In the course of January 2018, Agreements on Regulation of Mutual Relations for Participation in the Union Programmes and Agencies were signed with respect to IPA 2 - 2014 - 2020 Financial Perspective.

Projects in the field of labour and education are financed within 2017 Action Programme, the aim of which is to reduce high unemployment rate, increase share on the labour market, in particular the one of young people and women, increase the access to quality education and training, improve the results and the skills and establish a modern and flexible social protection system. In order to achieve the general objective, several projects are envisaged in following areas:

- institutional strengthening of the capacities for sustainable sectoral reforms;
- improving the quality of education and training through review of internal and external quality assessment system in schools and improvement of teacher professional development;
- improving the quality of pre-school education and care and expanding the network of public pre-school intuitions in rural and urban areas;
- improved employability and access to labour market and decent work through improvement of the adult education system, implementation of active labour measures, and strengthening the ESA's services for young people and harder to employ individuals;
- social protection, social inclusion and equal share on the labour market and in the society.

IPARD 2 Programme supports projects that will provide for attaining EU standards introduced in the field of agricultural production, food processing and rural development. In the period 2014-2020, total IPA funds in the amount of EUR 60 million are made available to the Republic of Macedonia under this Programme.

2014 - 2020 IPARD Programme implementation is launched with 4 measures (Investments in physical assets of agricultural holdings, Investments in physical assets concerning processing and marketing of agricultural and fishery products, Farm diversification and business development and Technical assistance to Programme implementation), while preparation for accreditation of one more measure (Investments in rural public infrastructure) is commenced.

First public call was published in the course of 2017, whereby 1,648 applications were submitted, with the total requested amount of EUR 55,192,640 (IPA part).

## 5. Public Debt

Efficient public debt management is of essential importance, encompassing reduced risks when designing the debt structure and debt management policy, aimed at avoiding the possible inability to service the debt on regular basis and in a timely manner. The main objective is to secure the funds necessary to finance the budget deficit and repay the due debt liabilities, as well as funds for project financing, without increasing the debt to a level that can jeopardise the stability of the economy and the economic growth of the country. Quality debt management, among other things, is determined on the basis of the institutional framework and the capacity to set and implement the public debt management policy. This implies clear definition of public debt management goals and measures.

The Public Debt Management Policy sets the framework for the Government of the Republic of Macedonia to act towards prudent public debt management in the medium term. Objectives of public debt management policy set in the Law on Public Debt ("Official Gazette of the Republic of Macedonia", no. 145/2014) are the following:

- financing the needs of the state with the lowest cost possible, in the medium and the long run and with a sustainable level of risk;
- identifying, monitoring and managing the risks which public debt portfolio is susceptible to; and
- developing and maintaining an efficient domestic financial market.

By adopting this Strategy, the Ministry of Finance sets the framework to act towards prudent public debt management in the medium term, i.e. in the next three years. Above-mentioned goals will be attained by defining short- and medium-term limits of certain debt portfolio indicators.

General government debt comprises financial liabilities incurred on the basis of borrowing by the Republic of Macedonia, public institutions established by the Republic of Macedonia and the municipalities, the municipalities within the City of Skopje and the City of Skopje. This is the definition of General government debt according to the national methodology envisaged in the Law on Public Debt. Central government debt accounted for 99.6% of the total general government debt at the end of 2017 and it is managed directly by the Ministry of Finance. As regards the other levels of debt, such as debt of municipalities and debt of public enterprises and state-owned companies, guaranteed by the state, the Ministry of Finance participates in the process of borrowing, but cannot influence the intensity of withdrawing the funds under the concluded loan agreements.

In the end of 2017, the general government debt of the Republic of Macedonia amounted to EUR 3,958.5 million, i.e. 39.3% of GDP. The central government debt accounts for the most of the general government debt, amounting to EUR 3,944.3 million, while the debt of the municipalities amounts to EUR 14.2 million.

Pursuant to the Law on Public Debt, public debt is a broader definition of the debt, including the general government debt and the guaranteed debt of public enterprises and companies fully or dominantly owned by the state or municipalities. Public debt amounted to EUR 4,786.9 million on 31<sup>st</sup> December 2017, i.e. 47.6% of GDP.

Although the debt level increased in the past years, the Republic of Macedonia still remains to be moderately indebted country compared to the EU Member States. In fact, according to the Eurostat Press Release dated 24<sup>th</sup> April 2018, average general government debt to GDP ratio in the EU28 was 81.6% at the end of the fourth quarter of 2017.

From the point of view of the interest structure, fixed - variable interest rate ratio was 72:28 respectively at the end of 2017. As regards currency composition, debt denominated in domestic currency accounted for 21.4% in the total general government debt portfolio, while share of foreign currency denominated debt was 78.6% (including government securities with FX clause issued on the domestic market), whereby euro-denominated debt accounted for the most with 71.6%, share of SDR was 5.6%, Japanese Yen-denominated debt accounted for 1.1% and US dollar-denominated debt accounted for 0.3%.

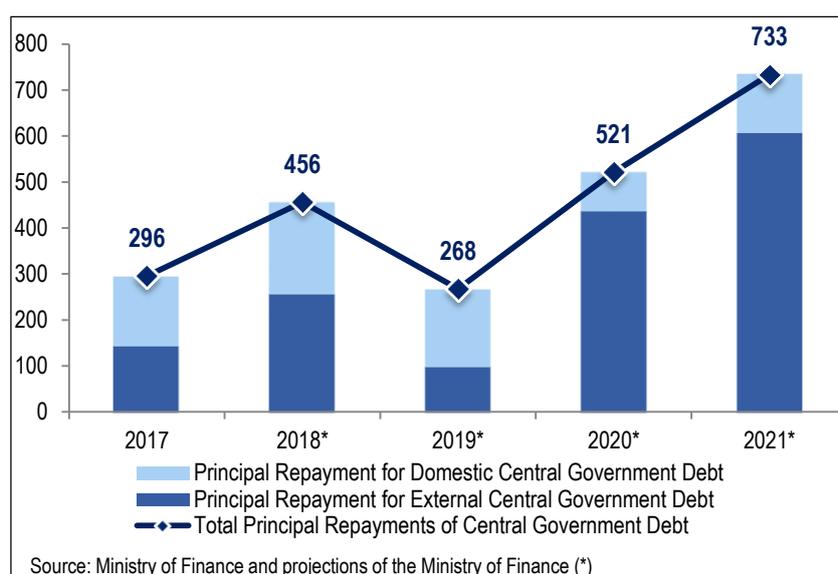
Special emphasis in the past period was put on developing the domestic government securities market by issuing government bonds with longer maturity. This has contributed to its deepening and extending the average time to maturity of the domestic debt portfolio. The average time to maturity of the domestic debt portfolio of the central government, which includes continuous government securities and structural bonds, at the end of 2012 was 450 days, while at the end of 2017, ATM was 1,606 days. In addition, the Ministry of Finance has continued its policy of lower auction frequency, whereby the auction calendar for the first and the second quarter in 2018 envisages two auction per month. Hence, the Ministry of Finance expects for secondary trading with government securities to be encouraged, where investors, needing liquid funds with shorter maturities than the ones offered at the regular auctions, will participate. In addition, in conditions of stable market trends and

continuously relatively high demand for government securities, interest rates on government securities have dropped since the beginning of 2018, thus providing for lower borrowing costs.

## 5.1 Projections and Limits on General Government and Public Debt Level and Structure

Investments launched in the past period in the field of road and rail infrastructure, water supply and sewerage, sports facilities, education, health, energy, construction of the National Gasification System, as well as other projects that are in line with the Programme of the Government of the Republic of Macedonia, are expected to continue in the 2019 - 2021 period. The projects, co-financed with foreign loans, will be implemented by the state administration bodies, strongly committed not to jeopardise the long-term sustainability of the debt level of the country. In addition, part of the borrowing is aimed at covering the budget deficit, i.e. providing for smooth Budget execution. In addition, part of the borrowing will also be intended for repayment of debt liabilities falling due in the coming period (Figure 12).

Figure 12. Central Government Debt Repayment Profile (EUR million)



In order to ensure sources of financing of the needs of the state with the lowest costs in the medium and the long run with a sustainable level of risk, public debt management policy defines several medium-term and short-term limits, in line with the Law on Public Debt.

### 5.1.1 Medium-Term Limits

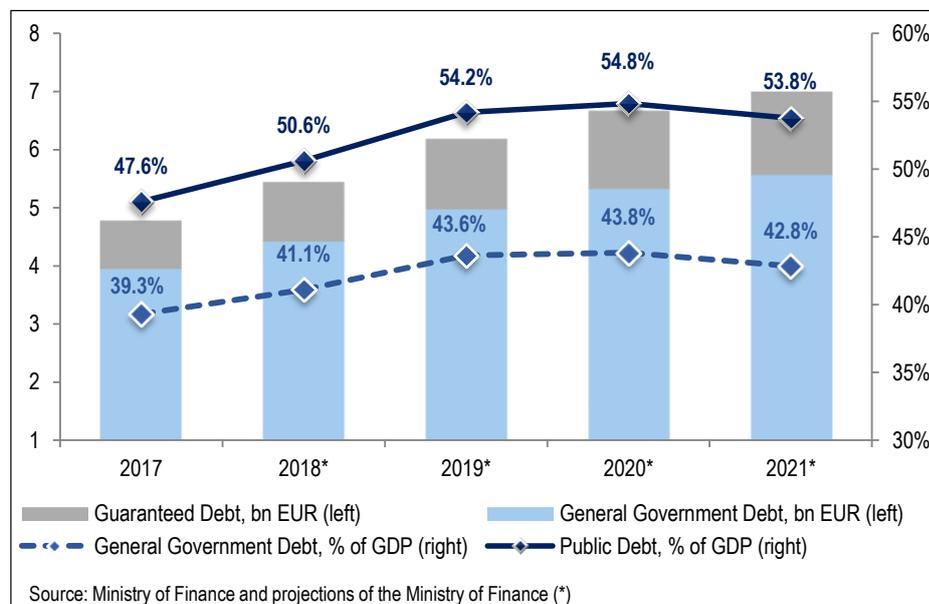
Medium-term limits are used to compile the framework for the movement of public debt in the 2019 – 2021 period. Such limits define the maximum sustainable level of total public debt in relation to GDP and the level of guaranteed public debt in relation to GDP. In addition, in order to reduce the risk factors affecting the total public debt portfolio, medium-term limits on currency and interest structure of the general government debt are also determined.

In order to keep a sustainable level of public debt, without disrupting the fiscal sustainability, the limit on the total public debt level in the medium and long run is set not to exceed 60% of GDP.

The public debt level is considered sustainable if it enables a timely servicing of the debt liabilities coming due in the longer run, which depends on several factors such as: the level of development of the domestic financial market, the liquidity of the international capital market, the rate of economic growth, the inflation rate, the level of budget deficit/surplus, etc. On the basis of the medium-term budget framework, which implies the need for budget deficit financing on the medium term, the needs for repayment of debt liabilities coming due, as well as the implementation of the projects outside the central government, the public debt in the medium run will

experience a moderate increase, but will still be within adequate framework, i.e. it will not jeopardise debt sustainability (Figure 13). More precisely, moderate increase of the total public debt is expected on the medium term to 54.8% of GDP in 2020, followed by a decline to 53.8% of GDP in 2021, which is significantly below the limit on the medium- and long-term level of the public debt.

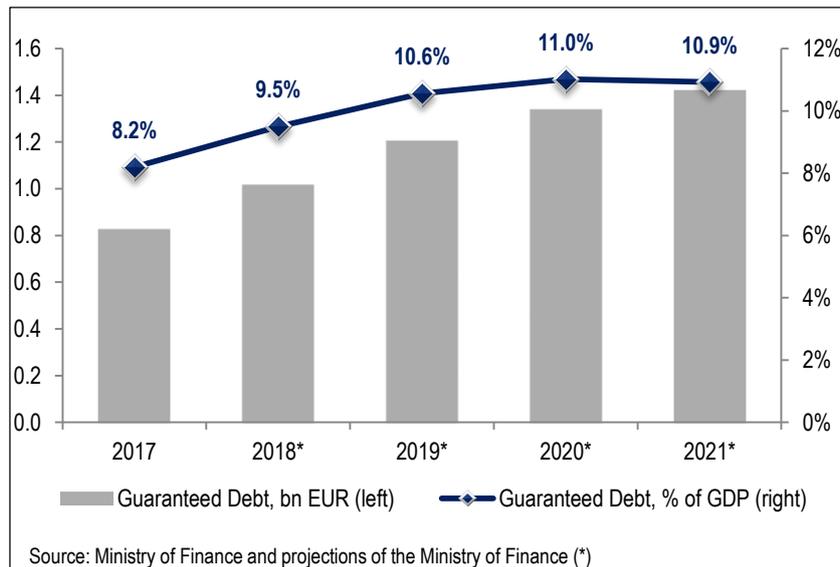
Figure 13. Projections on Total Public Debt (General Government Debt and Guaranteed Debt)



Issued sovereign guarantees are a contingent liability for the budget, i.e. there is a risk of increased costs related to servicing in case the guarantees are activated. Therefore, the sustainable level of issued guarantees in the medium term is of great importance for the Ministry of Finance. In addition, when selecting the projects for which a sovereign guarantee will be issued, special emphasis is put on self-sustaining projects, which generate revenues, support the economic growth and will provide for boosted competitiveness of the national economy in the medium term, which are in line with the strategic priorities of the Government of the Republic of Macedonia, and justify the purpose which the funds are used for. In accordance with this, the limit on the level of guaranteed public debt is defined not to exceed 13% of GDP in the 2019 -2021 period.

On the basis of the analyses made on the movement of the projected guaranteed public debt in the 2019-2021 period (Figure 14), it is expected to moderately increase by 2020 as a result of the disbursement of loan proceeds under the projects mainly in the road infrastructure, implemented with loans for which sovereign guarantee is issued. Following 2020, these loans enter into the repayment stage, and accordingly the guaranteed debt to GDP ratio is expected to be reduced. Related to this, the level of guaranteed debt throughout the whole period is below the defined maximum limit.

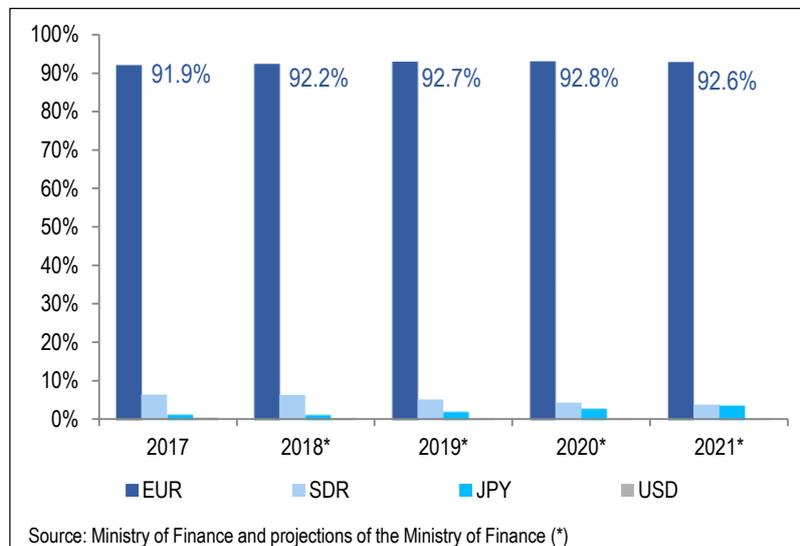
Figure 14. Guaranteed Public Debt



Changes in the exchange rate could largely affect, i.e. increase, the projected costs for repayment of debt denominated in foreign currency. However, taking into account the fact that since 1995 the Republic of Macedonia applies a de facto fixed exchange rate regime of the denar in relation to the German Mark, and since 2002 onwards in relation to the euro, and that this policy will continue in the future, the exposure to such a risk would be measured as a share of the euro in the total debt portfolio. Consequently, the limit on the currency structure of the general government debt - the minimum threshold of euro-denominated debt in the total general government debt portfolio denominated in foreign currency is defined to be 85% in the period 2019-2021.

A dominant share of euro-denominated debt is evident in the currency structure projections, experiencing moderate increase in the medium term as a result of the commitment of the Ministry of Finance for the new external borrowing to be denominated in euros (Figure 15). In the 2019-2021 period, the share of euro-denominated debt in the total general government debt portfolio denominated in foreign currency is significantly above the minimum threshold. The small share of other currencies (lower than 10% of the total general government debt denominated in foreign currency) is related to loans denominated in US dollars, Japanese Yen and Special Drawing Rights for credit lines. These loans were mainly concluded in the past and they are repaid in the period covered in this Strategy.

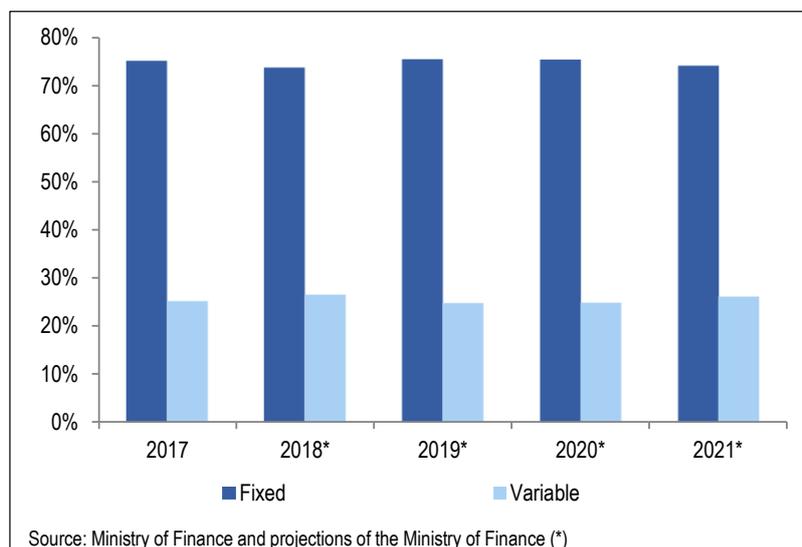
Figure 15. Currency Structure of General Government Debt Denominated in Foreign Currency



In order to protect the general government debt portfolio against possible future market shocks, i.e. unfavourable changes of interest rates that directly lead to increase of the costs of the Budget of the Republic of Macedonia, maintaining an optimal interest rate structure of the general government debt portfolio is one of the objectives of the debt management. Therefore, the limit on the interest rate structure of general government debt - the minimum threshold of debt with fixed interest rate is determined to be 60% for the 2019-2021 period.

Taking into account the current structure of the general government debt portfolio, as well as the medium-term projections, in the 2019-2021 period the fixed interest rate debt is significantly higher than the defined minimum threshold (Figure 16). This reflects the commitment of the Ministry of Finance to issue long-term securities on the domestic market, as well as the commitment to borrowing on the basis of instruments with fixed interest rate on the international capital market.

Figure 16. Interest Rate Structure of General Government Debt



### 5.1.2 Short-Term Limits

In line with the medium-term targets on determining both the optimal level and the structure of public debt portfolio, short-term limits, i.e. limits pertaining only to 2019, are also defined. These limits help to determine the maximum amount of net borrowing in 2019, as well as the maximum amount of net borrowing on the basis of guarantees issued in the course of the same year.

Net borrowing in 2019 includes the planned borrowing within the general government debt, reduced by its repayments. Related to this, sources of financing secured through the borrowing in 2018 will also be allocated for partial financing of the repayments falling due in the first quarter of 2019. The short-term maximum limit on net borrowing (domestic and external) on the basis of general government debt in 2019 is set at EUR 600 million.

In order to reduce the risk of contingent liabilities in the public debt portfolio, the annual amount of net borrowing on the basis of guaranteed debt of public enterprises is defined. Investments in road infrastructure, implemented with loans for which a sovereign guarantee is issued, are expected to intensify in 2018 and 2019. Therefore, the guaranteed debt stock is expected to increase, and the limit on maximum net borrowing on the basis of guaranteed debt in 2019 is set up to EUR 250 million.

Thresholds on the debt refinancing indicator (showing the average time for debt re-financing), as well as on the indicator of the average time to re-fixing (showing the average time for changing the interest rates of the debt portfolio) are calculated within this Strategy. More precisely, in order to protect the central government debt portfolio against the re-financing risk, the limit on re-financing risk - the minimum threshold of "average time to maturity" indicator in 2019 is determined to be 3 years. Further on, in order to protect the central government debt portfolio against the interest rate risk, the limit on the risk for interest rate changes - the minimum threshold of the "average time to re-fixing" indicator in 2019 is determined to be 2 years<sup>4</sup>.

<sup>4</sup> The debt refinancing risk, as well as the interest rate risk, are presented in more details in Section 5.2.

## 5.2 Public Debt Risk Management

In conditions of large oscillations of economic variables, the need arises to actively manage risks to which the public debt portfolio in the Republic of Macedonia is exposed. The risk management policy is of crucial importance for public debt management, being the main link between the proposing, designing, adopting and implementing the Public Debt Management Policy. The development of this policy is a challenge for the debt management and it comprises identifying, measuring and managing the risks, taking into account the trade off between risks and costs.

The main objective of public debt management is to ensure that government financing needs and liabilities are covered with the lowest costs in the medium and long run with an acceptable risk level. From the point of view of the risks the debt portfolio of the general government debt of the Republic of Macedonia faces, certain improvement in indicators on the re-financing risk and the interest rate risk can be observed. In fact, as a result of the commitment of the Ministry of Finance to develop the domestic government securities market, the process of restructuring the government securities portfolio has been underway since 2012, with newly issued securities with longer maturity, while the issue of short-term instruments has been gradually reduced. This strategy resulted in a significant improvement in terms of re-financing risk and interest rate risk regarding the domestic debt portfolio. As regards the other risks, debt management in the medium term will be focused on maintaining the lowest cost possible under a sustainable level of risk.

The main risks identified in managing the debt portfolio of the Republic of Macedonia are as follows:

1. Debt re-financing risk:
2. Market risk, involving the following risks:
  - Interest rate risk
  - Exchange rate risk.
3. Risk associated with the contingent liabilities and
4. Operational risk.

1. The refinancing risk is managed by preventing a considerable part of the liabilities to fall due at once at any time and providing an evenly distributed maturity of debt-related liabilities. The exposure of public debt portfolio to re-financing risk is measured by the debt repayment profile and the “average time to maturity” indicator. The greater the value of this indicator, the lesser the uncertainty, i.e. the re-financing risk.

Average time to maturity as regards the central government debt is expected to increase in the 2019-2021 period, from 4.2 years as projected for the end of 2019 to close to 4.6 years in 2021 (Table 8). As regards the domestic debt, maturity extends as a result of the commitment of the Ministry of Finance to focus on deepening the domestic securities market. In fact, particular emphasis was put on increased issuance of long-term securities, as well as extending the maturity and volume of the existing government securities portfolio by issuing 2-, 3-, 5-, 10- and 15-year government bonds, while a 30-year government bond was issued for the first time in April 2018. The re-financing risk is expected to drop in the period 2019 - 2021 as a result of the extended maturity of the external debt portfolio. These projections point out that average time to maturity in the period 2019 - 2021 is significantly above the defined limit on the minimum threshold for 2019.

Table 8. Average Time to Maturity - ATM (years)

	2019	2020	2021
Central Government Debt	4.2	4.4	4.6
Domestic Debt	4.3	4.5	4.3
External Debt	4.2	4.4	4.7

Source: Simulations of the Ministry of Finance

Taking into consideration the projections for the repayment profile in the coming years (Figure 12), it can be noticed that liabilities on the basis of repayment of the external and the domestic general government debt increase. A particular challenge for efficient management of the re-financing risk is expected in 2020 and 2021, when the Eurobonds issued in 2014 and 2015 (in the total amount of EUR 678 million), as well as the second

instalment on the basis of the loan secured under Policy Based Guarantee (PBG) from the World Bank (in the amount of EUR 155 million), fall due for repayment.

The sixth Eurobond, in the amount of EUR 500 million, with a 7-year maturity and historically lowest interest rate of 2.75%, was issued in January 2018, reflecting the exceptionally high confidence of the international investors in the perspectives of the Macedonian economy, as well as the favourable conditions on the international capital market. In order to reduce the re-financing risk in 2020, the Ministry of Finance made an early repayment of part of the previously issued Eurobond with an interest rate of 4.875%, falling due in 2020 in the nominal amount of EUR 91.7 million. The early repayment smoothened the redemption profile by reducing the refinancing amount in 2020, while also generating savings on interest costs from the Budget of the Republic of Macedonia. In order to further smoothen the redemption profile and reduce the re-financing risk, as well as generate additional savings, the Ministry of Finance will continue to consider the possibility for debt restructuring in the coming period by actively managing the debt portfolio through liability management activities.

2. The market risk is determined by the exposure of debt portfolio to economic variables, especially the changes of interest rates on the domestic and the international capital markets and the movements in foreign exchange rates. Identifying and managing market risks in the Republic of Macedonia is crucial for the public debt portfolio since these risks are determined mainly by external factors, i.e. variations in interest rates on the international financial markets where, due to their constant oscillations, medium- and long-term trend is very difficult to project.

Measuring and managing the interest rate risk is especially important in the countries in which domestic financial markets are underdeveloped and the financing needs are covered from external sources under non-concessional terms, where exposure to interest rate risk is greater. Changes of interest rates in the domestic and international markets affect the debt-related costs, especially when fixed interest rate debt should be refinanced or when the interest is re-set for variable interest rate debt. Therefore, there is a close connection between the interest rate risk and the debt re-financing risk.

The ATR (average time to re-fixing) indicator measures the average time to interest rate change. A higher value of this indicator shows that a larger portion of the debt portfolio will not be subject to a significant interest rate change and that such portfolio is a lower-risk portfolio. In the coming period, it is expected for the interest rate risk to drop by a slight increase of the average time to re-fixing indicator in the period 2019 - 2021 (Table 9). Increase in the average time to re-fixing is due to the increase at this indicator at both the domestic and the external debt. In fact, the increase of the ATR indicator is in line with the commitment to borrow on the basis of fixed-interest instruments on the domestic and the international capital markets in the coming period. These projections point out that average time to re-fixing in the period 2019 - 2021 is significantly above the set limit on the minimum threshold for 2019.

Table 9. Average Time to Re-Fixing (years)

	2019	2020	2021
Central Government Debt	3.7	3.9	4
Domestic Debt	4.3	4.5	4.3
External Debt	3.4	3.6	3.8

Source: Simulations of the Ministry of Finance

Exchange rate risk refers to the debt indexed or denominated in foreign currency. A higher share of the debt denominated in foreign currency points out to a higher exchange rate risk. This risk is crucial for the developing countries where external debt is fully indexed and also where a higher share of the domestic debt is denominated in foreign currency.

Changes in the exchange rate may largely affect, i.e. increase the envisaged costs for repayment of public debt denominated in foreign currency. However, taking into account that the Republic of Macedonia applies a de facto fixed exchange rate of the denar to the euro, the exposure to such a risk would also be measured as a share of the euro in the total general government debt portfolio, which was actually dominant currency with a 71.6% share in the total debt structure at the end of 2017.

3. The risk related to contingent liabilities - as a result of the projected investments, which are exceptionally important for the further development of the energy sector and the infrastructure, a moderate but controlled increase of the level of the guaranteed public debt is projected in the following period. In order to

ensure more favourable financing terms and conditions by the creditors, the state issues a sovereign guarantee, after carrying out analyses of the borrower and its ability to independently service its future liabilities.

Liabilities on the basis of guaranteed debt in relation to GDP falling due in the period 2019-2021 have a moderately upward trend, but borrowers will independently service such liabilities. In order for the central government budget not to be exposed to the risk of calling-up guarantees, the process of issuance of new guarantees is strictly regulated and is subject to certain criteria that claimants of guarantees should meet.

4. The operational risk includes the settlement risk and the error risk. The settlement risk occurs if numerous non-automated activities are used during data processing, while error risk is closely related to the manner of segregating the tasks related to the execution of transactions and their settlement across the units within the institution in charge of debt management. Public debt management is carried out with an IT system and adequate software platform, thus significantly reducing the risk of human errors. Measures to apply the “four eyes” principle (at least two executors of each operation) are also undertaken in a timely manner, in order to avoid the risk from untimely performance of the tasks in case the responsible person is prevented from fulfilling the working tasks.

### **5.3 Development of Government Securities Market**

Development and maintenance of an efficient and liquid domestic government securities market is an additional goal in public debt management in most of the developed economies and economies in transition. In order to ensure a stable and reliable source of financing of the budget needs, it is necessary for the domestic financial market to be deep enough so as to respond to the needs of the country in conditions of external shocks. In that way, budget needs are met without causing any crowding out effect. In addition, a developed domestic financial market enables a growing number of investors and a creation of a reference yield curve for the overall economy.

The Ministry of Finance will continue to regularly issue government securities on the domestic market in the coming period. The purpose is, by regular issuance of government securities, to provide for more efficient financing of budget needs in the short and the long run, reducing the financing costs, as well as encouraging further development of the financial market in the Republic of Macedonia.

In the upcoming period, Ministry of Finance will intend to retain regular issuance of treasury bills, as well as stay focused on expanding the maturity structure of the portfolio of government securities with longer maturities. Thus, particular emphasis will be put on extending the maturity of the existing government securities portfolio.

This measure will be implemented through the following activities:

- promotion and primary issuance of government bonds with 30-year maturity, on quarterly basis and in a standardised amount;
- issuance of government bonds with 15-year maturity at least 4 times a year;
- issuance of government bonds with 10-year maturity at least 4 times a year;
- issuance of government bonds with 2-, 3- or 5-year maturity on regular basis;
- reduction of the share of government securities with FX clause in the total issued government securities.

Pension funds, as well as commercial banks and insurance companies, are expected to show particular interest in investing in long-term securities issued by the Republic of Macedonia. In order to improve and further develop the government securities market, activities aimed at expanding the investor base will be continued, by considering the possibility to introduce new financial instruments adequate to the needs of the market participants, as well as carrying out marketing campaign in front of different target groups of investors and maintaining regular dialogue with all participants on the government securities market.

## **6. Fiscal Risks and Sensitivity Analysis**

Medium-term economic projections are based on certain assumptions, primarily on the macroeconomic environment, the design of economic policies and their implementation, as well as the absence of greater shocks. This also refers to medium-term macroeconomic and fiscal projections discussed so far as the baseline medium-term projection. Related to this, different assumptions on input variables may also result in variations of the projections of the key fiscal policy variables. Nevertheless, the projections on the deficit and the general

government debt for Macedonia by the international financial institutions are similar to the ones in this Fiscal Strategy (Table 10).

Table 10. Comparison of Projections on Budget Deficit and General Government Debt in Macedonia

Institution	Budget balance (% of GDP)				General government debt (% of GDP)			
	2018	2019	2020	2021	2018	2019	2020	2021
IMF	-3.0	-3.1	-3.2	-3.2	41.2	42.2	43.5	44.9
World Bank	-2.7	-2.5	-2.3	/	43.0	45.4	42.1	/
European Commission	-2.6	-2.6	/	/	42.0	43.9	/	/
Ministry of Finance	-2.7	-2.5	-2.3	-2.0	41.1	43.6	43.8	42.8

Source: IMF (World Economic Outlook Database, April 2018), World Bank (Western Balkans Regular Economic Report No. 13, April 2018) & European Commission (European Economic Forecast, May 2018).

Medium-term economic and fiscal projections are always accompanied by certain level of uncertainty and risks. The possible occurrence of these risks, which assume conditions other than those taken as basis for the medium-term projections discussed above, would result in deviations from the baseline medium-term projection, i.e. different movements of the key fiscal variables. Therefore, this section of the Fiscal Strategy analyses the possible effects of several main macro-fiscal risks on the budget deficit and the general government debt. In addition, this section also analyses the exposure of the external general government debt to the market risk, as well as the effect of various financing strategies on the debt level, the debt servicing costs and the portfolio structure.

### 6.1 Macro-Fiscal Risks and Sensitivity of the Deficit and the General Government Debt

This part of the Fiscal Strategy provides a review, for the first time, of the results from the sensitivity analysis of the budget deficit and the level of general government debt to the possible effects of the four main identified risks to fiscal policy in the medium term. All risks are analysed separately and all scenarios assume absence of other deviations from the baseline projection and the effects only of certain risks:

- Scenario 1 - lower economic growth,
- Scenario 2 - lower tax revenues by 5%,
- Scenario 3 - lower execution of capital expenditures by 25% and
- Scenario 4 - servicing the liabilities on the basis of issued guarantees from the central government budget.

Taking into account that the baseline medium-term fiscal projection is based on certain macroeconomic assumptions, they are considered to be a primary factor with a potential effect on the fiscal developments. Therefore, effects of downward risks regarding the external environment are used as the first risk scenario. This would deteriorate both the foreign trade and the financial flows, as well as increase uncertainty and deteriorate the expectations among the domestic economic agents, which would further result in a lower economic growth of the country. According to this scenario, the projection of the average real GDP growth between 2018 and 2021 is by 0.9 percentage points lower than in the baseline projection. Further, the possible lower economic growth would also imply lower performance of the cyclical component of budget revenues. Therefore, in relation to the baseline projection, this scenario would result in a higher budget deficit by 0.5 percentage points of GDP on average, while the general government debt would be higher by 1.3 percentage points of GDP on average between 2018 and 2021.

The second scenario assumes lower collection of tax revenues by 5% annually compared to the baseline projection. In conditions of unchanged level of budget expenditures and unchanged economic growth, lower tax revenues would lead to a higher budget deficit and higher general government debt by 1.3 p.p. of GDP each on average during the analysed period compared to the baseline projection.

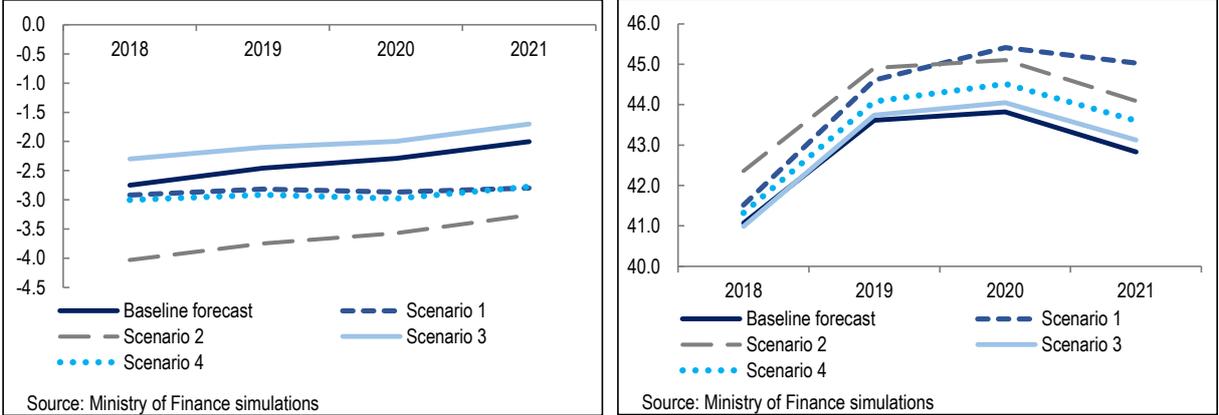
The third scenario assumes lower execution of capital expenditures, i.e. their execution at the level of 75% of the levels projected in the baseline projection, which is similar to the execution in the past. The lower

execution of capital expenditures would slow down the growth of gross investments and accordingly leading to a lower GDP growth rate in relation to the baseline projection on average by around 0.4 percentage points. This scenario would adversely affect tax revenues as well, but this effect would be lower compared to the one of reduced expenditures. Therefore, according to this scenario, the budget deficit would be lower by 0.3 p.p. of GDP on average annually in the projection period compared to the baseline projection, while general government debt would, in average, be almost at the same level as in the baseline projection.

The fourth scenario assumes that the liabilities falling due on the basis of principal and interest on loans guaranteed by the state to be fully serviced from the central government budget, which would increase the level of budget expenditures in the coming period. In conditions of unchanged level of budget revenues and unchanged economic growth, this would lead to a higher budget deficit, as well as higher general government debt by 0.5 p.p. of GDP on average annually in the period 2018 - 2021 compared to the baseline projection. The effect of the scenario would be more evident in 2020 and 2021, when the liabilities falling due on the basis of principal and interest on loans guaranteed by the state account for 0.7% and 0.8% of GDP respectively.

In summary, the realisation of any of the four risk scenarios, which reflect the main identified macro-fiscal risks in the coming period, would mostly result in relatively limited effects on the budget deficit and the general government debt (Figure 17). More precisely, the sustainability of fiscal policy in the medium run is in no case jeopardised.

Figure 17: Analysis of the Sensitivity of the Budget Deficit (left) and the General Government Debt (right) to Main Macro-Fiscal Risks (% of GDP)



**6.2 Analysis of the Scenario on the Effects of Interest Rate Risk and Currency Risk on the External General Government Debt**

In order to analyse the exposure of the debt portfolio of the Republic of Macedonia to the market risk, a short simulation is prepared on the effects of the interest rate changes and changes in the foreign exchange rate on the costs related to servicing of the external general government debt (Table 11). The sensitivity analysis of the movements of the servicing-related costs on the basis of external debt in the central government budget is based on the following assumptions:

- by changing one variable, all other variables remain the same, i.e. ceteris paribus;
- in conditions of possible currency movements in relation to the euro, the Denar exchange rate in relation to the euro remains stable;
- non-correlation between interest rate movements and exchange rate movements.

Table 11. Sensitivity Analysis of Costs Related to Servicing the External General Government Debt in Cases of Interest Rate Changes and Changes in Foreign Exchange Rates

	2019	2020	2021
Baseline scenario	100.0	100.0	100.0
Scenario 1 - increase of corresponding interest rates by 1 percentage point	105.2	105.1	105.0
Scenario 2 - appreciation of other currencies in the portfolio in relation to the euro by 10%	101.4	100.5	100.4

Source: Simulations of the Ministry of Finance

Main conclusions that may arise from this analysis are as follows:

1. Servicing-related costs on the basis of external general government debt are sensitive to the interest rate movements. Should interest rates in 2019 surge by 1 percentage point in relation to the baseline projection, this would cause interest-related costs to increase by 5.2%, i.e. by EUR 5.3 million, with similar effects in 2020 and 2021. Such sensitivity could be explained as exposure of the debt portfolio to interest rate risk.

2. Possible euro depreciation in relation to the other currencies in the portfolio (US dollar, Japanese Yen and Special Drawing Rights) by 10% will cause an increase of servicing-related costs by 1.4% in 2019, i.e. by EUR 3 million, while the effects are weaker in 2020 and 2021. Given the obtained results, it may be concluded that possible unfavourable movements of exchange rates of other currencies in relation to the euro will not cause any significant increase of the servicing-related costs, as a result of the fact that most of the external general government debt is euro-denominated.

### 6.3 Alternative Financing Strategies

In order to improve the decision-making process related to financing the Budget needs, aimed at successful fulfilment of the goals set in the public debt management policy, quantitative analysis is prepared in this Strategy by applying the Medium-Term Debt Strategy (MTDS), an analytical tool developed by the World Bank and the IMF.

The MTDS model uses the following as an input data:

- projections of macroeconomic and financial variables,
- principal and interest flows on the existing debt portfolio;
- alternative strategies on financing the budget deficit and debt repayment and
- financial variables shocks (interest rate and exchange rate).

The model analyses the effect of the different financing strategies on the debt level, the debt servicing-related costs and the portfolio structure. Alternatives that could be used as sources of financing are the following:

1. Treasury bills and government bonds on the domestic government securities market;
2. Eurobond on the international capital market;
3. Withdrawal of funds from already concluded loan agreements with international financial institutions;
4. Using funds from the World Bank as budget support in the form of development policy loan (DPL) or policy-based guarantee (PBG) loan.

The MTDS model analyses four alternative financing strategies, elaborated below. Certain unfavourable shocks to the exchange rate and the interest rates are introduced to the model, in order to observe the effect on the debt level and the debt portfolio in such conditions. The model is set in a manner that the debt not denominated in domestic currency is an external debt. This means that all government securities with a Euro clause are registered as external debt.

Time framework pertaining to the analysis is three-year period, i.e. the period pertaining to this Strategy.

Alternative manners of financing differ among themselves in the financing structure in relation to the domestic or the external financing, as well as in the instrument structure.

The first alternative envisages covering the financing needs through the domestic government securities market, the international capital market, World Bank funds for budget support, as well as withdrawal of funds for project financing by the international financing institutions. Within the domestic financing, most of the net financing is realised on the basis of short-term instruments, i.e. treasury bills. Therefore, this alternative is accompanied by unfavourable results at the risk indicators. Indeed, the value of ATM and ATR indicators drops at the end of 2021, showing an increased refinancing risk and interest rate risk, while the share of the debt falling due within one year in the overall debt increases.

The proportion between domestic (also including government securities with FX clause) and external financing in the second alternative is the same as in the first one, but, the second alternative envisages extended maturity of the government securities. Market analysis shows interest by investors in the new 30-year instrument, and therefore this alternative envisages higher financing through the 30-year government bonds with FX clause. In addition, the second alternative envisages lower net financing through short-term instruments on the domestic market in relation to the first alternative. The result arising from the application of this alternative is improvement at the ATM and ATR risk indicators and deepening of the domestic market. In terms of costs, this alternative is slightly more expensive in relation to the first alternative, but in terms of riskiness of the debt portfolio, this alternative has significantly better performances.

The third alternative largely relies on external financing. In fact, roll over of debt securities coming due is mainly expected on the domestic market, while financing of the other budgetary needs is envisaged to be provided from external sources. This alternative is accompanied by the most unfavourable costs-to-risks ratio. The exchange rate risk is the most pronounced in this alternative due to greater relying on external sources of financing, and it is also the most expensive alternative. In fact, the debt-to-GDP ratio and the interest cost-to-GDP ratio are the highest at this alternative. At the same time, decline is observed at ATM and ATR indicators, showing an increased refinancing risk and interest rate risk.

The fourth alternative envisages greater amount of financing the budgetary needs to be provided on the domestic government securities market (also including government securities with FX clause). Financing for the other budgetary needs will be provided from external sources. Interest cost-to-GDP ratio is the lowest at the fourth alternative due to the lower interest rates on the domestic market, and debt-to-GDP ratio is the lowest compared to the other alternatives. Considering that larger amount of financing needs is provided from domestic sources, this alternative is the least exposed to the exchange rate risk, however, it is not favourable in terms of the other risks to the debt portfolio. Like at the first alternative, ATM and ATR indicators drop, showing an increased re-financing risk and interest rate risk, while the share of the debt falling due within one year in overall debt increases. In addition, the model does not take into account the probability of a need for upward revision of the interest rates on the domestic market in order to enable the realisation of larger amounts of net borrowing, nor the possible effect of crowding-out of domestic investments.

The objective of the MTDS tool is to quantify the costs and the risks and to find out the optimal ratio between them. In addition, the tool enables observing the different structure of the debt portfolio at each of the alternatives, thereby taking into account the effects of the shocks on the financial variables. According to the analysis of the results from the application of the alternative approaches, it can be noticed that the second alternative is the most favourable in terms of the debt portfolio riskiness (as per the refinancing risk and the interest rate risk indicators), because of the greater focus on the instruments with longer maturities on the domestic market, although it is a slightly more expensive option than the first alternative. In fact, the first alternative, gives better results from the point of view of the costs, but it also has a more significant deterioration of the risk indicators. The third alternative is the most expensive and with the highest risk, and therefore it is rejected as the most unfavourable financing alternative, while the fourth alternative, despite the low costs and low exposure to exchange rate risk, is still unfavourable in terms of re-financing risk and interest rate risk.

## Appendix 1. Maximum Amounts of Expenditures by Budget User, 2019 - 2021

Table A1. Maximum Amounts of Expenditures of the Core Budget (637 Account), Denar

BUDGET USER	2019	2020	2021
PRESIDENT OF THE REPUBLIC OF MACEDONIA	74,963,000	74,963,000	74,963,000
INTELLIGENCE AGENCY	222,546,000	222,546,000	222,546,000
ASSEMBLY OF THE REPUBLIC OF MACEDONIA	575,836,000	575,836,000	575,836,000
STATE AUDIT OFFICE	92,816,000	92,816,000	92,816,000
STATE COMMISSION FOR PREVENTION OF CORRUPTION	33,594,000	32,594,000	32,594,000
STATE ELECTION COMMISSION	328,878,000	428,878,000	78,878,000
COMMISSION FOR PROTECTION OF COMPETITION	21,960,000	21,960,000	21,960,000
DIRECTORATE FOR PERSONAL DATA PROTECTION	17,885,000	17,885,000	17,885,000
STATE APPEALS COMMISSION FOR PUBLIC PROCUREMENT	19,085,000	19,085,000	19,085,000
REGULATORY COMMISSION FOR HOUSING	10,237,000	10,237,000	10,237,000
COUNCIL FOR ADVANCEMENT AND OVERSIGHT OF AUDIT	5,496,000	5,496,000	5,496,000
COMMISSION FOR PROTECTION AGAINST DISCRIMINATION	5,540,000	5,540,000	5,540,000
STATE SECOND LEVEL COMMISSION FOR ADMINISTRATIVE AND LABOR RELATION PROCEDURE	57,625,000	57,625,000	57,625,000
AUDIT AUTHORITY FOR AUDIT OF INSTRUMENT FOR PRE-ACCESSION ASSISTANCE	41,822,000	41,822,000	41,822,000
STATE SECOND LEVEL COMMISSION FOR INSPECTION SUPERVISION	27,470,000	27,470,000	27,470,000
CONSTITUTIONAL COURT OF THE REPUBLIC OF MACEDONIA	38,382,000	36,882,000	36,882,000
GOVERNMENT OF THE REPUBLIC OF MACEDONIA	2,126,585,000	2,160,260,000	2,161,885,000
SERVICE FOR GENERAL AND COMMON AFFAIRS OF THE GOVERNMENT OF THE REPUBLIC OF MACEDONIA	946,280,000	905,180,000	905,880,000
SECRETARIAT FOR LEGISLATION	17,135,000	17,135,000	17,135,000
PUBLIC ATTORNEY OF THE REPUBLIC OF MACEDONIA	80,695,000	80,695,000	80,695,000
AGENCY FOR ADMINISTRATION	40,260,000	40,260,000	40,260,000
SECRETARIAT FOR EUROPEAN AFFAIRS	104,470,000	112,020,000	120,538,000
SECRETARIAT FOR IMPLEMENTATION OF OHRID AGREEMENT	644,457,000	647,874,000	648,510,000
AGENCY FOR COMMUNITY RIGHTS REALIZATION	10,420,000	10,420,000	10,420,000
AGENCY FOR MANAGEMENT OF CONFISCATED PROPERTY	22,155,000	22,155,000	22,155,000
INSPECTION COUNCIL	25,290,000	25,290,000	25,290,000
AGENCY FOR USE OF LANGUAGE	8,350,000	8,350,000	8,350,000
MINISTRY OF DEFENCE	6,600,000,000	6,800,000,000	7,000,000,000
DIRECTORATE OF SECURITY OF CLASSIFIED INFORMATION	29,914,000	29,914,000	29,914,000
PROTECTION AND RESCUE DIRECTORATE	258,900,000	258,900,000	258,900,000
CRISIS MANAGEMENT CENTER	174,100,000	189,100,000	209,100,000
MINISTRY OF INTERIOR	9,348,600,000	9,489,000,000	9,558,900,000
MINISTRY OF JUSTICE	321,450,000	294,350,000	296,350,000
DIRECTORATE FOR EXECUTION OF SANCTIONS	799,076,000	915,928,000	908,395,000
OFFICE FOR MANAGEMENT OF REGISTERS OF BIRTHS, MARRIAGES AND DEATHS	186,598,000	186,598,000	186,598,000
THE BUREAU FOR REPRESENTATION OF THE REPUBLIC OF MACEDONIA BEFORE THE EUROPEAN COURT OF HUMAN RIGHTS	5,195,000	5,195,000	5,195,000
INSPECTORATE FOR USE OF LANGUAGES	7,360,000	7,360,000	7,360,000
MINISTRY OF FOREIGN AFFAIRS	1,228,664,000	1,247,594,000	1,247,594,000
MINISTRY OF FINANCE	836,015,000	665,644,000	688,454,000
CUSTOMS ADMINISTRATION OF THE REPUBLIC OF MACEDONIA	829,553,000	820,696,000	812,000,000
COMMODITY RESERVES AGENCY	59,240,000	59,240,000	59,240,000
PUBLIC REVENUE OFFICE	777,000,000	782,000,000	940,000,000
FINANCIAL POLICE	34,700,000	34,700,000	34,700,000
STATE FOREIGN EXCHANGE INSPECTORATE	6,870,000	6,870,000	6,870,000

MINISTRY OF ECONOMY	457,851,000	477,551,000	497,551,000
AGENCY FOR FOREIGN INVESTMENTS AND EXPORT PROMOTION	199,030,000	213,926,000	229,998,000
AGENCY FOR PROMOTION AND SUPPORT OF TOURISM	134,518,000	134,518,000	134,518,000
DIRECTORATE FOR TECHNOLOGICAL INDUSTRIAL DEVELOPMENT ZONES	808,500,000	749,700,000	625,700,000
STATE MARKET INSPECTORATE	175,300,000	173,300,000	173,300,000
STATE INSPECTORATE FOR TECHNICAL INSPECTION	21,314,000	21,314,000	21,314,000
MINISTRY OF ENVIRONMENT AND PHYSICAL PLANNING	532,550,000	532,900,000	542,490,000
STATE INSPECTORATE OF ENVIRONMENT	24,700,000	24,700,000	24,700,000
MINISTRY OF TRANSPORT AND COMMUNICATIONS	2,051,147,000	2,016,648,000	1,600,050,000
STATE TRANSPORT INSPECTORATE	26,950,000	26,950,000	26,950,000
STATE INSPECTORATE FOR CONSTRUCTION AND URBAN PLANNING	14,141,000	14,141,000	14,141,000
STATE COMMUNAL INSPECTORATE	13,570,000	13,570,000	13,570,000
MINISTRY OF AGRICULTURE, FORESTRY AND WATER ECONOMY	702,780,000	716,794,000	693,606,000
AGENCY FOR ENCOURAGING THE DEVELOPMENT OF AGRICULTURE – BITOLA	56,546,000	56,546,000	56,546,000
NATIONAL HYDRO-METEOROLOGICAL SERVICE	92,109,000	92,109,000	92,109,000
AGENCY FOR FINANCIAL SUPPORT IN AGRICULTURE AND THE RURAL DEVELOPMENT	8,785,600,000	8,788,533,000	8,789,356,000
FOOD AND VETERINARY AGENCY OF THE REPUBLIC OF MACEDONIA	540,633,000	540,633,000	540,633,000
STATE INSPECTORATE FOR AGRICULTURE	84,758,000	84,758,000	84,758,000
STATE INSPECTORATE FOR FORESTRY AND HUNTING	15,930,000	15,930,000	15,930,000
MINISTRY OF LABOR AND SOCIAL POLICY	44,184,959,000	45,519,160,000	46,709,571,000
STATE LABOR INSPECTORATE	101,800,000	101,800,000	101,800,000
MINISTRY OF EDUCATION AND SCIENCE	21,513,163,000	21,514,163,000	21,515,163,000
OFFICE FOR DEVELOPMENT OF EDUCATION	196,210,000	198,220,000	195,300,000
NATIONAL AGENCY FOR EUROPEAN EDUCATION PROGRAMS AND MOBILITY	24,235,000	24,235,000	24,235,000
STATE EDUCATION INSPECTORATE	54,530,000	54,530,000	54,530,000
AGENCY FOR YOUTH AND SPORT	384,962,000	309,798,000	216,339,000
MINISTRY OF INFORMATION SOCIETY AND ADMINISTRATION	1,488,077,000	1,475,167,000	1,475,167,000
STATE ADMINISTRATIVE INSPECTORATE	24,770,000	24,770,000	24,770,000
MINISTRY OF CULTURE	3,583,051,000	3,622,451,000	3,654,151,000
MINISTRY OF HEALTH	4,748,930,000	4,703,290,000	4,703,290,000
STATE SANITARY AND HEALTH INSPECTORATE	37,000,000	37,000,000	37,000,000
MINISTRY OF LOCAL SELF-GOVERNMENT	423,192,000	493,192,000	583,210,000
STATE INSPECTORATE FOR LOCAL SELF-GOVERNMENT	5,210,000	5,210,000	5,210,000
EMIGRATION AGENCY	20,897,000	20,897,000	20,897,000
COMMISSION FOR PROTECTION OF THE RIGHT TO FREE ACCESS TO PUBLIC INFORMATION	16,580,000	16,580,000	16,580,000
COMMISSION ON RELATIONS WITH RELIGIOUS COMMUNITIES AND RELIGIOUS GROUPS	13,130,000	13,130,000	13,130,000
AGENCY FOR REAL ESTATE CADASTRE	200,000,000	200,000,000	200,000,000
STATE STATISTICAL OFFICE	190,776,000	169,234,000	168,524,000
STATE ARCHIVES OF THE REPUBLIC OF MACEDONIA	134,000,000	134,000,000	134,000,000
BUREAU FOR COURT EXPERTISE	20,356,000	20,356,000	20,356,000
MACEDONIAN ACADEMY OF SCIENCE AND ARTS	104,632,000	104,632,000	104,632,000
BUREAU FOR REGIONAL DEVELOPMENT	136,000,000	146,000,000	156,000,000
COURT COUNCIL OF REPUBLIC OF MACEDONIA	1,971,150,000	2,048,240,000	2,048,240,000
PUBLIC PROSECUTION OF THE REPUBLIC OF MACEDONIA	694,778,000	720,213,000	745,879,000
OMBUDSPERSON	82,260,000	87,150,000	92,410,000

Table A2. Maximum Amounts of Expenditures Financed with Loans, Denar

BUDGET USER	2019	2020	2021
GOVERNMENT OF THE REPUBLIC OF MACEDONIA/FUND FOR INNOVATIONS AND TECHNOLOGY DEVELOPMENT	186.000.000	211.909.000	0
DIRECTORATE FOR EXECUTION OF SANCTIONS	347.097.000	405.294.000	452.600.000
MINISTRY OF FINANCE	1.820.637.000	684.008.000	261.525.000
MINISTRY OF TRANSPORT AND COMMUNICATIONS	4.090.971.000	5.735.910.000	6.544.325.000
MINISTRY OF ENVIRONMENT AND PHYSICAL PLANNING	0	0	620.000.000
MINISTRY OF AGRICULTURE, FORESTRY AND WATER ECONOMY	695.000.000	898.795.000	871.416.000
MINISTRY OF LABOR AND SOCIAL POLICY	124.000.000	310.000.000	310.000.000
MINISTRY OF EDUCATION AND SCIENCE	540.934.000	468.774.000	398.050.000
MINISTRY OF INFORMATION SOCIETY AND ADMINISTRATION	0	31.000.000	155.000.000
MINISTRY OF HEALTH	496.000.000	496.000.000	0

Table A3. Maximum Amounts of Expenditures of the Core Budget (660 Account), Denar

SOCIAL FUNDS	2019	2020	2021
Pension and Disability Insurance Fund of Macedonia	71.234.000.000	74.908.000.000	78.790.000.000
Health Insurance Fund of Macedonia	30.349.000.000	31.739.000.000	33.293.000.000
Employment Service Agency of Republic of Macedonia	2.468.000.000	2.615.000.000	2.785.000.000