



Country briefing Macedonia



**BALKAN
MONITORING
PUBLIC
FINANCES**

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CREDITS

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This document has been produced as a part of the project “CSOs as equal partners in the monitoring of public finance“, which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on <http://wings-of-hope.ba/balkan-monitoring-public-finance/> and on the Facebook Page Balkan Monitoring Public Finances



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EXECUTIVE SUMMARY

The broad - based GDP growth supported by robust exports and by public investments, improved the macroeconomic outlook of the country. Macroeconomic situation is sound and stable and certainly it is expected to stay on the track in the future. The economic growth was mainly generated by domestic factors, primarily investments and exports. Also, there is a permanent decline in the unemployment rate, as well as slower inflation rate. The fiscal policy continued stimulating and supporting the economic recovery. The support was financed by borrowing, primarily external, thus further increasing the external debt. Economic growth is expected to continue in 2016. The anticipated growth projections are backed by foreign export -oriented investments and public infrastructure investment. Moreover, the stable monetary policy and macro-prudential measures taken by the National bank monetary authority, should improve the credit growth and domestic consumption. However, domestic political uncertainties and the crisis in Greece constitute significant downside risks.

The fiscal policy of the Republic of Macedonia is aimed at achieving reasonable balance between strategic goals, preserving macroeconomic stability and encouraging economic activity by increasing the quality of public finances. Public finances, as the other side of the coin of the overall macro policy of the country are certainly very interesting and instigating field for analyzing. In this document, a few of the many aspects of public finances will be shortly elaborated, i. e. public debt, public private partnership, tax justice and public infrastructure.

At first, the report gives a legal definition and the main principles of the public debt. According to the Fiscal Strategy, the public debt of the Republic of Macedonia at the end of 2015 amounted to 46.5% of GDP, while the state debt in the same period amounted to 38.0% of GDP. With respect to limits set in the policy for public debt management, it can be concluded that public debt is within the situated limits, having in mind that at the end of the first quarter of 2016 the its value amounted to 45% of GDP, thus it is expected not to exceed 60% of GDP in the long run. However, public debt levels have risen noticeably in recent years.

Regarding the other dimension of public finances, the public-private partnership is relatively new topic in the Republic of Macedonia. The new Law on concessions and PPP was adopted in 2012. Over the past years, the only form that was used for PPP projects was the concessions leading to many infrastructure and other public interest projects in the form of concessions, mainly at the state level. The main benefits of putting into law and regulating the PPP are usually for the local self-government,



especially for stimulating more intensive use of public-private partnerships in developing infrastructure and public services.

Regarding the issue of tax justice there is not a simple national definition used to define the term “Tax justice”. In the beginning of the 90’s, along with the introduction of the new economic system in the Republic of Macedonia, a new fiscal system was introduced based on the principles of market economy, private property, independence of the economic subject, etc. New principle which was incorporated in the current fiscal system of the Republic of Macedonia was the principle of allocated neutrality of taxes and the budget according to which, with the instruments of the fiscal policy some sectors would not be stimulated and supported.

Public infrastructure investments present the development component of the fiscal policy with intent for improving the economic perspectives and quality of life of the citizens. The crucial objective of this type of investment is to advance the transportation network in the country (highways, railroad tracks, regional and local roads), as well as to improve the energy and utilities infrastructure, the educational, social and health systems. These capital investments, in addition to the recent positive effect on the economic activity, also contribute for strengthening and boosting the competitiveness of the country in the long term period, thus being of key importance for increasing productivity and production.



INTRODUCTION

The macroeconomic policy of the Republic of Macedonia is aimed at maintaining the strategic goals for long-term and sustainable economic growth, achieving financial and macroeconomic stability, increasing the competitiveness of the economy, job creation and better standard of living. These main goals are continuously accomplished by enhancing the business environment, conducting tax and customs in a way that supports the development of economic entities, encouraging investment activity and attracting foreign direct investment (FDI), and last but not least, by developing human capital and economic infrastructure in the country.

The aim of this policy brief is to describe the macroeconomic environment in the country and to present the key economic and social indicators, particularly in the public finances with exceptional focus on public debt, tax justice, Public Private Partnership and Public Infrastructure. This preliminary analysis is to provide the most important characteristics and the current situation of the above-mentioned areas of public finances.

This policy brief will be written using research methodology which includes quantitative methods based on secondary data such as statistical data, analysis of the legal framework, relevant studies and reports and available literature and articles in the field of public finances. Based on the research, this paper will provide policy recommendations that could be used for improved management and higher transparency of public finances.

Fiscal policy is designed to achieve reasonable balance between the two strategic goals of the Government of the Republic of Macedonia, those being maintaining macroeconomic stability and encouraging economic activity by increasing the quality of public finances, above all, through increasing capital expenditures related to improving the infrastructure and strengthening private sector capacities for growth and job creation.

In terms of monetary policy in 2016 its primary objective is maintaining price stability by keeping stable exchange rate in relation to the Euro. The other objective of the National Bank is directed towards maintenance of a stable, competitive and market-based financial system, as an important component of macroeconomic stability.

Domestic macroeconomic environment in the year of 2015 was favorable for preserving stability and recovering economy presenting a solid real GDP growth of 3.7%. The economic activity growth in



Macedonia in 2016 is projected at around 4%.¹ The rate of inflation in the period of 2015 was -0.3% and at end of the year of 2016 is projected at the level of 2%. The low inflation rate is mainly due to lower fuel prices in line with the downward movements at the international markets.²

In line with positive performance of economic activity positive results were realized in other sectors as well. Analyzed according to GDP by production method, positive performance was observed in many sectors. Exports of goods and services recorded 8.5% in 2015 and are projected to achieve real growth of 10.4% in 2016, mainly due to expectations of activity in export capacity foreign companies, with a gradual growth in external demand.³

Considering the social indicators, positive trends were realized on the labor market in 2015 and continuing in 2016. According to the statistical indicators of the Ministry of finance, the unemployment rate continuously declines, dropping to 26.1% at the end of 2015 with a further projected drop of 2.7 percentage point at the end of 2016. Number of employees in the first quarter of 2016 is increased by 2.5% in relation to the same period in 2015. Increase of the employment rate is mainly due to the operations of the companies in the free economic zones and realization of the active measures and the unemployment reduction policies, including the new measure “Macedonia Employs”.⁴

At-risk-of-poverty rate is general indicator for measuring poverty, according to the State Statistical Office of Macedonia, reflecting the percentage of persons with an equalized disposable income below the poverty threshold and its value in 2014 is 22.1%.⁵

Regarding the human development index (HDI), the Republic of Macedonia’s value for 2014 is 0.747—leaving it in 81th place of 188 countries and territories and belongs in the high human development

¹ Government of the Republic of Macedonia, National Programme for adoption of the Acquis Communautaire – Revision 2016-2018

² Economic Reform Programme 2016, available at: <http://finance.gov.mk/en/node/4832>

³ Source: Ministry of Finance, Macroeconomics, Indicators and Projections. Available at: <http://finance.gov.mk/en/node/882>

⁴ Ministry of Finance (2015), Fiscal Strategy of Republic of Macedonia 2016-2018

⁵ State Statistical Office, MAKStat Database, available at:

http://makstat.stat.gov.mk/PXWeb/pxweb/en/MakStat/MakStat__ZivotenStandard__LaekenIndikatorSiromastija/125_ZivStd_Mk_LaekenGENERAL_en.px/?rxid=46ee0f64-2992-4b45-a2d9-cb4e5f7ec5ef



group of countries. Between 2005 and 2014, HDI value increased from 0.697 to 0.747, an increase of 7.2 percent or an average annual increase of about 0.78 percent.⁶

As for income inequality or GINI index, which reflects the deviation of the distribution of income among individuals or households within a country from a perfectly equal distribution, the value for Macedonia is 35.2%.⁷

Stable and sound public finance management should be one of the top priorities of the country, taking into account the strong economic and social significance of the Budget, especially in conditions of uncertainties and harsh challenges.

Nevertheless, medium-term projections of the main macroeconomic and fiscal parameters present an essential element of the professional public finance management, with the end goal attaining financial safety and sustainability of public finances.⁸

Public finances field comprises of many crucial pillars. Four of them, such as public debt, public private partnership, tax justice and public infrastructure, will be briefly analyzed below.

First, and presumably most important one is the public debt.

⁶ UNDP, Human Development Report 2015, Work for human development, Briefing note for countries on the 2015 Human Development Report, The former Yugoslav Republic of Macedonia

⁷ Income inequality, Gini coefficient, available at: <http://hdr.undp.org/en/indicators/67106>

⁸ Ministry of Finance (2015), Fiscal Strategy of Republic of Macedonia 2016-2018



PUBLIC DEBT

The Public Debt Law defines public debt as sum of government debt and debt of public enterprises established by the state or by the municipalities, municipalities within the City of Skopje and the City of Skopje, as well as companies being fully or predominantly owned by the state or by the municipalities, municipalities within the City of Skopje and the City of Skopje, for which the government have issued sovereign guarantee.⁹

Government debt includes all financial liabilities created via borrowing by the Republic of Macedonia, public institutions founded by the Republic of Macedonia and municipalities, municipalities within the City of Skopje and the City of Skopje, excluding debt of public enterprises and companies being fully or predominantly owned by the state, by the municipalities and the debt of National Bank of the Republic of Macedonia. Thus, debt of the National Bank of the Republic of Macedonia is not considered as public debt. Public debt issuers are allowed to borrow in accordance with the criteria and procedures stipulated in the Law.

Main principles of the public debt management pursuant to this Law are: financing the needs of the state at the lowest cost, in both medium- and long-term, and sustainable level of risk; identifying, monitoring and managing the risks which public debt portfolio is susceptible to and developing and maintaining efficient domestic financial markets.

The Fiscal Strategy as a significant strategic document of the country provides allocation of the available funds in compliance with the strategic priorities, identifies the most significant goals and action policies, as well as sets out the policy for public debt management. The last Fiscal Strategy adopted by the Government covers the period 2016-2018.

According to the Fiscal Strategy, the public debt of the Republic of Macedonia at the end of 2015 amounted to 46.5% of GDP, while the state debt in the same period amounted to 38.0% of GDP. With respect to limits set in the policy for public debt management, it can be concluded that public debt is within the situated limits, having in mind that at the end of the first quarter of 2016 the its value amounted to 45% of GDP, thus it is expected not to exceed 60% of GDP in the long run.¹⁰

⁹ Public Debt Law - cleared version - "Official Gazette of the Republic of Macedonia" no. 165/2014

¹⁰ Ministry of Finance (2015), Fiscal Strategy of Republic of Macedonia 2016-2018



However, public debt levels have risen noticeably in recent years. Central government debt is the largest component of public debt and accounted for more than 80 percent of total public debt during the period between 2008 and 2014. At the same time, the financing needs of state-owned enterprises increased, carrying out major infrastructure projects, thus contributing to a marked rise in overall public debt, and at the end 2014, the debt of almost all state established enterprises has been guaranteed by the central government.

In terms of pursuing adequate fiscal policy and increasing the quality of public finances, the Ministry of Finance in 2014 resumed the publication of public debt statistics, including of all the external and domestic debt of the central government, the SOEs and the municipalities, on a quarterly basis. Additionally, by amending the Law on Public Debt in 2014, public debt data transparency was improved, meaning that the Ministry of Finance publishes quarterly reports for the stock of the total public debt, including the central government debt, the debt of municipalities and the guaranteed debt of public enterprises and state-owned companies. Also, the Ministry of Finance prepares Annual Report on Public Debt, which is a comprehensive report showing the public debt level and structure, as well as the activities related to public management undertaken in the past period.

As for the new borrowings, account is taken of the long-term sustainability of debt, whereby the process of issuing new guarantees is strictly regulated and subject to the borrowing procedure prescribed in the Public Debt Law, according to which the public debt issuers should fulfill certain criteria so as for the country to be able to issue guarantees.¹¹

Main risks identified when managing debt portfolio are re-financing risk, market risk, including interest rate risk and exchange rate risk, risk associated with contingent liabilities and operational risk. In order to improve the management of public finances several measures and activities were taken in the past period such as strengthening the capacities for budget planning, supplementing the public debt management strategy in terms of determining the maximum amount of refinancing, as well as currency risks and interest rate risks.

Currently, the process of planning and implementation of the budget is guided by medium-term fiscal strategy that contains binding targets for revenues and expenditures at aggregate level, deficit and debt. In this context it is necessary to strengthen the capacity for annual preparation of a Medium-term budget framework (MTBF) and Medium-term expenditure framework (MTEF), which will focus on medium-

¹¹ Economic Reform Programme 2016, available at: <http://finance.gov.mk/en/node/4832>



term plans and the manner of meeting the economic criteria for EU membership. The EU twinning project, which is at the beginning of its implementation, should improve the effectiveness of the medium-term budget planning, program budgeting and fiscal reporting, thus contributing to the formulation of sustainable medium-term fiscal projections and strengthen fiscal discipline and credibility.¹²

¹² Ibid.



PUBLIC-PRIVATE PARTNERSHIPS

Public-Private Partnership shall imply a form of contractually regulated long-term cooperation between the public partner and the private partner, characterized by the following: a. private partner assumes the obligation to provide public services to end users within the area of public partner competence and/or the obligation to ensure the public partner necessary preconditions for the provision of public services to end users and/or activities within its area of competence.¹³

In order to establish Public-Private Partnership projects certainly there are rules that should be considered in order to have a winning project. First, the PPP in Macedonia are regulated by Law on Concessions and Public-Private Partnership. The Law gives the rules for awarding PPP contracts. Also, the existing regulatory and social environment of the country must be considered.

Namely, for the purpose of fulfilling the obligations from PPP, the private partner may take over the obligation to: finance, design, construct or/and reconstruct/renovate public infrastructure– facility, operate and maintain a newly constructed or/and reconstructed/renovated public infrastructure facility, or use, operate and maintain an existing public infrastructure facility, or– any combination of the above-mentioned obligations. The private partner usually assumes substantial part of the risks associated with financing, construction, demand and/or availability, and other such operations, management, maintenance and technical risks, depending on the contractual basis when establishing public-private partnership and subject to case-by-case determination. Each partner in a public-private partnership shall, for the duration of the public-private partnership, assume responsibility for risk events that are under his sphere of influence, or the responsibility is shared.¹⁴

Public-private partnership is relatively new topic in the Republic of Macedonia. The new Law on concessions and PPP was adopted in 2012. Over the past years, the only form that was used for PPP projects was the concessions leading to many infrastructure and other public interest projects that have been concluded in the form of concessions mainly at the state level. The main benefits of putting into law and regulating the PPP are usually for the local self-government municipalities, especially for stimulating more intensive use of public-private partnerships, in developing infrastructure and public services.

¹³ Law on Concessions and Public Private Partnership - Official Gazette of the Republic of Macedonia”, no. 6/2012, 144/2014, 33/2015, 104/2015 and 215/2015

¹⁴ Ibid.



Actually, what is PPP is a process of making public finances closer to the people and as well both public and private partners. This makes the whole process of structuring and awarding PPP projects more transparent and clear.¹⁵

Successful PPPs have been implemented in the energy and transport sectors and the country has allowed private sector participation in the form of concessions, divestitures and greenfield projects in several sectors. The situation as regards PPP projects in the Republic of Macedonia is as follows: 9 projects are signed in the period of 2010 - 2013 and 8 projects are in tender status or in potential status, as from 2014 till 2016. The PPP projects are mostly in the areas of transport, social & communal issues, government buildings, environment and energy. In comparison, currently there are 9 concessions projects and they are performed in the area of hydro power plants, transport and municipality buildings.¹⁶

The two international airports “Alexander the Great” in Skopje and “St. Paul the Apostle” in Ohrid are examples of successful PPP projects within the country.

¹⁵ The new Macedonian concessions and PPP Act: A need for further improvement, April 2009, S. Georgievski. Available at: http://www.lex-localis.info/files/5654a64d-5d98-453c-88e8-b7a22fc41d7a/633755996718441250_Lex%20localis_2-2009_Georgievski_The%20new%20Macedonian%20Concessions.pdf

¹⁶ Overview of the PPP Legal and Institutional Frameworks in the Western Balkans, European PPP Expertise Centre. Available at: http://www.eib.org/eppec/resources/publications/eppec_wbif_overview_ppp_institutional_arrangements_institutional_frameworks.pdf



TAX JUSTICE

Regarding the issue of tax justice there is not a simple national definition used to define the term “Tax justice”. In the beginning of the 90’s, along with the introduction of the new economic system in the Republic of Macedonia, a new fiscal system was introduced based on the principles of market economy, private property, independence of the economic subjects, etc. New principle which was incorporated in the current fiscal system of the Republic of Macedonia was the principle of allocated neutrality of taxes and the budget according to which, with the instruments of the fiscal policy some sectors would not be stimulated and supported.

New important principle was the repeal of the higher number of contributions and their replacement with taxes. Only the contributions for social funds were kept i.e. the contributions for health, pension and disability insurance. Also, the principle of transferring the tax burden from direct to indirect taxes was promoted, which meant reduction of the income taxes and increasing the consumption taxes. In this function it was also the introduction of the Value Added Tax (VAT), from 1st of April 2000, replacing the previous Turnover Tax.

Namely, the Republic of Macedonia has established a simple tax system which is consisted of direct taxes (income tax, personal income tax and property tax) and indirect taxes (VAT and excise duties). In 2007 the Republic of Macedonia introduced a flat rate system. The introduction of flat tax of 10% for corporate and personal income tax simplifies the tax administration for individuals and stimulates the operations of companies. Consumption in the country is taxed at the general rate of 18% and a reduced rate of 5% value added tax.¹⁷

With the implementation of the flat tax and a range of progressive cuts, Macedonia is today considered a tax haven. Combined with low VAT and a number of policies to encourage investment, business opportunities in Macedonia are increasing constantly. Special tax breaks and exemptions were specifically targeted to investors and attractive fiscal benefits for Technological Industrial Development Zones. Under the law, any income realized by a corporate tax payer is exempt from corporate tax on the condition that such income is not distributed (i.e. kept as retained earnings). The tax exemption is applicable on the profit distribution to resident legal persons as well.

¹⁷ Source: Ministry of Finance. Available at: <http://finance.gov.mk/mk/node/4442>



The types of income exempt from personal income tax include:

- Compensation for periods of unemployment;
- Compensation for per diems from trips within the approved limits;
- Salaries paid by employers for conducting business activities in the technological industrial development zones for a period of ten years from the commencement of activities in such area;
- Certain types of compensation provided under the labor law;
- Fees for children;
- Interest on demand deposits, time deposits, current accounts and securities issued by the Republic of Macedonia;
- Certain types of compensation under insurance contracts.

Macedonia has signed agreements on avoiding double taxation with 42 countries: Netherlands, France, Italy, Sweden, Denmark, Kosovo, Norway, Finland, Switzerland, Hungary, Croatia, Turkey, Yugoslavia (applicable for Serbia and Montenegro), Poland, People's Republic of China, Taiwan, Russia, Ukraine, Slovenia, Bulgaria, Egypt, Albania, Iran, Romania, Belarus, Spain, Czech Republic, Slovakia, Moldova, United Kingdom of Great Britain and Northern Ireland, Ireland, Qatar, Austria, Latvia, Lithuania, Estonia, Belgium, Morocco, Germany, Kuwait, Luxembourg and Kazakhstan. Seven treaties have not entered into force yet (the treaties signed with Egypt, Iran, Kosovo, Kuwait, Luxembourg, Kazakhstan and Belgium). As for Belgium, corporate tax payers can benefit from the treaty concluded by Former Yugoslavia.¹⁸

¹⁸ Source: Ministry of Finance. Available at: <http://finance.gov.mk/mk/node/385>



PUBLIC INFRASTRUCTURE

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²⁰ Source: Ministry of Finance. Available at: <http://finance.gov.mk/mk/node/385>



CONCLUSIONS AND RECOMMENDATIONS

What can be concluded from all the above written and analyzed is that the macroeconomic stability is still sound and healthy. Namely, there was a constant GDP growth followed by strong export growth and high private transfers. FDI were also rising. However, since 2008, the year when Macedonia entered the global financial crisis with one of the lowest public debt to GDP ratios in emerging Europe, the public debt ratio has nearly doubled reaching 43.3 percent of GDP in 2014 and 45% in 2016. What is utmost priority for preserving the macroeconomic stability is maintaining the financial stability, realizing solid economic growth and performing responsible fiscal policy.

As regards public finances, both revenue and expenditure measures are needed to achieve fiscal consolidation and to meet the governmental medium term fiscal strategy goals.

A careful evaluation of spending priorities and determined implementation of the proposed fiscal rule would be important to maintain Macedonia's moderate debt level. In order to avoid public debt increasing abruptly, the Government should carefully evaluate the costs and economic and social returns of the different policy proposals, properly prioritize and sequence the different policies and support the fiscal path in the Medium-Term Fiscal Strategy. Macedonia has already started a procedure for constitutional amendments to establish a binding ceiling on public debt and the fiscal deficit by 2017. Front-loading these targets to even earlier than 2017 and combined with measures to strengthen PFM could slow down the increase in public debt while supporting long-term growth.

Strengthening public investment management will be the key for improving the efficiency of public spending. Capital investment projects should be subject to mandatory national rules for economic analysis and prioritization in the context of sector strategies and budget processes. These rules should be comprehensive and cover all elements of the capital investment cycle, including repairs, maintenance and recurrent operational costs. The recent decline in the quality of public investments also raises concerns about the selection criteria applied. Increasing the use of cost-benefit analysis, strengthening the capacity of budget users, developing transparent criteria for prioritizing investment projects and creating a clear framework for monitoring and evaluating projects would increase the quality of investment spending. (Progress Report)

PPP projects, as one of the tools of public finances are not common practice in the Republic of Macedonia. There are few successful PPP projects but the contracts, conditions and the real benefits for the both parties regarding these projects are not transparent. This leads to the first thing that should be



done in order to promote PPP projects – to establish education, raise transparency and facilitate strong and stable political commitment. In order for PPP to become more widely used, especially on regional level, it is very important that governments have in place institutional capacity to create, manage and evaluate PPP projects. For countries like the Republic of Macedonia, as developing country, the help from international institution in the field of education and capacity building regarding PPP projects is very important. At the same time, the impact of PPP projects should be also assessed through various sectors. Findings show that PPP projects are better for economic infrastructures like transport and electricity sectors because the demand of these sectors is stable and predictable and the service quality is easy to asses. In middle and low-income countries such as the Republic of Macedonia, there is a risk for accomplishing efficiency results in PPP projects in social sectors like health and education because the criteria of access and equity of the service cannot be accomplished.

As regards the tax policy, the Republic of Macedonia is tax haven for foreign investors. Likewise, the tax and pension and social insurance contribution rates are among the lowest in the region. The government strategic decision to maintain low tax rates and other incentives to attract FDI certainly has its positive results and benefits, i.e. robust exports and new employments. However, the domestic private sector feels the burdens from this policy, being discriminated by paying the regular and not favorable tax and other incentives rates. Moreover, opposite to this, the domestic private sector should be stimulated as same as the foreign investors. Nevertheless, this very generous tax and contribution policy for the foreign investors should be reconsidered in a long run as whether it is sustainable for the country's budget or not.