REPUBLIC OF MACEDONIA

MINISTRY OF FINANCE

FISCAL STRATEGY OF THE REPUBLIC OF MACEDONIA

2010-2012

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Pursuant to Article 16, paragraph 2 of the Budget Law (Official Gazette of the Republic of Macedonia, nos. 64/2005, 04/2008 and 103/2008), Government fo the Republic of Macedonia, at its session held on 30 June 2009, adopted the 2010-2012 Fiscal Strategy of the Republic of Macedonia.

INTRODUCTION

Medium-Term Fiscal Strategy, prepared in line with the Budget Law, outlines the macroeconomic and the fiscal policy on the medium term, necessary for the successful realization of the overall complex process of budget planning. Preparation of the Fiscal Strategy of the Republic of Macedonia is in compliance with the methodology of the developed countries and it is proven in practice as necessary when defining the global trends of the medium-term economic development.

Main strategic priorities of the Government of the Republic of Macedonia for the coming period are defined as continuation of the development of the Macedonian economy, and ensuring the necessary conditions for intensification of the EU and NATO accession process. Such defined priorities are as follows:

- maintenance of positive growth rates of the Macedonian economy, although at lower level than the previously realized ones, and enhancement of the competitiveness of all areas in the economy;
- maintenance of macroeconomic stability and Denar exchange rate;
- intensification of the combat against crime and corruption and respecting the legal order;
- investments in knowledge and education as the safest way to create professional personnel and a stong state, and
- reduction of unemployment by job creation and increase of the living standard.

Present global financial economic crisis is one of the biggest challenges to the fiscal policies in all countries affected by the crisis. Global economic crisis, which at the beginning was felt only in the financial sector, surprised with its depth and multi-dimension. Thereby, during the first wave, when the crisis affected only the financial sector, CEE countries, including the Republic of Macedonia, were quite resistant. Soon these countries faced risk aversion to invest in risky areas, in particular in the transition countries which based their development on this model. In fact, in the last few years, the Macedonian economy, as well as other countries in the region, mainly based their development model on the inflow of foreign and domestic investments with high current account deficit, which had sound sources of financing in the form of direct and portfolio investments, foreign currency remittances from abroad, etc.

Second problem for the Macedonian economy and the countries experiencing similar conditions is the reduced external demand, leading to contractions of the domestic demand. Decisions of the banks to extend loans to the households and the economy, as well as the decision of the households regarding the saving, are also affected by the global expectations. All this especially reflected in the real sector within which, metal industry, textile industry and transportations were hit the most.

Recession in the developed countries significantly limited the export possibilities for the Macedonian companies, which is an unfavourable concurrence with the high BOP current account deficit, mainly determined by the trade deficit.

In the light of this context, it is important to underline that 2010-2012 Medium-Term Fiscal Strategy is prepared in conditions of altered macroeconomic environment, directly under the influence of the consequences from the global economic crisis, which, to a great extent, sets the trends and the assumptions of the development of the Macedonian economy.

CURRENT ECONOMIC TRENDS

1.MACROECONOMIC PERFORMANCE

Macroeconomic Trends and Projections in 2009

Financial economic crisis, which emerged in the USA, and spilled over in waves through Western Europe to East Europe, did not circumvent the Republic of Macedonia either. Although the crisis did not hit the Macedonian financial system, still its adverse effects strongly reflected on the real sector, mainly by reducing the external demand for the Macedonian products. Despite the fact that 5.0% annual GDP growth was realized in 2008, being among the highest rates in Europe in this year of crisis, in the fourth quarter in 2008 already the negative effects of the global economic crisis were felt in the Republic of Macedonia as well, creating a concerning and deteriorated situation at the beginning of 2009 compared to the end of the previous year. Following statistical data speak for the adverse economic trends:

- Industrial production dropped by 7.6% in the last quarter in 2008 and by 14% in the first two months in 2009, while recovery was registered in March and April, whereby the industry experienced a decline by 5% and by 7% respectively.
- Export also declined by 43% in the first two months. In March 2009 already, export grew by 12% compared to the previous month.
- Number of registered unemployed persons in the Employment Agency in the period January-February 2009 increased by 7,700 persons, while in March and April, the upward trend of new unemployed was stemmed.
- MSEI Index showed 52% increase in May.
- Deflation tendencies registered at the beginning of the year stopped in May, when the inflation was low and positive, amounting to 0.5%.

Even at the earliest stage of the crisis, the Government of the Republic of Macedonia, as a respond to the global crisis, adopted fiscal package of measures generally divided in two groups, as follows:

- Measures aimed at firms with deteriorated liquidity, having outstanding contributions, taxes and other public duties, to the end of rescheduling the debts and writing off the interest, provided that principal is paid on regular basis. When arrears registration deadline expired, 2,807 companies submitted requests in the total amount of 165 million as principal and EUR 60 million as interest. It actually means that these companies, if paying the arrears on regular basis, would have had EUR 60 million as support to reduce their arrears. At the same time, debt of four state-owned companies was converted into state equity to the end of increasing the competitiveness of these companies and their attractiveness for sale.

- Second set of measures is aimed at better-standing companies, which, in addition to the policy for reduced contributions, are also provided the possibility for reinvested profit tax exemption. At the same time, the envisaged reduction of customs duties on raw materials and intermediate goods for large number of raw materials in the textile industry, machines and equipment in the metal industry will provide for the Macedonian companies to be more competitive on the international market.

First signs of recovery of the Macedonian economy do not mean that the Republic of Macedonia has exited the crisis. On the contrary, all this points out that 2009 will be a year experiencing low economic growth. Thus, by analyzing and continuously monitoring the trends in the Macedonian economy, need arises for adequate adjustment of the 2009 macroeconomic policy, and accordingly of the fiscal policy, i.e. preparation of Supplementary Budget, corresponding to the present situation, to the end of easier overcoming of the crisis this year and larger amortization of the adverse effects of the crisis.

In such conditions, the Government of the Republic of Macedonia adopted new package comprising 70 anti-crisis measures, among which the need to revise the initial projections on budget revenues and expenditures, i.e. preparation of Supplementary Budget. Underlying assumptions for the Supplementary Budget were the decline of the projected revenues, and accordingly of the expenditures by: freezing of new employments, postponement of the envisaged salary increase in the public administration, reduction of all non-productive costs and import-intensive capital projects so as to continue the projects engaging the construction sector and the national companies. Measures for direct credit support to the private sector were also adopted within the new anti-crisis package by providing EIB credit line in the amount of EUR 100 million, to the end of granting favourable credits to small- and medium-sized enterprises, measures for streamlining customs operations and faster flow of goods at the border, measures to regulate the liabilities and claims between companies, as well as measures in the field of transportation for support to carriers.

Analysis carried out on the basis of all so-far available data on domestic and foreign competent institutions shows that economic growth in 2009 is expected to be 1%, while inflation, as a result of the reduction of prices of goods and reduction of import prices, will be low and will amount to around 1%.

From the point of view of the expenditures side of GDP, main driving force of the economic growth will be the final; consumption, accounting for 5.3 percentage points. Such role of the final consumption will be mainly due to the higher share of personal consumption as a result of the successfully implemented salary reform (gross salary concept), which contributed to the increase of the net salary in January 2009 by 13% compared to December (as a result of including travel and food allowance in the gross salary). This caused for the number of workers who did not receive salary to drop from 8% to only 2.6%, i.e. expressed in nominal terms, 20,000 more citizens received regular salary. At the same time, public consumption will reflect positively on the growth, taking into account that its strong investment component projected for 2009. Net-export in 2009 is expected to contribute negatively to GDP by 3 p.p., taking into account that projected GDP growth in 2009 (according to OECD) at our biggest trading partners is negative: -5,3% in Germany, -2% in Serbia, around 0% in Greece and -4,3% in Italy. Republic of Macedonia exports around 25-30% of the domestic production or 65% of the total export to these four countries. Such expectation is also confirmed by the import growth projections in the countries – the biggest trading partners of the Republic of Macedonia. In fact, according to the latest projections, import in Germany will drop by 10%, in Italy by 13% and in the USA by 11%, which will considerably lead to reduction of the external demand and export from the Republic of Macedonia. At the same time, gross investments in 2009 are expected to be low, but negative in GDP growth by 1.4 p.p., mainly due to the weak global investments activity and the high level of uncertainty to invest.

From the point of view of the production method to calculate GDP, services, as main driving force of the growth, will account for the most in its creation, i.e. 1.3 p.p.. Another component aimed at maintaining GDP growth in 2009 will be the civil engineering, which, as a result of the government program to intensify public investments in all social and economic areas, will participate with 1.1 p.p in the growth, being higher compared to the previous years. Due to the difficulties the industry faces, as one of the most important sectors in the economy (22% of GDP) in conditions of global economic crisis, it will negatively contribute to GDP growth with 2.1 p.p., but in the coming years already its positive effect in GDP it is expected to continue.

Regarding the external sector, as a result of the reduced external demand for the Macedonian products in 2009, current account deficit is expected to keep the high level as in 2008, however, the proposed adjustment of the fiscal policy to the actual economic situation is expected to contribute to its certain decline and gradual elimination as risk to the macroeconomic stability, whereby it would reach 11% of GDP. Projected reduction of the export as percentage of GDP is 4.6 p.p., and og the import is 5.5 p.p., meaning slight decline of the trade deficit to 26% of GDP. The same level of private transfers (real reduction) is projected in 2009 as in 2008, as well as low surplus at services and decline of income deficit (as a result of the expected reduction of profitability of foreign companies in the Republic of Macedonia).

Table 1: Selected macroeconomic indicators

	2008	2009*
GDP (real growth)	5,0%	1.0%
CPI	8,3%	1,0 %
Industrial production (growth)	5,5%	-7,5%
Budget deficit (% of GDP)	-1,0%	-2,8%
Trade deficit (% of GDP)	-26,8%	-26,0%
Current account deficit (% of GDP)	-12,7%	-11,0%
Unemployment rate	34,0%	34,5%

*Revised projections of the Ministry of Finance

Taking into account that the declining trend of unemployed persons stopped in December 2008, zero employment growth is expected in 2009, as well as stoppage of the downward trend of unemployment and increase of the number of unemployed persons, although the unemployment rate is expected to increase by only 0.5 p.p.

Taking into account the unpredictable economic circumstances, due to which the intensity of the economic crisis on global and national level cannot be envisaged, let alone its duration, it is necessary to constantly monitor the situation and to promptly react to each new aspect of the crisis. Main goal of the Government of the Republic of Macedonia, shown through the proposed adjustment of the fiscal policy and through the other so-far undertaken measures, will be to maintain the continuity of GDP growth and avoid recession, even if GDP is significantly lower compared to the previous years.

Trends in the world economy and their influence on CEE countries.

Global economy since 2008 onwards is facing the most severe recession in the post-war period, caused by the serious financial crisis and the sharp decline of confidence in the credibility of the financial institutions.

Due to the strong mutual connection between the economies in the developed countries and the economies in the CEE region, it was inevitable for the negative effects to spill over these economies. These effects spilled over through higher capital costs, reduced FDIs, reduced export, repatriation of already invested foreign capital and decline in net-inflows on the basis of remittances from abroad. All this caused for serious slowdown of the economic growth, deepening of the BOP deficit and budgets in these countries. At the end of 2008, some of the countries in Central and East Europe, in the Baltic region, etc., were brought to the verge of economic collapse (such as is the case of Hungary) and the governments had to conclude arrangements with the IMF.

Table 1.2. Selected macroeconomic indicators for selected CEE economies

	Real GDP growth			Inflation (CPI)			BOP current account (% of GDP)		
	2007	2008	2009F	2007	2008	2009F	2007	2008	2009F

Bulgaria	6,2	6,0	-3,6	7,6	12,0	3,7	-25,1	-24,4	-12,3
Turkey	4,7	1,1	-5,1	8,8	10,4	6,9	-5,8	-5,7	-1,2
Poland	6,7	4,8	-0,7	2,5	4,2	2,1	-4,7	-5,5	-4,5
Romania	6,2	7,1	-4,1	4,8	7,8	5,9	-13,9	-12,6	-7,5
Slovakia	10,4	6,4	-2.1	1,9	3,9	1,7	-5,4	-6,3	-5,7
Slovenia	6,8	3,5	-2,7	3,6	5,7	0,5	-4,2	-5,9	-4,0
The Czech Republic	6,5	3,2	-3,5	2,9	6,3	1,0	-3,2	-3,1	-2,7
Western Balkan									
Albania	6,2	6,0	0,4	2,9	3,4	1,5	-9,1	-13,5	-11,3
Bosnia and Herzegovina	6,8	5,5	-3,0	1,5	7,4	2,1	-12,7	-15,0	-9,3
Croatia	5,5	2,4	-3,5	2,9	6,1	2,5	-7,6	-9,5	-6,5
Serbia	6,9	5,4	-2,0	6,5	11,7	10,0	-15,3	-17,3	-12,2
Macedonia	5,9	5,0	-2,0	2,3	8,3	1,0	-7,2	-13,1	-14,1

Source: IMF, World Economic Outlook, April 2009 and European Commission (for Western Balkan countries)

Highest economic growth rate in 2008 in this group of countries was reached by Romania (7.1%), followed by Slovakia, which registered 6.4% GDP growth in 2008. In the Republic of Macedonia, growth was also significant, reaching 5%. Republic of Bulgaria experienced the highest level of BOP current account deficit of 24.4% of GDP, without any consequences to the national currency, as a result of the introduced Currency Board. Republic of Serbia registered 17% deficit, Croatia experienced 10% deficit, while deficit in the Republic of Macedonia amounted to 13%. The lowest current account deficit was registered in the Czech Republic of 3.1% of GDP, which on the other hand experienced high inflation rate of 6.9%. Latvia showed the highest inflation rate of 15.3%, while the lowest one of 3.9% was registered in Slovakia. Among CEE countries, Slovakia and Latvia have the highest unemployment rates of 9.5% and 7.5% respectively, while the lowest unemployment rates were registered in the Czech Republic (4.4%) and Estonia (5.5%).

As a result of the effects of the global crisis and the decline of the global aggregate demand, in the last quarter in 2008, significant export decline of 25.3% was registered in Ukraine, 17.7% in Estonia, 13.5% in the Czech Republic, 11.8% in Hungary, 11.6% in Slovenia and 11.2% in Slovakia. Within the CEE region, the lowest export decline of 0.8% was recorded in Lithuania, while in the Western Balkan region, the lowest export drop of 1.7% was registered in Croatia. in the last quarter in 2008, the Republic of Macedonia experienced export decline by 7.6%.

Regarding Q1 in 2009, as shown in the Table below, industrial production experienced significant decline in all countries in SEE region.

	Q4 2008	Jan. 09	Feb. 09	March 09	Q1 2009
Macedonia	-7,6	-16,7	-11,3	-4,8	-10,9
Czech Republic	-13,5	-22,9	-23,4	-17,5	-21,3
Hungary	-11,8	-23	-28,9	-19,6	-23,8
Poland	-6,1	-15,3	-14,6	-2	-10,6
Slovakia	-11,6	-31,4	-26,4	-15,9	-24,6
Slovenia	-11,2	-17,4	-22,3	-18,5	-19,4
Estonia	-17,7	-29,2	-32,7	-33	-31,6
Latvia	-10,3	-24	-24,2	-23,4	-23,9
Lithuania	-0,8	-7	-15,5	-17,9	-13,5
Bulgaria	-7,0	-18,4	-17,7	-17,1	-17,7

Croatia	-1,7	-14,2	-12,5	-6,6	-11,1
Romania	-11,0	-16,4	-14,5	-8,5	-13,1
Serbia	-5,0	-17,7	-19,4	-14,2	-17,1
Russia	-6,3	-15,9	-13,2	-13,7	-14,3
Ukraine	-25,3	-31,8	-31,5	-30,8	-31,4

Source: National statistics

Thereby, the decline was the largest in Estonia and Ukraine, while the lowest one of around 10% was recorded in Poland, Croatia and Macedonia Such decline was accompanied by the export decline, which was 35% in Serbia, 37% in Estonia, 44% in Macedonia and 14% in Croatia.

Abovementioned economic indicators point out that the Macedonian economy is not an exception in term of the influence of the global economic crisis, however it is important to point out that, compared to the countries in the region, some of the economic indicators show better performance.

2. EXECUTION OF GENERAL GOVERNMENT BUDGET

During this year, fiscal policy, reflected through the general government budget, has been implemented within the initially planned policies, guidelines and projections, without any significant deviations as a result of the adverse influence of the global economic crisis. During this period, in conditions of deviations in the revenue performance, regular financing and performance of the functions of the state on both national and local level has been ensured, as well as timely financing of the legal obligations, timely commencement of the tender procedures for the new and continuation of the on-going capital projects and continuation of the policy of active management of the public debt of the Republic of Macedonia.

In the period January-May 2009, despite the adverse effects of the global crisis, reform policies were successfully realized, in particular the ones related to reduction of social contribution rates, gross salary project and realization of the measures envisaged in the fiscal package of anti-crisis measures at the end of the last year and April 2009.

Total revenues of the general government budget (Budget of the Republic of Macedonia and the budget pf the local government units) in the first five months amounted to Denar 55,903 million, while total expenditures were realized in the amount of Denar 58,964 million, whereby deficit of 0.75% of GDP projected for 2009 was realized. This level of deficit is a result of the realized central government budget revenues and expenditures at the level of 0.8% of GDP and the realized low level of deficit from the regular operations of LGUs.

2.1 Budget of the Republic of Macedonia

Dynamics of realizing revenues and expenditures in the first five months in 2009 was under stong influence of the global economic crisis and the negative effects on the Macedonian economy. Thereby, successfully implemented tax reforms in the last several years improved, to a great extent, the endurance and the persistence of the Macedonian economy and buffered the external blows from the crisis. The fact that in the last two years the functioning of the state was performed in conditions of lowest personal income tax and profit tax rates speaks in favour of the endurance and the persistence of the Macedonian economy. If we add the effects of the reduction of the contribution rates, which, as a measure, is yet be undertaken by the countries hit by the crisis, one can envisage that the Macedonian economy will resist the blows of the crisis this year.

In the period January-May 2009, budget deficit was realized in the amount of Denar 3,392 million or 0.8% of GDP. In the same period, central government budget deficit amounted to Denar 3,931 million, i.e. 0.9% of GDP, while Funds' budgets showed surplus in the amount of Denar 530 million.

Budget deficit was due to the budget revenue performance in the amount of Denar 53,519 million and budget expenditure execution in the amount of Denar 56,911 million. At the same time, net inflows were realized from borrowing on the basis of short-term securities in the amount of Denar 898 million, and outflows on the basis of debt repayment in the amount of Denar 3,000 million. During this period, budget deposits were withdrawn, intended for payment of an installment for the old-foreign currency saving bond in the amount of around Denar 5 billion.

In general, the realized deficit was characteristic for this period of the year, taking into account that it is expected for the dynamics of the expenditure execution to accelerate, in particular the capital expenditures, which are mainly expected at the end of the year. During this period of the year, deviation in the realization of budget genuine revenues is evident, as well as limited sources of financing the realized deficit (low level of deposits and short-term securing of funds via issues of government securities). Realized inflows included the inflows on the basis of credit lines in the amount of around Denar 381 million from the World Bank and EBRD for financing construction works in the Agency for State Roads, as well as certain earmarked credit lines at the budget users for financing capital and development projects,

Total budget revenues in this period of the year accounted for Denar 44,344 million on the basis of tax revenues and social contributions, i.e. 83% of the total genuine revenues.

In the past five months of 2009, ***tax revenues*** were realized in the amount of Denar 28,599 million, showing underperformance in relation to the projected dynamics for the respective period. Lower realization is characteristic for the whole period, and with respect to January-May plan, total tax revenues were realized at the level of 96.1% (taking into account that the projected amounts were revised during May with the Supplementary Budget).

Decline of the tax revenues in this period, especially evident at the VAT, revenues on the basis of excises and customs duties, was mainly due to the reduced import of goods, which, expressed as percentage, accounted for around 20.8% less in relation to the same period last year, reduced consumption of excise goods in conditions of global economic crisis and reduction of customs rates pursuant to the Law on Modifications and Amendments to 2009 Customs Tariff, as well as the annual reduction of the weighted customs rates. With respect to revenues on the basis of the profit tax, drop was registered at all types of profit tax, and at the same time significant amount was spent on the basis of refund of overpaid amounts on the basis of advance payments in 2008.

Social contributions in the first five months were realized in the amount of Denar 15,745 million, which was stronger performance that the projected one, as a result of the effects of the integrated contribution collection in the Public Revenues Office, the new gross salary concept and the measures undertaken at the taxpayers.

Non-tax revenues in this period were realized according to the planned dynamics in the amount of Denar 8,237 million on the basis of payment of NBRM profit, revenues on the basis of Telecom dividend, collection of administrative and court fees, other non-tax revenues, as well as revenues on the basis of collected road tolls in the Budget of the Agency for State Roads.

Capital revenues in the respective period accounted for Denar 560 million, mainly as a result of the privatization proceeds and lease of construction land by natural persons and legal entities and funds from the social-owned flats.

In the period January-May 2009, ***total revenues*** of the consolidated budget were realized in the amount of Denar 56,911 million, being 36.8% performance compared to the total projected expenditures. Expenditure performance was higher compared to the same period last year and was mostly due to the higher transfers for agricultural subsidies, which were mainly realized in the last quarter in 2008.

Current expenditures were realized in the amount of Denar 52,045 million, Denar 9,417 million out of which was spent for salaries and allowances for the public administration employees, i.e. 35% compared to the projections, mainly including the effect of increase of salaries last year. In fact, as a result of the election-related activities, and the temporary freezing of new employments as part of the anti-crisis measures, no new employments were realized in this period of the year.

Realized reductions on the revenue side limited the spending, in particular the expenditures related to goods and services, as a continuation of the disciplined budget spending, especially of non-productive costs. Lower performance of these expenditures was evident, realized in the amount of 35% in relation to the projections, mainly as a result of the rigorously controlled spending, especially the expenditures related to official trips, mobile phones, entertainment costs and costs related to advertisement campaigns, which is also part of the anti-crisis measures, and such policy will continue to be applied in the coming period as well.

Social transfers accounted the most in the current expenditures, which, in this period of the year, were realized in the amount of Denar 34,810 million or 41% in relations to the projections. Liabilities of the state were serviced on regular basis in the field of guaranteed social protection of the specific categories of citizens, accounting for Denar 1,690 million, most of which was intended for payment of allowances to socially vulnerable households and child allowance.

During this period of the year, Denar 14,963 million was spent for regular payment of pensions, including the effect of the last regular increase of 3.5%, to 277,965 pension beneficiaries, with average pension in the amount of Denar 9,876. At the beginning of the year, Pension and Disability Insurance Fund, in addition to the support by the Public Revenues Office in the process of integrated collections, transferred, on regular basis, the portion of the contributions to the private pension funds for the members of the second pension pillar, amounting to Denar 1,170 million, for 216,404 members, and the number of new members-beneficiaries was 21,210 (as of April inclusive).

Denar 776 million was earmarked for payment of pecuniary allowance to unemployed persons through the Employment Agency for assistance to 26,595 persons, 2,302 persons out of which were beneficiaries of pecuniary benefits pursuant to the Bankruptcy Law. In addition to the regular and timely payment of allowances to the unemployed persons, the Employment Agency provided greater support to the active employment measures, implementation of the Self-Employment Project, organizing public works, as well as regular training for pre-qualification and re-qualification of unemployed persons.

Denar 8,069 million was spent for financing health services and allowances, or 43% of the projected amount for this purpose, according to the type and the scope of the health services. In this period, Health Insurance Fund continued to amend and revise the reference prices for hospital care, improvement of the process of budgeting and strengthening the established controls, intensification of the activities for introduction of treasury operations in the public health institutions.

With respect to other transfers, local government units were regularly transferred grants from the Budget, whereby Denar 487 million from VAT revenues was transferred to local level, while Denar 4,793 million was transferred as block grants for financing the transferred competences in 68 municipalities that moved to the second stage of decentralization (payment of salaries and allowances for the employees in the local public institutions) and earmarked grants for financing operating costs in the local public institutions.

During this period of the year, activities for awarding agricultural subsidies commenced, whereby more than 40% were paid in relation to the projected amount for subsidies, in particular for tobacco production, fruit plantations, labeled herds of beef, produced and sold milk and crops.

In the same period, Denar 930 million was allocated for regular servicing of liabilities on the basis of interest, according to the amortization plans for domestic and external borrowing, Denar 542 million out of which was for interest on foreign borrowing.

Capital expenditures were realized in the amount of Denar 4,866 million or around 20.5% of the projected amount, mainly for timely commencement of tender procedures. Within the realized capital expenditures, total of Denar 603 million was spent as investments in the road infrastructure of the Agency for State Roads. Agency's activities in the respective period were mainly aimed at completion of the construction works on Skopje Ring Road (first stage) and Tabanovce-Kumanovo section. With respect to the other portion of Corridor 10, i.e. Demir Kapija-Smokvica section, agreement for preparation of master and design project was concluded, while regarding the other road sections within Corridor 8, the master project was fully prepared, and land in eastern region of Macedonia is undergoing expropriation at the moment. At the same time, construction works on road section Kozuv Ski Center, Porece-Skopje and Kuklis-Bansko are in the process of realization.

Within the project for reconstruction and rehabilitation of 11 regional roads financed under World Bank credit, construction works were agreed and commenced for the following road sections: Ilinden-Kalugerac, Rzanicino-Sveti Nikole, Lakavica-Negotino, Davidovoo-Rabrovo, Stracin-Probistip, Struga-Debar, Prilep-Makazi-border with Greece, Prilep-Makedonski Brod, Prilep-Krivogastani, Prevalec-Smojmirovo and Strumica-Dojran. Regarding the remaining 9 regional roads financed under EBRD credit, tenders were announced for preparation of the projects Angelci-Veljusi and Radovis-Konce.

During this period, despite the limited budget inflows, principal on the basis of credits was serviced on regular basis, in the total amount of Denar 3,000 million, Denar 1,947 million out of which on the basis of domestic borrowing, and Denar 1,053 million on the basis of external borrowing by the central budget and the Agency for State Roads.

Budget of the Republic of Macedonia	2009 Budget	Realization in Jan-May 2009	Revised 2009 projection
1. TOTAL REVENUES	**153.213**	**53.519**	**143.076**
1.1. Tax revenues and contributions	**126.525**	**44.344**	**116.482**
1.1. 1 Tax revenues	88.594	28.599	78.451
1.1. 2 Contributions	37.931	15.745	38.031
1.2. Non-tax revenues	**21.105**	**8.237**	**21.745**
1.3. Capital revenues	**2.537**	**560**	**2.537**
1.4. Donations	**3.046**	**379**	**2.312**
2. TOTAL EXPENDITURES	**164.808**	**56.911**	**154.516**
2.1. Current expenditures	**135.928**	**52.045**	**130.753**
2.1.1 Salaries and allowances	25.154	9.417	24.173
2.1.2 Goods and services	22.693	6.888	19.187
2.1.3 Transfers	84.577	34.810	84.458
2.1.4 Interest	3.504	930	2.935
2.2. Capital expenditures	**28.881**	**4.866**	**23.763**
2.3.Future government policies			**0**
3. DEFICIT	**-11.595**	**-3.392**	**-11.440**
4. DEFICIT FINANCING	**11.595**	**3.392**	**11.440**
4.1 Inflow	**19.702**	**6.392**	**19.548**
4.1.1 Revenues from privatization	2.550	50	50
4.1.3 Foreign credits	7.155	381	13.498

4.1.3 Domestic borrowing	6.000	898	6.000
4.1.4 Deposits/additional sources	3.997	5.063	0
4.2 Outflow	**8.107**	**3.000**	**8.108**
4.2.1 Repayment upon external borrowing	2.271	1.053	2.272
4.2.2 Repayment upon domestic borrowing	5.836	1.947	5.836
4.2.3 Buying government securities		0	0

2.2 Local Government Budget

Improvement of the budget process has led to enhancement of the transparency and the reporting method in line with international standards on LGU budgets. At the same time, adoption of budget calendar by the municipalities and observance of the deadlines set therein proved to be a positive instrument in the overall budget process.

Revenues of around 3% of GDP were realized with the commencement of transfers of block grants from the central government budget in mid-2007 to 42 municipalities and of earmarked grants to the other municipalities In 2009, improved collection and updated database on property taxes and utility fees, as well as transfer of block grants from the central government budget, including salaries for the employees in local public institutions, are expected to increase the revenues of local government to around 6% of GDP.

Own revenues of the municipalities are collected from local taxes and fees within the set spread of rates that are proportionate and determined by the Municipal Council. Transfers to local government units provided from the central government budget in the form of earmarked, block and capital grants are allocated in the Budget of the Republic of Macedonia for the current fiscal year.

Revenues of the local government units significantly increased with the introduction of property tax on business facilities and business premises; rise of the utility fee for street lightening and additional administrative fees.

Additional revenues to local government units are provided from the distribution of revenues from utilisation of public national goods (mineral raw materials), providing revenues from concessions to the municipalities in the amount of 40% of the set concession fee in cases when the public goods exploited is located on the territory of the respective municipality.

Revenue structure shows significant share of revenues on the basis of property tax and utility fees, as well as transfers from the central government. Regarding the expenditure side of local government budget, share of capital expenditures is significant. However, by financing the transferred competences with block grants, expenditure structure has significantly changed in favour of the current expenditures, including salaries to employees in education, culture and child and social protection.

Since the beginning of 2009, 68 municipalities have fulfilled the requirements for full fiscal decentralization. Consolidated management with public finances and the application of budget principles in financing the local government units, as well as strengthened financial controls, have provided for successful realization of the fiscal decentralization and proper management with public finances on local level. During the first four months of the year, earmarked and block grants were transferred regularly from the central budget, thus enabling normal and dynamically harmonized financing of competences transferred to local level.

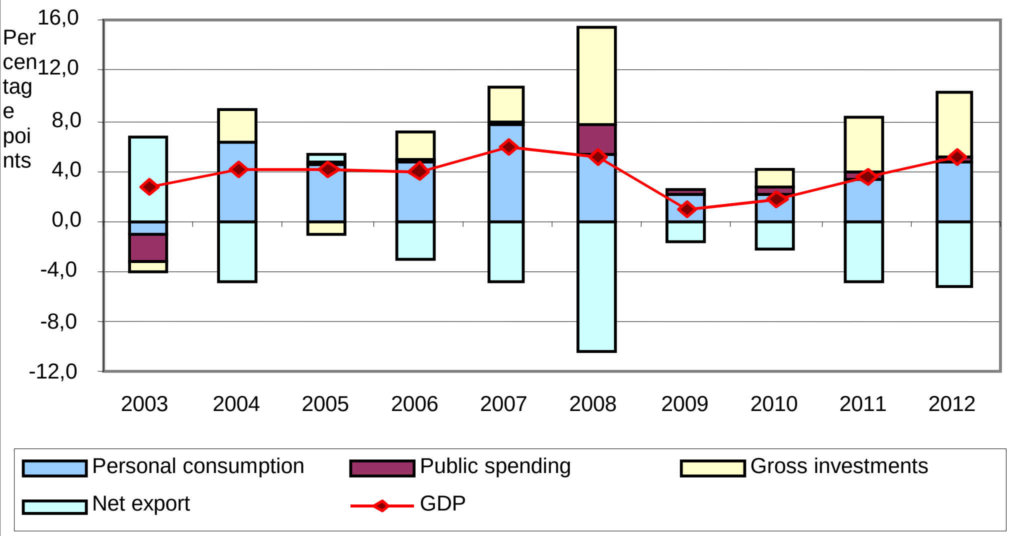
MEDIUM-TERM FISCAL STRATEGY

1. 2010-2012 Medium-Term Fiscal Expectations

Main goal of the Government of the Republic of Macedonia, according to its economic program, is mitigation of the negative consequences of the global economic crisis, as well as acceleration of the economic growth, whereby it is necessary to realize high growth rates several years in a row, so as for the citizens to feel larger increase of the available income and improvement of their living standard. In 2010, as post-crisis year, it is expected for the gross domestic product to increase by 2%, and high growth rates as in 2007 and 2008 are again expected in 2012 (5% projected growth). Thereby, such projection depends on the pace of recovery of the global economy, the announced visa liberalization and expected membership of Macedonia in NATO, as well as further success in attracting FDI and realization of the planned capital investments.

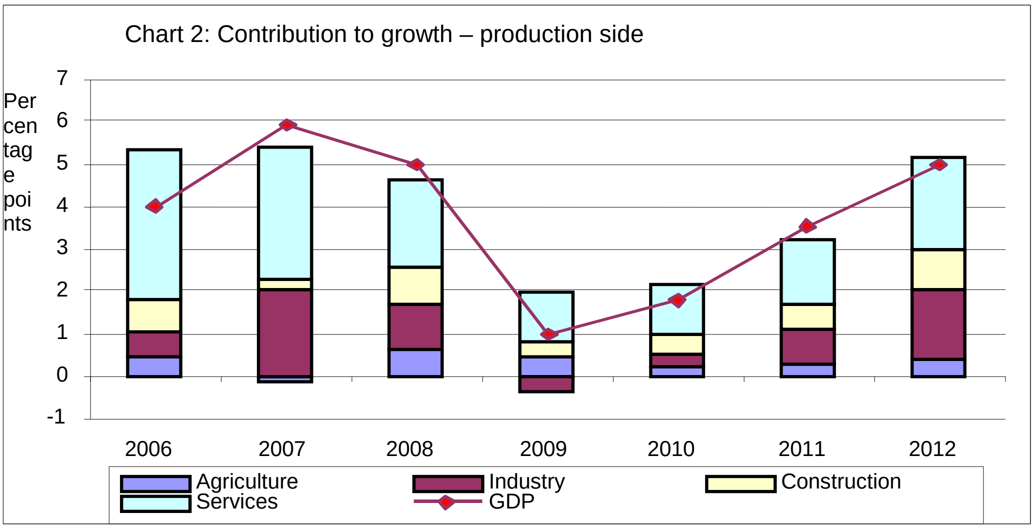
Regarding the expenditure side of GDP, driving force of the economic growth will be the personal consumption and the gross investments, the share of which in 2012 growth is expected to reach 5.9 p.p. and 4.1 p.p. respectively. With respect to investments, FDIs are expected to contribute significantly, however, not less important will be the capital investments, which, according to the adopted eight-year Program for Infrastructure Development of the Government of the Republic of Macedonia, will significantly increase and account for higher share in the referred period, as well as improve the competitiveness of the Macedonian economy on the medium and the long run.

Chart 1: Contribution to GDP growth – expenditure side



Source: Ministry of Finance

From the point of view of the production method to calculate GDP, services, as main driving force of the growth, will account for the most in its creation, contributing with 1.1 p.p. in 2011 and 2.1 p.p. in 2012. However, high growth of 7.2% is also expected in the industrial production, as a result of the continuation of the restructuring of the domestic capacities, as well as the entrance and commencement of production in the realized and the new FDIs.



Source: Ministry of Finance

Share of personal consumption in GDP growth in the period 2010-2012 is expected to be between 3.7 p.p. and 5.9 p.p. Such assumption is based on the following:

- projected employment growth between 3% and 4%;
- projected average increased of salaries of 7.5% in the analyzed period, led by the increase of salaries in the private sector, which will follow the increase in the productivity;
- increase of credits to households of 40% annually;
- expected stable level of private transfers.

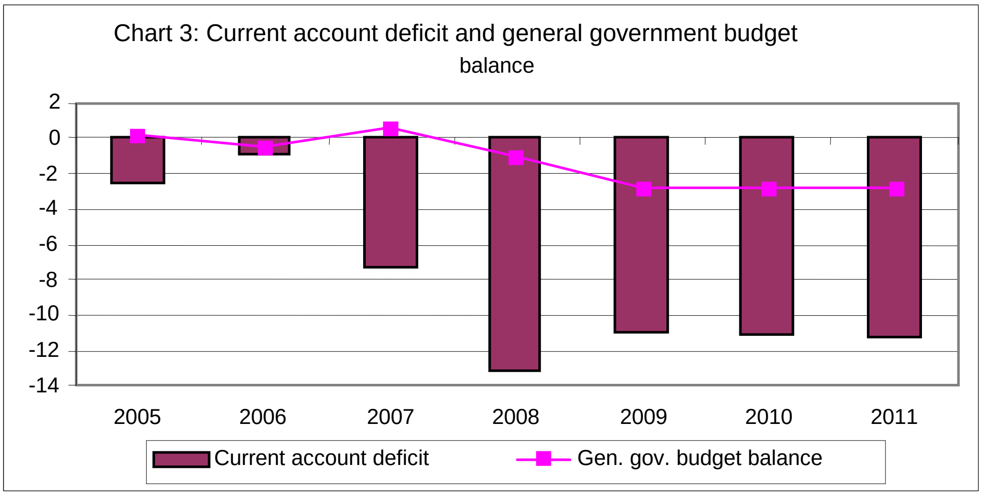
In the period 2010-2012, share of the increase public consumption will range between 0.6 p.p. and 1 p.p. in conditions of general government budget deficit up to 2.8% of GDP, mainly as a result fo the expected increased capital investments. Intensification of reform activities by the Government of the Republic of Macedonia, especially in the tax area, improvement of the business climate, as well as the expected integration of the Republic of Macedonia in the EU and NATO, are expected to intensify the investment activity in the country. In the light of this context, direct impetus to enhancement of the investment activity is the significant reduction of the contribution rates for pension, health and employment insurance, which will contribute to reducing the administrative burden on the enterprises. This measure, coupled with the previous decisions on reducing the profit tax and reinvested profit tax exemption, speaks in favour of the determination of the Government to improve the investment climate in the Republic of Macedonia. Thus, in the period 2010-2012, gross investments are expected to surge by around 15%, contributing to growth with 2.3 p.p. to 4.1 p.p. Expected high future inflow of FDIs, taking into account the high import component which brings the expected expansion of the personal consumption, is envisaged to lead to negative net export, the share of which in the growth will vary from –3.6 p.p. and –5.1 p.p. on the medium term.

On the medium terms, inflation rate, following the growth in 2008, is expected to be low, single-digit and consistent with the expected increase of the employment, the salaries, the personal consumption, as well as with the projections for movements of prices of the energy sources on the world markets. Thus, inflation rate projections in the period 2010-2012 show that the inflation will be kept at around 2.8%.

Regarding foreign trade, slight increase of trade deficit and current account deficit is expected in the analyzed period, corresponding to the achieved results in attracting foreign direct investments.

Due to the import dependence of the Republic of Macedonia, as well as the high import component of FDIs, in the period 2010-2012, import is expected to show higher increase (8% in 2010), which will cause to slight deepening of the trade deficit. Increase will also be registered on the export side (expected rate of 5.1% in 2010), mainly as a result of the measures aimed at improving the business climate, increasing the competitiveness of the export-oriented companies and the trade policy of the Government aimed at improving the conditions for increase of export of goods.

Similar to the trade deficit, current account deficit will also register slight increase, and it will be around –11.1% of GDP in 2010, in conditions of certain nominal increase of private transfers.



Source: National Bank of the Republic of Macedonia and Ministry of Finance

Improvement of the overall economic climate, especially the increased economic activity of small- and medium-sized enterprises, i.e. the realization of more dynamic economic growth rates, will contribute to increasing of the employment by around 3-4% on annual level in the observed period, with a simultaneous reduction of the unemployment rate. At the same time, the realized economic growth will provide for further fiscal and structural reforms to the end of improving the business environment, improving the infrastructure and enhancing the capacity of the public institutions.

2. Medium-Term Fiscal Framework

Process of successful implementation of the fiscal consolidation, which is an imperative in conditions of negative consequences from the global economic crisis, will continue in the coming medium-term period, expressed through a low and controlled fiscal deficit. Fiscal framework is defined on the basis of clearly set guidelines by the Government of the Republic of Macedonia and it creates real basis for designing the economic policies in the next medium-term period, having in mind the pending challenges posed by integration processes. In addition, foreseeable and credible medium-term fiscal policy is important from the point of view of the expectations of the economic entities and their reactions within the overall economic development.

Thereby, realization of the planned medium-term fiscal policy is directly conditioned by the realization of the planned economic policies and the projected macroeconomic indicators, including the achievement of the following challenges and assumptions:

- stabilization of the global economic deteriorations on the medium term, which will have a positive impact on mitigating the negative consequences and the faster recovery of the Macedonian economy;

- achievement of positive and sustainable economic growth rates in the Republic of Macedonia, mainly through further improvement of the business climate and of the business surrounding, as well as ensuring favourable conditions for the necessary increase of investments;

- further improvement of the business climate to the end of increasing the level of foreign direct investments, simultaneously ensuring relaxation of the monetary policy, reduction of BOP deficit and the pressure on interest rates and the stability of the Denar exchange rate;

- adhering to the principle of budget discipline and rational and efficient utilization of public revenues, which ensure sustainability of low level of deficit. At the same time, improvement of the expenditure budget structure so as to reduce non-discretionary costs via strict control over non-productive budget spending and ensuring greater space for development investments and co-financing projects financed from the European funds.

- efficient utilization of credit funds earmarked for investments in infrastructure facilities in the road and railway traffic, energy sector, cadastre reforms, reforms in the judiciary, social protection, health and education, municipal development, as well as of the available resources from EU pre-accession funds to provide for job creation;

Projected fiscal policy in conditions of meeting the indicated assumptions will ensure further strengthening of fiscal consolidation, expressed through reduction of the level of public consumption and tax burden, which will provide for fiscal sustainability on the medium run and support to the development of both the economy and the private sector.

Projected revenues of the ***consolidated government budget*** in the next three-year period decline as a share of GDP in relative terms, from 37.8% of GDP in 2009 to 34.0% in 2012. Projected decrease is mainly result of the reduction of the tax burden, which will provide more resources for the private sector and their focusing on higher level of investments and new jobs that would directly accelerate the development of the domestic economy.

Total expenditures in the period 2010-2012, in conditions of rational management with public finances at all government levels, according to the planned policies and low level of budget deficit, decline as a share of GDP from 40.6% in 2009 to 37.1% in 2012.

CONSOLIDATED GENERAL GOVERNMENT BUDGET	**2009**	**2009 Supplementary Budget**	**2010**	**2011**	**2012**
(Denar million)					
Consolidated general government budget - revenues	**169.755**	**154.882**	**151.466**	**158.367**	**167.797**
% of GDP	40,8	37,8	35,3	34,7	34,0
Consolidated general government budget - expenditures	**181.341**	**166.314**	**164.336**	**172.138**	**182.614**
% of GDP	43,6	40,6	38,3	37,7	37,1
Consolidated general government budget - deficit	**-11.586**	**-11.432**	**-12.870**	**-13.771**	**-14.817**
% of GDP	-2,8	-2,8	-3,0	-3,0	-3,0
Central Budget - revenues	**98.528**	**87.758**	**83.818**	**89.305**	**95.936**
% of GDP	23,7	21,4	19,5	19,6	19,5
Central Budget - expenditures	**108.611**	**97.149**	**94.215**	**101.183**	**109.488**
% of GDP	26,1	23,7	22,0	22,2	22,2
Central Budget - deficit	**-10.083**	**-9.391**	**-10.397**	**-11.878**	**-13.552**
% of GDP	-2,4	-2,3	-2,4	-2,6	-2,7

Extrabudgetary Funds - revenues	**41.045**	**41.345**	**43.074**	**44.087**	**46.487**
% of GDP	9,9	10,1	10,0	9,7	9,4
Extrabudgetary Funds - expenditures	**42.548**	**43.386**	**45.547**	**45.980**	**47.752**
% of GDP	10,2	10,6	10,6	10,1	9,7
Extrabudgetary Funds - deficit	**-1.503**	**-2.041**	**-2.473**	**-1.893**	**-1.265**
% of GDP	-0,4	-0,5	-0,6	-0,4	-0,3
Local Government Budget - revenues	**30.182**	**25.779**	**24.574**	**24.975**	**25.374**
% of GDP	7,3	6,3	5,7	5,5	5,1
Local Government Budget - expenditures	**30.182**	**25.779**	**24.574**	**24.975**	**25.374**
% of GDP	7,3	6,3	5,7	5,5	5,1
Local Government Budget - deficit	**0**	**0**	**0**	**0**	**0**
% of GDP	0,0	0,0	0,0	0,0	0,0
Gross Domestic Product	**416.230**	**410.075**	**429.145**	**456.602**	**492.856**

Such determined basic postulates of the fiscal policy actually mean further maintenance of optimal level of ***deficit at around 3%*** of the projected GDP.

2.1 Medium-Term Projections of the Budget of the Republic of Macedonia

2.1.1 Projected Revenues in the Budget of the Republic of Macedonia

Expected stabilization and recovery of the global economy, as well as the potential effect of the membership of the Republic of Macedonia in the EU and NATO, provide real basis for gradual increase of the economic growth rates and gradual increase of the expenditures.

Projections for ***genuine revenues of the Budget of the Republic of Macedonia*** for the coming medium-term period are mainly based on the realized and revised revenues in the current 2009, and the expected macroeconomic indicators for the next period. When projecting the revenues, effects of the so-far reforms in the tax sphere have been taken into consideration, especially the effects of the reinvested profit tax exemption, functioning of the Large Taxpayer Office and electronic submission of tax forms, expanding the capacity of the existing portal e-tax services for electronic submission of tax returns by small and medium taxpayers, policy for reduced social contributions, as well as the effects of the integrated collection of all types of contributions and personal income tax.

Thus, total revenues in period 2010-2012 are projected in the amount of around 32.5% of the planned GDP. Tax revenues still account for the most in the projected revenue structure with around 56%, followed by revenues on the basis of social contributions with around 28%, non-tax revenues and capital revenues with around 15%, while the rest of the revenues are expected to be realized from the IPA funds. With respect to tax revenues, most revenues will be realized on the basis of VAT, personal income tax and excises.

Projections for ***social contributions***, which are genuine revenues of the Pension and Disability Insurance Fund, Health Insurance Fund and the Employment Agency, show slight increase in the next medium-term period as share of the genuine revenues, according to the effects of the successful implementation of the reform for integrated collection of social contributions and personal income tax and the gross salary concept.

Regarding the structure of revenues on the basis of social contributions, the highest share is the one of the contributions for pension insurance, being at the level of around 65% and the contributions for health insurance at the level of around 30%, while the employment contribution is at lower level. Such structure of social contributions is in accordance with the legally set rates of contributions on salaries of employees.

Non-tax revenues in the next medium-term period account for around 12% in overall revenues, and the most significant is the share of revenues on the basis of administrative fees and fines and revenues from road tolls and registration of vehicles generated by the Agency for State Roads. As a result of the measures undertaken for more efficient collection of road tolls, the share of Agency's revenues is expected to grow in the next period.

Projection of the revenues of the Budget of the Republic of Macedonia with regard to ***foreign donations*** in the coming period include the donations that the budget users would realize for specific projects, as well as disbursements from the EU pre-accession funds.

2.1.2 Projected Expenditures in the Budget of the Republic of Macedonia

Expenditure side of the Budget of the Republic of Macedonia in the next period is designed to the end of supporting the Macedonian economy so as to overcome the crisis period caused by the present economic turbulences, as well as intensifying the integration processes for EU and NATO.

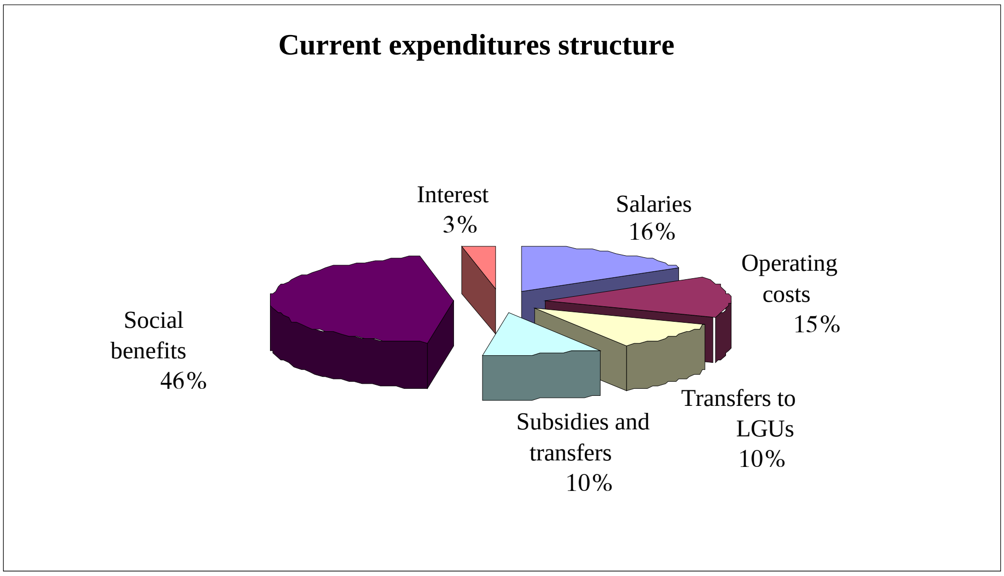
Expenditure projections in the state budget for the next medium-term period are prepared on the basis of three key postulates:

Average share of budget expenditures in the coming medium-term period accounts for around 35% of the projected GDP, whereby share of capital expenditures is projected to increase by 2.4 percentage points (from 15.6% in 2010 to 18.5% in 2012 compared to the total expenditures) as a result of reducing the current expenditures (from 84.4% in 2010 to 81.5% in 2012). Such positive change in the structure of public expenditures is inevitable, as well as expected, in conditions of stronger support to the economic growth and the expected inflow of investments to finance capital projects from both domestic and foreign sources (IPA funds).

When projecting the expenditures for the next period, the following assumptions were taken into account:

- expenditures for payment of *salaries and allowances* envisage no significant changes, taking into account that the planned increase of salaries in the public administration this year is postponed as one of the measures to consolidated the public expenditures, and such increase would be realized in conditions of recovery of the Macedonian economy and sound collection of budget revenues. Thereby, the projections include the effect of the planned institutional strengthening of the public administration through new employments related to the integration processes and full implementation of the second phase of the fiscal decentralization.

- *social transfers, including health services*, still have the dominant share in the ***current expenditures***, at around 47.3% of the current expenditures in 2010 and their reduction by 0.7 percentage points, i.e. 46.6% in 2012. Projected level of social transfers is in line with the existing legal solutions, to the end of full and timely payment of the social allowances and ensuring material existence of the beneficiaries of these rights.



Around 98% of the total expenditures of the Pension and Disability Insurance Fund refer to the payments related to the rights arising from pension and disability insurance. Thereby, expenditures related to pensions are projected on the basis of the assessed increase in the number of pension beneficiaries and the calculated pension indexation according to the projected indicators for increase of the costs of living and of the salaries in the coming period. On the medium term, it is envisaged for the number of beneficiaries of the right to pension to be around 280,000 persons.

Around 91% of the total expenditures of the Employment Agency in this period will be intended for payments on the basis of rights arising from unemployment, whereby it is expected for the right to pecuniary allowance to be used by around 26,000 persons, which actually is retaining the same level of beneficiaries.

In the next medium-term period, around 97% of the total expenditures of the Health Insurance Fund will be focused on services and allowances arising on the basis of health insurance of the population. Introduction of overall health protection of the population from the middle of this year is taken into consideration therein.

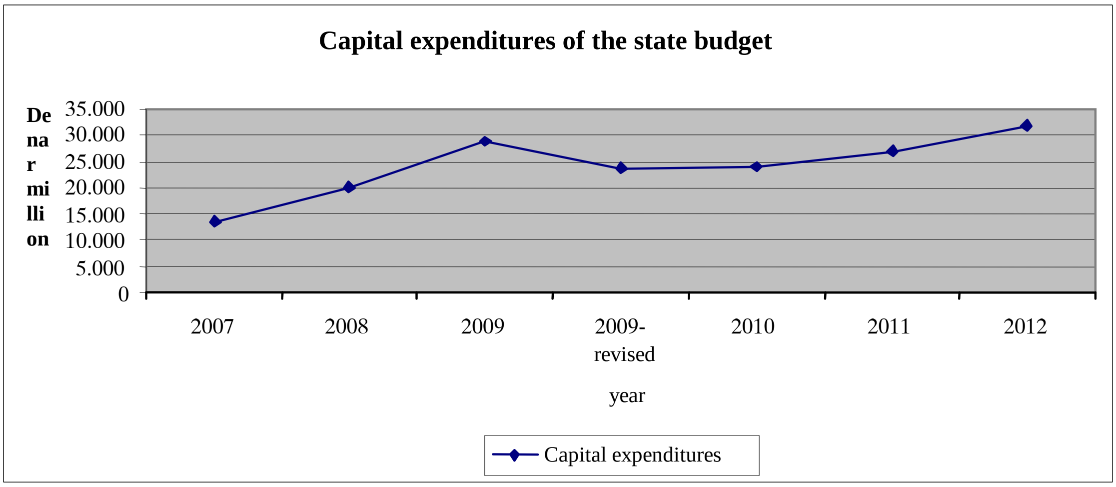
To the end of strengthening the control and efficient usage of the funds intended for health protection, implementation of the health treasury system is expected by the end of this year. This means full integration of the total revenues and expenditures of the public health in a single health treasury account, i.e. moving the accounts of the public health institutions from the commercial banks to the single account in NBRM. Thus, in addition to the full application of budget principles, comprehensive coverage of public health revenues and their earmarked usage will be ensured.

Within the medium-term projections of social transfers, funds were planned for regular coverage of obligations of the state towards the socially most vulnerable families in the form of social welfare, child allowance, allowances on the basis of the rights of disabled persons, invalids of war and civilian invalids and asylum seekers. Planned reforms in the social sphere by simplifying the procedures for exercising these rights, as well as the envisaged reforms in the area of employment and labour market, will contribute to gradual reduction of their share in the total expenditures.

Envisaged reforms in the agricultural sector will create conditions for establishing an efficient and competitive agricultural sector and its successful integration in the EU. These reforms will be successfully implemented through increased financial support to the farmer, provision of credit lines from the Agriculture Credit Discount Fund and development of the market for purchase of agricultural products by establishing purchasing distribution centers. To that end, subsidies to farmers are envisaged in the amount of EUR 100 million in 2010, EUR 115 million in 2011 and EUR 130 million in 2012.

To the end of realizing and maintaining positive economic growth rates, it is envisaged to increase the level of ***public investments***, the share of which in the total expenditures the coming medium-term period is 15.6% in 2010, 16.5% in 2011 and 18.5% in 2012.

Such level of capital expenditures means investments, above all in the toad, railway and utility infrastructure, capital investments in the houses of correction, improvement of the conditions in the educational and health system, as well as improving the cultural and social life of the citizens. Regarding the road infrastructure, implementation of the project for reconstruction and rehabilitation of regional and local roads will continue, as well as the construction of the rest of the road network included in Corridor 10, sections Kumanovo-Tabanovce and Demir Kapija-Smokvica, and construction and modernization of other road sections for which project documentation is already prepared. With respect to the construction and maintenance of the envisaged road sections in the period 2010-2012, around Denar 6.5 billion is allocated annually, being 22% of the total capital expenditures of the Budget of the Republic of Macedonia. During this period, part of the road infrastructure is envisaged to be extended under concession, including the electronic collection of road tolls, and it is expected for the concessionaries to increase their investments in state roads. Regarding the railway infrastructure, it is envisaged to continue the commenced activities for modernization of the rolling stock, modernization of the railroad tracks along Corridor 10 and Corridor 8, as well as introduction of e-ticket collection in the railway traffic. Total amount of capital investments also includes the funds for reconstruction and maintenance of facilities in education, sports, culture, child and social protection. At the same time, funds are projected for continuation of the ongoing multi-annual projects for which obligations have already been assumed, such as sewerage infrastructure, IT, transportation, health and environment.



In the coming period, it is planned to continue the implementation and to begin the realization of many projects financed with foreign credits, which will, to a great extent, contribute to successful completion of the already commenced structural and reform processes.

Efficient usage of funds provided under loans from international financial institutions and bilateral creditors will be the basis for a series of investment activities and reforms envisaged in line with the loan agreements, which will provide for job creation and favourable business environment. To the end of realizing one of the key priorities, creation of favourable investment climate and stimulating the development of the private sector through reforms in the business environment and strengthening the institutional capacities, World Bank BERIS Project (Business Environment Reform and Institutional Strengthening Project) will continue to be realized.

With respect to the judiciary, comprehensive reform efforts will continue to be supported through the Legal and Judicial Implementation and Institutional Support Project, which contributes to reducing the costs for doing business and increasing the possibilities for job creation, by supporting the efforts to improve the protection of the contractual, property-related and the rights of the creditors, as well as improving the efficiency and the effectiveness of the judiciary.

To the end of continuing the reforms for protection of property and legal relations and registration of property rights, in the course of 2010, activities related to cadastre reforms, supported under the Real Estate Cadastre and Registration Project, will be finalized.

Within the process of transformation of the health and increasing the transparency, efficiency and fiscal discipline of the health sector, reforms envisaged to be implemented under the Health Sector Management Project, financed with World Bank loan, will be finalized in the course of 2010. Project for Rehabilitation of Health Provider Institutions (covering 49 HPIs), financed with a loan from the Council of Europe Development Bank, is in preparatory stage.

Education Modernization Project, supported by a loan from the World Bank and grant from the Kingdom of the Netherlands, provides support to the decentralized educational system. Council of Europe Development Bank, by financing the Physical Education Facilities Project, will upgrade the level of physical education and its harmonization with the Council of Europe recommendations.

With respect to social policy, the activities are supported by the Social Protection Implementation Project of the World Bank, the main objective of which is to improve the effectiveness and the efficiency of the social protection system through improved administration and long-term stability of the pension system, as well as better targeting and administering of other cash social benefits. Conditional Cash Transfer Project, to commence this year, is financed by the World Bank and it is aimed at poverty reduction at vulnerable groups by conditioning the existing pecuniary allowances.

Implementation of the Prisons Reconstruction Project will commence in 2010, and it will be financed with a loan from the Council of Europe Development Bank. This project envisages the reconstruction of 5 houses of correction, by implementing the standards set in the European prison rules.

Project for social housing for individuals belonging to vulnerable groups, which, in addition to budget funds, will be financed with a loan from Council of Europe Development Bank (50%), is aimed at ensuring access to proper housing and combat against poverty and social exclusion.

Agricultural Strengthening and Accession Project, funded with a loan from the World Bank, will continue the activities aimed at creating a modern and competitive agricultural sector, which is of great importance for the economic and the social development of the country, supporting the Republic of Macedonia in acquiring absorptive power for using the IPA assistance from the EU and meeting the requirements for EU membership.

Activities of the Government aimed at improving the management at local level will be supported by the Municipal Services Improvement Project, financed with a loan from the World Bank. The project, the implementation of which will commence in the second half of 2009, will provide for the municipalities and the communal service enterprises which, pursuant to the legal regulations, will be able to borrow so as to finance the investment activities in line with their needs, and to be extended certain grant funds after fulfilling respective criteria.

To the end of improving the conditions and the quality of life in the rural areas in the Republic of Macedonia, preparation of Project for Construction and Rehabilitation of the Water Supply and

Sewerage Infrastructure in the Rural Areas will commence, financed by KfW, thus providing for sustainable supply of potable water for the population in the selected municipalities.

Due to the urgent need to ensure fresh capital in times of economic and financial crisis and mitigate its consequences on the small- and medium-sized enterprises, Project for Financing Small- and Medium-Sized Enterprises, financed from the European Investment Bank, will be implemented in the coming period. In addition, this project is expected to result in support to new projects, new employments, increased liquidity in the economy and increased export. Project implementing agency will be the Macedonian Bank for Development Promotion, which will extend the loan to the final beneficiaries through the commercial banks.

2.1.3 Projected Deficit and its Financing

According to the projections for the revenues and the expenditures of the Budget of the Republic of Macedonia in the next medium-term period, sustainable level of fiscal deficit of 3% is envisaged in relation to the projected gross domestic product, which includes the central government budget deficit and the deficit of the Agency for State Roads. Central government budget deficit in the period 2010-2012 is planned at around 2.4% - 2.8% of the projected GDP (including credit disbursements by budget users to their own accounts, leading to deficit of around 0.3% - 0.6% of GDP), while the Agency for State Roads is envisaged to realize deficit from 0.6% to 0.3% in the respective period.

Financing the projected state budget deficit in the next medium-term period will mainly be provided from foreign sources, such as credits from international financial institutions, credit lines intended for financing certain projects and other type of foreign borrowing, and at the same time from domestic sources via continuous issues of government securities. Foreign borrowing, as source of financing, will be used by budget users for specific projects and by the Agency for State Roads in accordance with the concluded contracts for construction of certain road sections of the national roads.

Controlled deficit level, in conditions when significant amount of funds are intended for infrastructure investments, is expected to have positive effects on the stabilization of the Macedonian economy and overcoming the negative consequences of the global economic crisis.

(Denar million)

DEFICIT AND SOURCES OF FINANCING	**2010**	**2011**	**2012**
BUDGET BALANCE	**-12.879**	**-13.770**	**-14.817**
DEFICIT FINANCING	**12.879**	**13.770**	**14.817**
Inflow	**21.033**	**21.921**	**21.148**
Revenues from privatization	2.949	5.396	1.103
Foreign credits	17.775	15.551	15.938
Domestic borrowing	2.500	2.500	2.500
Deposits/additional sources	-2.190	-1.526	1.607
Outflow	**8.154**	**8.151**	**6.331**
Repayment upon external borrowing	2.608	2.989	3.417
Repayment upon domestic borrowing	5.546	5.162	2.914

2.2 Local Government Budget

In the coming period, process of administering the revenues of the local government will continue in line with the European Charter of Local Self-Government, i.e. the right of the municipalities to independently determine the tax rate and the fees. In line with the fiscal projections for the coming medium-term period, revenues of the local government are envisaged at the level of around 5.5% of GDP, within which it is expected to increase the own revenues pursuant to the legal solutions and the improved collection. Certain effect is also expected from the legal possibility for participation of private capital in the public sector through public-private partnership, which will, at the same time, be an impetus to improve the quality of local services and increase the revenues.

In general, it is envisaged for the fiscal decentralization on the medium terms to enter its final stage, i.e. transferred competences to all municipalities to be financed with block grants, which will contribute to stabilization of the local government revenues.

Medium-term projections do not include the effect of possible change of the legal solutions related to recomposing the existing financing model or to new methodologies that would increase the genuine revenues or would ensure new sources of financing the LGUs, although activities are undertaken on ongoing basis to find ways to strengthen the fiscal capacity of the LGUs.

Absorption of EU Pre-Accession Assistance

Republic of Macedonia, as a candidate country for EU membership, has the possibility to use significant financial support from the European Union through the five components under the IPA instrument.

According to the Multi-Annual Indicative Financial Framework (MIFF), under which EU assistance is allocated by country and by component, the Republic of Macedonia will be able to use funds in the amount of around ***Denar*** ***31.2 billion*** *(EUR 507,7 million)* through the five IPA components in the period 2007 - 2012. This financial framework is a budget to plan the assistance included in the Multi-Annual Indicative Planning Document (MIPD), which covers three-year period and is revised each year.

IPA-funded projects will be implemented in centralized and decentralized manner, meaning that the Republic of Macedonia has, within the state administration, established system of institutions in charge of programming, as well as of correct and efficient usage of the awarded IPA funds. Pre-condition for decentralized implementation of the projects is the conferral of management powers by the European Commission. Commission Decision for Conferral of Management Powers is expected in the second half of 2009.

When management powers are conferred, projects under the first two IPA components can be implemented in centralized manner, i.e. conclusion of contracts and implementation of projects will be carried out by the EC Delegation to the Republic of Macedonia.

With respect to utilization of the funds allocated under the component ***Transition Assistance and Institution Building***, 2007 National Program for Transition Assistance and Institution Building and 2008 National Program for Transition Assistance and Institution Building were prepared, providing for the support to the projects in the following areas:

1. Good Governance and Rule of Law: projects aimed at meeting the political criteria, such as the ones in the field of public administration reform, institution building and capacity strengthening for decentralized management of IPA funds, justice and internal affairs. This component includes the *Police Reform* project as top political priority.

2. Economic Development and Social Cohesion projects aimed at improving the investment climate, strengthening the administrative capacities at central and local level in the field of fiscal policy (tax collection, costs control, etc.), institution building in the field of regional policy to the end of better implementation of both the national and the regional development policies.

3. Acquis: projects related to EU legislation in the field of public finances, statistics, customs operations, institutional strengthening of the capacities of regulatory bodies, offices and/or inspectorates and land management.

4. Technical Assistance: projects aimed at support for *project preparation* (support for preparation of tender dossier and other project documentation as support for realization of Components 3, 4 and 5).

Finalization of project fiches is on going for the projects financed within the 2009 Program for Transition Assistance and Institution Building, expected to be implemented in decentralized manner after the conferral of management powers by the European Commission in the second half of 2009.

Taking into account that the Republic of Macedonia has not been conferred the management powers by the European Commission on decentralized management of EU assistance, allocation of IPA funds for 2007 and 2008, to be implemented in a centralized manner, are not projected in the Budget of the Republic of Macedonia. However, necessary funds for the projects within these two programs which require national co-financing are projected in the Budget of the Republic of Macedonia.

Second IPA component ***Cross-Border Cooperation (CBC)*** is aimed at strengthening the cooperation between the border regions in the Republic of Macedonia and all neighboring countries.

Operational Program for 2007-2013 is prepared for the usage of the funds for cross-border cooperation with the ***Republic of Albania*** and it is approved by the European Commission. This Program envisages encouragement of the economic, social and environmental development, focusing on tourism development.

IPA allocations for 2007 and 2008 will be implemented in centralized manner, i.e. through the EC Delegation. Having in mind the abovementioned, IPA funds for 2007/2008 will not be projected in the Budget of the Republic of Macedonia. IPA allocations for 2009 are expected to be implemented in a decentralized manner after conferral of management powers for the second IPA component from the European Commission.

Operational Program for 2007-2013 is prepared for the cross-border cooperation with the ***Republic of Bulgaria*** and it is approved by the European Commission. This Program envisages encouragement of the economic development and social cohesion, as well as improvement of the quality of life. Taking into account that the tender procedure and the executing of payments for the projects under this Program will be carried out by the respective bodies established in the Republic of Bulgaria, IPA funds for the period 2007-2009, amounting to *Denar 202,3 million (EUR 3,3 million),* will not be shown in the Budget of the Republic of Macedonia.

The third IPA component ***Regional Development*** is aimed at preparing the country for the usage of the funds from the Structural Funds and Cohesion Funds allocated by the EU. 2007-2009 Regional Development Operational Program will finance projects in the field of transportation (70-80% of the total allocations) and projects in the field of environment (20-30% of the total allocations).

The two big projects to be financed under this component are the ***Upgrading of the Road Section of the Pan-European Corridor X and Waste Water Treatment Plant Project in Prilep.*** In addition, this component also envisages smaller projects for which studies should be prepared in the field of transportation and environment, as basis for project preparation to be financed within the next Regional Development Operational Program.

The fourth IPA component ***Human Resources Development*** will support projects in the field of employment, education and social inclusion.

Projects in the field of ***employment*** are aimed at attracting and retaining more people at work through further development of the Employment Agency (improvement of the IT structure), support when implementing the Employment Strategy, improvement of the conditions for the young people, women and longer-term unemployed persons on the labour market.

Projects in the field of ***education*** are aimed at investments in human capital by improving the educational process to the end of its adjustment to the needs of the labour market, as well as equal access for all ethnic communities to the educational institutions.

Assistance in the field of ***social inclusion*** is intended for strengthening the integration of the individuals with special needs, developing infrastructure for alternative forms of social services for promotion of social inclusion, integrating minorities, as well as active participation of the civil sector.

Rural Development component will support projects that would provide for attaining EU standards introduced in the field of agricultural production, food processing and rural development.

Assistance through this component is aimed at support to projects related to *investments in agriculture and processing capacities and marketing of agricultural products and fish*. These investments will contribute to improvement of the quality and safety of food and cattle, increased competitiveness of the farmers by using modern production technologies and reduced production costs, promotion of ecological methods of production, improvement of the performance of farms in primary production and marketing so as to attain EU standards in the field of environment protection, public health status (food quality and safety), safety at work, opening new markets, improvement of management of animal waste and waste waters, as well as job creation.

Measures for *diversification and rural development* will be realized through support to rural tourism, support to small- and medium-sized enterprises for modernization of farm production, modernization/adaptation of the infrastructure, encouraging traditional craftsmanship, support to rural and agricultural services (organizing workshops for maintenance and repair of agricultural machines and tools, construction of youth centers, children playgrounds, procurement of office supplies). In 2010, support to projects will be extended with projects in the field of *improvement and development of rural infrastructure and training of farmers*.

4.PUBLIC DEBT TRENDS

According to the national methodology and IMF methodology, public debt[1] dropped by EUR 59.8 million in the period 1 January – 31 December 2008, reaching **EUR 1,868 million** at the end of 2008. This explains the decline of the value of public debt indicator in relation to gross domestic product by 5.1 percentage points from 33.34% to 28.22% respectively.

Accordingly, government debt[2] dropped by EUR 43.3 million, amounting to EUR 1,386.7 at the end of 2008. Government debt declined by 3.8 percentage points in relation to GDP, i.s. from 24.7% to 20.9%, being within the Maestricht Criteria on public debt, according to which general government debt must not exceed 60% of GDP.

[1] ***Public debt*** comprises government debt and the debt of the public enterprises and companies fully or predominantly owned by the state, the municipalities, the municipalities in the City of Skopje and the City of Skopje, as well as of the National Bank of the Republic of Macedonia.

[2] ***Government debt*** comprises all financial liabilities incurred under borrowing by the Republic of Macedonia, including the debt of the municipalities, the municipalities in the City of Skopje and the City of Skopje, excluding the debt of the public enterprises and companies fully or predominantly owned by the state, the municipalities, the municipalities in the City of Skopje and the City of Skopje, as well as of the National Bank of the Republic of Macedonia.

In 2010, government debt is projected to be EUR 1,939.3 million, i.e. 24,6% in relation to GDP. In 2011, government debt is projected to increase by EUR 290 million, amounting to EUR 2,229.8 million, which is 25.7% in relation to GDP. The gradual upward trend of the debt also continues in 2012, when government debt is projected to increase by EUR 87 million, reaching EUR 2,317.3 million at the end of 2012. Although government debt shows increase in absolute amount, still the debt expressed as percentage of GDP in 2012 is projected to slightly decline by 1.3 percentage points, amounting to 24.4%. Such increase of the government debt in absolute amount is result of the new investments in the field of road and railway infrastructure, water supply and sewerage, sports facilities, construction of social flats, as well as investments in the field of education, to be implemented by the government administration bodies.

	2009	2010	2011	2012
Government debt (EUR million)	1636,5	1939,3	2229,8	2317,3
Government debt as % of GDP	22,6%	24,6%	25,7%	24,4%

Active public debt management in the Republic of Macedonia continues in the coming period as well, whereby the primary objective is efficient financing of the needs of the state with an acceptable risk level and reduction of the sensitivity of the debt portfolio to the adverse trends on the international financial markets.

According to 2009-2012, Public Debt Management Strategy, public debt trends are based on several medium-term targets, as well as targets covering only 2009. Medium-term targets used when compiling the framework of public debt trends for the period 2009 - 2012 are the following:

- level of government debt in the next three years not to exceed 30% of the gross domestic product;

- level of total public debt in the next three years not to exceed 40% of the gross domestic product;

- share of external debt in the total public debt in next three years to range between 70-80%;

- amount of guaranteed public debt in the next three years not to exceed 10% of the gross domestic product;

- share of euro-denominated debt in the total public debt to be at the level of 70% (maximum allowed deviation of +/- 5 percentage points);

- share of denar-denominated debt in the total public debt to be at the level of 13% (maximum allowed deviation of +/- 3 percentage points).

Targets for 2009 alone are the following:

- net borrowing in 2009 is envisaged to amount to EUR 370 million (in addition to new credits, withdrawal of funds for already concluded credits that are active are included here);

- during 2009, maximum amount of net borrowing on the basis of guaranteed debt should not exceed EUR 150 million.

To the end of realizing the above-mentioned target, following measures have been determined, to be undertaken in the coming period:

- development of the government securities market;

- development of cash management function;

- use of financial derivatives and

- implementation public debt software