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FISCAL SUSTAINABILITY OF MACEDONIA ON ITS PATH TOWARDS THE EU

1. Introduction

The 2008 global economic crisis exposed the importance of government fiscal intervention, and after more than two decades of neoclassic paradigm and a "non-fiscal dominance" paradigm, it brought back fiscal activism and the Keynesian ideas and measures at the top of government agendas. However, the drastic worsening of many developed nations' fiscal state, as a result of a decreased economic activity and of various fiscal packages aimed at the financial sector and the economy as a whole, complemented by budgetary pressures from an aging population, activated debates on the size, sustainability and the consequences of budget deficits and public debt.

Recent events, particularly the conditions created by the European debt crisis under which, some EU member states faced difficulties in access to markets, confirmed that the challenges of fiscal sustainability are not only long-term, and are not typical only for developing countries, but are a real problem for developed countries with a growing public debt, stagnant economic growth, unfavorable demographic trends and obligations passed on by the financial sector. This imposed the sustainability of public finances (important for the creation of sufficient fiscal space to tackle future unfavorable macroeconomic shocks and with costs associated with an aging population) as one of the most important macroeconomic issues for EU member states and candidates, considering its importance in maintaining EU's stability.

The issue of fiscal sustainability is relevant for the Republic of Macedonia which has a relatively low but growing level of public debt, that from the beginning of the crisis until December 2015 grew more than 20pp of GDP and reached 46.5% of GDP (38% of GDP general government debt). Estimation of fiscal sustainability is an infallible part of the analyses carried out by international financial institutions (IMF, World Bank) in countries of interest,

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including Macedonia. This is particularly important taking into account the growth dynamics of Macedonia's debt, its structure, and efficiency of fiscal policy, one of the key indicators for assessment of our stability on the path towards the EU.

In context of the above, this paper firstly defines the concept of fiscal sustainability, then presents the problem's relevance for developed countries through the European debt crisis case, and lastly, elaborates Macedonia's fiscal policy, public debt, and fiscal sustainability.

2. The concept of fiscal sustainability

Often times when fiscal sustainability is mentioned, it is in the context of the country's solvency. In that sense, fiscal sustainability[1] can be defined as the country's ability (theoretically) of indefinitely maintaining current fiscal policy without the need for changes in public spending or taxation, in order to influence the primary budget balance; and such a policy can be maintained indefinitely without continuous growth and excessive debt accumulation (EC, 2015; IMF, 2009; Greene, 2012). It follows that a continuous rise and/or extremely high coefficient of debt is unsustainable (Balassone et al., 2009; Afonso, 2005). Theoretically, the concept of sustainability refers to satisfying the intertemporal budget constraint according to which the sum of the current value of primary budget surpluses has to be at least equal to the initial debt (Chalk and Hemming, 2000; IMF, 2002). In the case of EMU's Stability and Growth Pact, according to Balassone and Franco (2000), sustainability can be seen as "on-violation of arbitrarily predefined parametric standards".

Fiscal unsustainability implies that the existing fiscal policies cannot continue indefinitely and, sooner or later, adjustment will be necessary. Otherwise, public debt will explode (Cottarelli, 2012). Usually, the later determined unsustainability and necessary adjustment are very costly due to the loss of trust among participants in the financial markets. Thus, the focus of fiscal sustainability analysis is often times on the consequences from the required changes in policies.

3. Why fiscal sustainability on the path towards the EU – The European debt crisis

The fiscal stimuli as a response to the global financial and economic crisis caused a serious problem for the Eurozone and many countries infringed on

[1] Fiscal sustainability had been discussed long ago and it is intuitively clear that a sustainable policy is the one that prevents bankruptcy, but there is no clear and widely-accepted analytical and operative definition on what constitutes the sustainable position of debt (review of definitions in Balassone and Franco, 2000).

the established Maastricht criteria by which the deficit shouldn't pass 3% of GDP during normal times, whilst public debt 60% of GDP.[2]

Economic growth disappointed in the EMU. The Eurozone barely achieved growth in 2008, and entered a recession in 2009 with a fall of GDP of 4.4%. However, the European debt crisis was caused by other factors as well: a lack of common fiscal policy; great disparities in the level of development among countries from the center and the periphery; great financial instability in some countries; disagreements among member states about the direction of fiscal policies, etc. (Fiti and Tashevska, 2013).

EMU is the only example in the world of the existence of a common monetary area but without a common fiscal policy, banking union and political union (Balassone et al., 2009; Lane 2012). The Maastricht criteria and the Stability and Growth Pact (SGP) have been established in order to discipline fiscal governments of member states and were meant to serve as a replacement for a common fiscal policy in the EMU. However, without efficient control over public spending in some EMU countries, fiscal rules weren't followed (Fiti and Tashevska, 2013). Budgetary discipline in a monetary union is very important since fiscal expansion of an undisciplined country causes negative externalities in other countries in the zone, while the absence of a central fiscal body creates conditions for the existence of a moral hazard and chronic deficits in certain countries. The possibility for countries to borrow in a common currency causes a free rider problem as long as there are incentives to save heavily indebted countries. The crisis confirms that the existence of a monetary union without a common fiscal policy is unsustainable (Bosomworth, 2012). These are some of the reasons why it is important to devote attention to mechanisms that sustain the stability of public finances in each country that aspires to join the EU and which will have a share in the stabilisation/destabilisation of the macroeconomic environment in the Union.

The seriousness of the crisis in the Eurozone caused violation of SGP's clause according to which problematic countries should not be bailed out. Greece was the first to receive a bailout package from the EU and the IMF in May 2010, followed by Ireland, Portugal, Spain, and Cyprus. The ECB took unconventional monetary measures of support for the European system, such as purchasing public debt of problematic countries. Later, a set of measures and activities were taken: the EU and the IMF formed a European mechanism of financial stability to aid problematic countries. The countries agreed a Europact, a European semester (a timetable for all monitoring elements, including fiscal, macroeconomic and structural policies), signed

[2] European countries were exposed to various reasons for debt growth: some had a traditionally high public debt – Greece, Portugal and Italy, while in some, the aid for private and the banking sector led to rising public debt – Spain and Ireland (Semmler and Semmler 2013, Fiti and Tashevska, 2013).

a New Fiscal Compact as part of the Treaty on Stability, Coordination and Governance with the EMU, etc. Pressed by fiscal rules and the pressure of financial markets, European countries took on fiscal contraction during conditions of deep negative production gaps. Some authors are against the implemented fiscal consolidation i.e. fiscal austerity policy during conditions of recession, warning that it can cause nervousness in financial markets, added by its restrictive effect on the GDP that can reduce the deficit reduction, even cause the debt coefficient to rise if the beginning debt level and fiscal multipliers are high, and the real time for consolidation is the boom and not the fall (example. Krugman, 2010; Cafiso and Celini 2012; DeLong and Summers, 2012).

The European Commission's report (EC, 2015) on the EU's fiscal sustainability, states that current conditions of low inflation and modest growth of the real GDP (1.9% in 2015) hinder the debt reduction, and fiscal consolidation is required, mainly by cutting unproductive public spending and increasing efficiency of public expenditure. Low interest rates reduce debt service costs and facilitate the reduction of the debt burden. Despite lowered risks to fiscal sustainability compared to the beginning of the crisis, there are serious mid-term and long-term challenges, mainly due to the high amount of accumulated debt and projected growth of costs associated with an aging population.

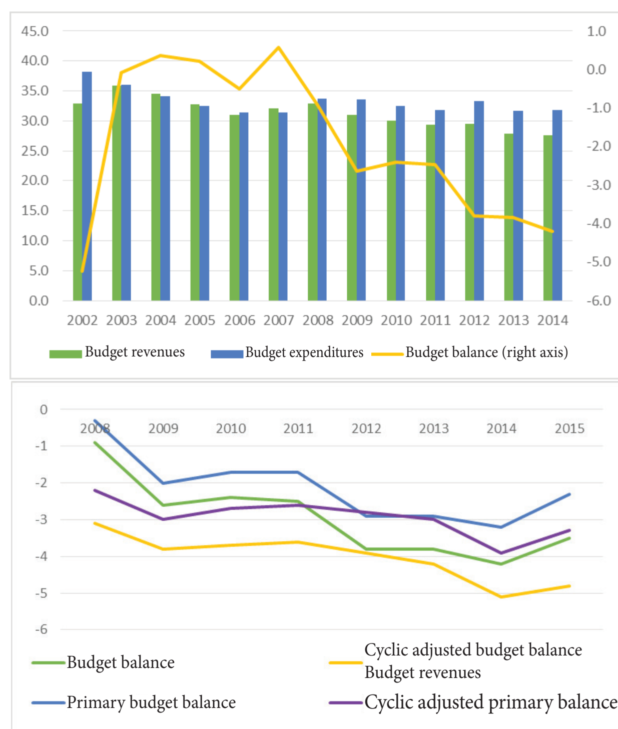
4. Fiscal policy, public debt and fiscal sustainability in the Republic of Macedonia

Before the Global crisis, the Republic of Macedonia was characterized by stable growth rates (ave. 5% in 2004-2008); reduced unemployment; low inflation rates and deflation in 2004 (-0.4%) and in 2009 (-0.8%); an almost balanced budget (a surplus in 2004, 2005 and 2007); modest public debt (reduced to just 23% of GDP in 2008); a significant level of international reserves; a small and well-capitalized banking system with limited dependency on external financing, and more on domestic deposits which reduced exposure to global financial conditions; positive signals for potential investors and business partners from progress on EU integration by becoming a candidate country; large deficit in the current account – the main vulnerable spot at the beginning of the crisis.

The fiscal policy prior to the crisis was oriented toward the creation of conditions for higher economic growth through the stimulation of aggregate supply and demand: in 2007, legal reforms were passed which introduced flat tax rate; tax exemption was also introduced with an amount of reinvested profit; there was an introduction of a 5% VAT rate on some products; in July 2008 a measure was passed that saw the reduction of social

benefits for 10 pp;[3] in 2005, Macedonia borrowed under favorable conditions from the global capital markets by issuing the first Macedonian Eurobond used for repayment of principal to the London Club[4].

Graph 1. Budget revenues, budget expenditures and budget balance of RM (% of GDP)



Source: Ministry of Finance of the Republic of Macedonia, NBRM

However, Macedonia was not immune to the crisis. As a small and open economy, it is especially vulnerable to external shocks from changes to economic activity in neighboring countries, and in EU countries as its main trade partners. Due to the insufficiently developed financial markets in the region and in Macedonia, the crisis arrived, first, through the real sector, through reduced demand for exports (for the crisis' transmission see Trenovski, 2013; Fiti and Tashevska, 2013).

The fall of economic activity in the country was first felt with the reduction of budget revenues and the 2007 surplus (0.6% of GDP) turned into a deficit of -0.9% of GDP in 2008 and a primary deficit[5]of -0.3% of GDP (graph 1, right image). The fiscal impulse was around 3% of GDP. The expansionary discretionary fiscal policy implemented by the Government in 2009 (anti-crisis packages to facilitate the effects of the crisis, increasing potential growth of the economy, improving living standards, and protection for vulnerable groups), despite contributing to the limiting of the economic fall to just 0.4% in 2009, led to the deepening of the

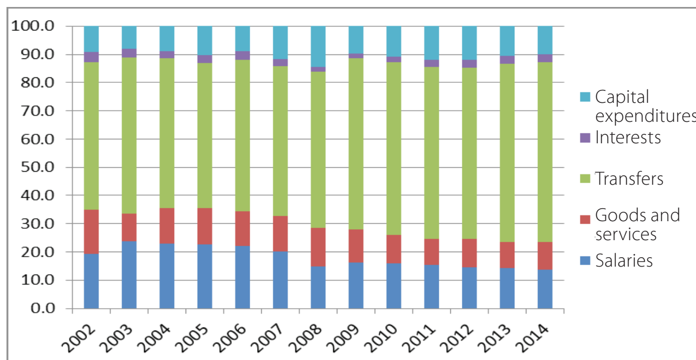
[3] The reduction of tax rates (however, a widening of tax coverage) and contribution rates, primarly increased public revenues as % of GDP (Trenovski, 2013).

[4] In 2009 a new Eurobond was issued, but now under more unfavorable conditions – its interest rate was almost two times higher than the one in 2005 and was 9.875% on an annual level.

[5] The primary balance is more appropriate when analyzing the current course of policy and when examining the efficiency of discretionary fiscal policy because it doesn't include the interest costs which aren't dependent on current decisions by the Government, but arise from previous obligations.

budget deficit, to a level of -2.7% of GDP in 2009, whilst the primary deficit reached -2.2% of GDP. It is logical during conditions of a fall in economic activity to implement fiscal stimuli, especially when the monetary policy has its hands tied (here due to the fixed exchange rate). The monetary policy was tightened in order to reduce the pressure on the foreign exchange reserves.[6] Most often, the fiscal and monetary policy acted in opposite directions, as strategic substitutes, especially visible with the expansionary fiscal policy, when the restrictive monetary policy neutralized a part of the stimulating effect (Bexheti 2010; Trenovski, 2013; Trenovski and Tashevska, 2014). In 2010 the fiscal policy was aimed at the gradual tightening of the budget deficit mainly through the adjustment of public spending; however, in recent years, the budget deficit had deepened, reaching -4.2% in 2014 and 3.5% of GDP in 2015.[7] The 2011-2014 period is characterized, once again, by a structural deficit and positive fiscal impulse, indicating an expansive discretionary fiscal policy, while in 2015, there is a negative fiscal impulse (see NBRM, 2016). The IMF (2015) expect the deficit to remain over 3% of GDP in the mid-term, should there be no changes in policy.

Graph 2 Structure of public expenditures of the Republic of Macedonia (in %)



Source: MF and NBRM.

Macedonia's public revenues are in a downward trend and are among the lowest in Europe in relation to the GDP. They dropped from 33.8% of GDP in 2007 to 27.8% in 2014, among the lowest in the region due to reduced revenue tax rates and income tax rates, as well as social security contribution

[6] The increased offer of state bonds to finance higher public expenditures and NBRM's efforts to stop the growth of inflation encouraged growth of interest rates of MF and NBRM, and they reached the peak of 9% in mid-2009.

[7] This decrease is largely due to the increased public revenues, partially due to the reintroduction of non-reinvested revenue tax, as well as the efforts to improve tax collection.

rates.[8] The relaxing of fiscal policy and the fiscal stimuli increased public expenditures to 34.1% in 2008 and 34.2% in 2012 (31.8% in 2004). Despite the level of public expenditures not being worrying, their structure isn't favorable to growth. Current expenditures make up around 90% of the total budget expenditures (graph 2). Social benefits have increased as a GDP percentage, and pension growth (they were 9% of GDP in 2015), together with the effects from an aging population and the outflow of young qualified workers will cause further pressure on the budget. The country carried out several successful pension reforms in the past two decades, however, they aren't enough to prevent the growth of expenses. Doemeland et al. (2015) point out the low efficiency of public spending. The share of capital investments in the total budget expenditures increased to 10.1% in 2014 (14.4% in 2008). But they also carry many unproductive costs; while large sums of money end up abroad from where they have no multiplicative effect on the domestic economy. The research and development and education expenditures that support growth have a particularly low share in the total budget expenditures.

4.1 Public debt

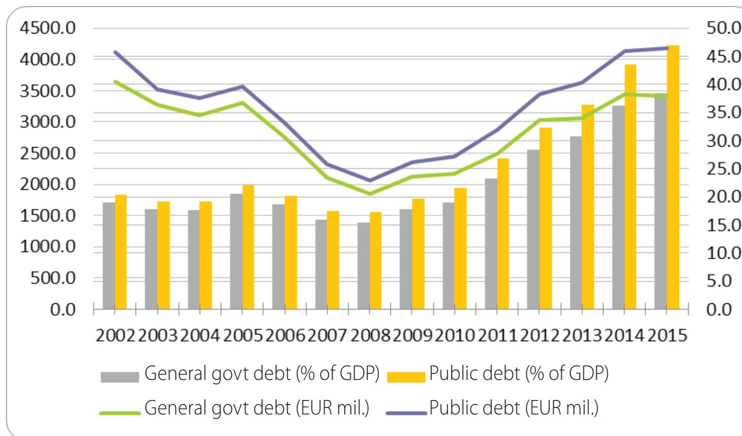
The 2000-2008 period is characterized by continuous decline of public debt from 47.9% of GDP to the lowest level of 23% of GDP in 2008, while the 2008 general government debt was 20.5% of GDP (graph 3). Strong domestic demand, favorable lending conditions, helped the acceleration of economic activity. The differences between the economic growth rates and public debt interest rates were favorable, while a policy of fiscal discipline and balanced primary budget (small surplus) was also carried out. The earnings from privatization, especially of ESM-distribution (225 million EUR in 2006) also played a big part. In 2007 the debt to the Paris and the London Club was paid, parts of the debt to multilateral creditors, and two structural bonds.

However, from 2008 the debt began to rise as a result of worsened economic conditions and the Government's expansive fiscal policy. The country's borrowing, especially from abroad, became an important source of funds to cover public expenditures (the borrowing from abroad has increased from 1.1% in 2004 to 10.2% in 2013). In August 2014, Macedonia took out a 36.4-million-euro Competitiveness Development Policy loan, financed by the World Bank. In 2014 public debt reached 45.9% because the Government issued a 500-million-euro bond under very favorable conditions (3.975%, 7 years) and thus completely and ahead of time financed the 15-million-euro bond, and carried out payments to the IMF in 2015 (154 million EUR). Public debt was reduced in the first half of 2015 to 43,7% of GDP. Nevertheless, the

[8] Doemeland et al. (2015) points out that the SDI policy contributes towards increase of the employment and growth, but also towards decrease of the correlation between revenues and GDP due to tax exemptions.

issuing of a new Eurobond of 270 million euros and increased borrowing at home of 94 million euros caused the general government debt to be 38% of GDP, while the total public debt 46.5% of GDP, which is an increase of 23.5 pp compared to 2008 (23% of GDP). Public debt is becoming increasingly different to the central government debt due to certain capital expenses being transferred from the budget to public companies (e.g. the Government dislocated a big share of road infrastructure projects from the budget by transforming the former Roads Fund into a Public Enterprise for State Roads), and due to the support in financing of small and medium-sized companies by the MBDP, whose debt rose from 0.4% of GDP in 2009 to 2.2% in 2012 and reflects the use of lines of credit from the European Investment Bank. The public debt of state companies increased from 2.6% of GDP in 2009 to 7.7% in 2014. In the future, it is important that spending and borrowing of the SOEs to be estimated as part of fiscal risks and sustainability of the government debt. (Doemeland et al., 2015)

Graph 3. General government debt and total public debt of the Republic of Macedonia



Source: MF of RM.

The main instigator of debt growth is the central government's primary deficit (2.5% on average in 2009-2014), as a result of fiscal measures and automatic stabilizers, the borrowing by state companies, the real interest rates (due to low inflation) etc. Only the growth of GDP went in the other direction but with smaller intensity compared to the pre-crisis period.

The debt structure reveals some risks: a growing share of short-term debt and a high percentage of debt denominated in a foreign currency. A larger part of the debt is external, while the larger percentage of debt in foreign currency draws a foreign currency risk, something that is important for a country like Macedonia with a de facto fixed exchange rate. An exchange

rate shock can increase the liabilities expressed in domestic currency and the liquidity problems, with a negative effect on the country's risk premium.

4.2 Macedonia's fiscal sustainability

Despite its growth, the public debt is among the lowest in Europe (the average of SSE in 2014 is 52.6% of GDP) and it is on a significantly lower level than the one established by the Maastricht criteria of 60% of GDP. Nevertheless, the accelerated dynamic of its growth since the start of the crisis (the debt doubled in the 2008-2015 period) presents a cause for concern, and imposes the need for higher caution in the management of public finances in order not to endanger their sustainability (a warning also given by the IMF and the World Bank), especially because of the notion that in countries with lower incomes, the negative implications of public debt (consequences for macroeconomic stability, decreased capital earnings and financial constraints of the private sector) appear on a lower level of indebtedness. (Presbitero, 2010; Reinhart and Rogoff, 2010).

There aren't many empirical analyses that touch the problem of Macedonia's fiscal sustainability. We can mention Tashevska (2015), Trenovski and Tashevska (2015), Doemeland et al. (2015), reports on Macedonia by the IMF. Below, we give a review of some of the results of those analyses.

The growth of budget revenues doesn't fully follow the growth of budget expenditures i.e. they diverge, implying that their development doesn't help the decline of the country's indebtedness (Tashevska, 2015[9]). That study also shows that the growth of revenues causes a successive growth of the expenditures, implying that they aren't used to narrow the budget deficit.

A way to determine fiscal sustainability is by estimating the reaction of the primary budget balance to changes in the level of debt. Trenovski and Tashevska (2015) and Tashevska (2015) find a negative reaction of the primary balance during a short-term shock to the debt, and conclude that the indebtedness level has no deciding meaning when determining the fiscal position, in spite of the fact that during a longer period, the primary balance does react to the higher debt. But in order to prevent debt accumulation, a faster reaction by the primary balance is required.

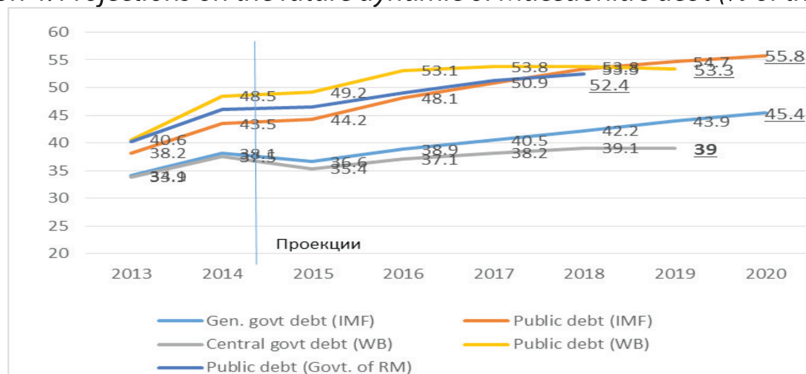
Most often, debt sustainability is analyzed by projecting its future trend. Economists from the World Bank (Doemeland et al., 2015) are projecting that the central government's gross debt will stabilize at around 40% of GDP by 2019, while public debt will surpass 53% of GDP, within the baseline scenario

[9] There is a co-integration among budget revenues and budget expenditures which meets the condition of a so-called "weak" alternative of fiscal sustainability. But the co-integration coefficient ($b<1$) shows the budget expenditures grow over-proportionately in relation to budget revenues.

which forecasts that the Government will implement the planned path of fiscal consolidation (decreasing fiscal deficits from 4.2% in 2014 to 2.9% by 2017), stated in the Medium-term Fiscal Framework 2015-2017. This borrowing trend is confirmed by reports from the IMF, where the last one (IMF, 2015) predicts that the general government's debt will reach 45% of the GDP by 2020, while the total public debt will be 54% of GDP (graph 4).

The Government of the Republic of Macedonia (2015) predicts the public debt in 2018 to reach 52.4% of GDP, while state debt 41.5%, which is similar to the basic scenario in Tashevska's projections (2015)[10]. The projected fiscal trend mainly comes from the high primary deficit, and is partially neutralized by the favorable perspectives of growth. The total public debt will increase rapidly, primarily due to higher spending by state companies.[11] A weaker GDP growth will negatively impact the share of debt through the lower denominator (nominal GDP) and with the worsening of the budget balance as a result of the automatic stabilizers which can cause for the debt to endanger the threshold of 60% of GDP. The same can occur if there is no success in the implementation of fiscal consolidation, while the primary balance maintains a level of around -3%, or if all investment projects are implemented, without changes to the pension policy. It can be concluded that all debt projections point to a growing trend and caution in further public finance management. (Doemeland et al., 2015; IMF, 2015; Tashevska, 2015)

Graph 4. Projections on the future dynamic of Macedonia's debt (% of the GDP)



Source: IMF (2015); Doemeland et al. (2015), Government of the Republic of Macedonia (2015)

The accelerated pre-crisis growth dynamic of public debt imposes the need for a good medium-term fiscal strategy of consolidation. In

[10] Tashevska (2015), using stochastic simulations of the central government debt, based on the methodology by Garcia and Rigobon (2004), estimates a debt growth to over 40% of GDP by the end of 2017.

[11] The debt of state companies is predicted to rise for 14.4% by 2019 (Doemeland et al., 2015)

order to secure debt sustainability, the central government primary deficit should be gradually reduced, primarily to stabilize the debt, and then to build fiscal buffers. According to the IMF's estimates, in order to stabilize the debt, it is necessary to reduce the central government primary deficit of around 1.6% of GDP (IMF, 2015).

The Government predicted fiscal consolidation by tightening the budget deficit to -2.6% in 2018. (Government of RM, 2015), and fiscal rules that should come into force from 1 January 2017, with a budget deficit ceiling of 3% of GDP and public debt ceiling of 60% of GDP. Nevertheless, according to the IMF (2015), an even lower debt limit would help Macedonia create a sufficient fiscal space in order to respond to future challenges from macroeconomic shocks and from medium-term pressures associated with an aging population, while simultaneously lowering the risks of increased needs for financing.

Conclusion

Macedonia's public debt is among the lowest in Europe (by the end of 2013, the general government debt was 34.2 % of GDP, while the total public debt 40.5% of GDP). While on a moderate level, the accelerated dynamic of debt growth since the emergence of the crisis attracts the need for a good medium-term fiscal strategy of conciliation. The smaller threshold of debt tolerance of lower income countries should be taken into account. The risk of debt defaults has a tendency to grow with the debt, however, which level is compatible with fiscal sustainability is acceptable remains a matter of estimation. Nevertheless, the empirical analyses of developing markets show that countries can enter a debt crisis even if the debt is surprisingly low. In 55% of debt default cases in medium income countries, their public debt was below 60% of GDP; and in 35% of the cases it was less than 40% (Doemeland et al., 2015).

Based on our analysis, we can make the following recommendations for the economic policy in Macedonia:

- While the level of debt is not very high, measures of gradual fiscal consolidation are required, in order for a fiscal space to be created. It is recommendable that each over-performance of revenues i.e. achieved surplus, be used to lower public debt. To ensure debt sustainability, the primary deficit should gradually decrease, in order to stabilize the debt, and then build fiscal buffers;
- The consolidation would be best achieved by cutting current expenditures, since they have smaller multiplicative effects and a smaller negative effect on economic growth (see Trenovski, 2013).

According to the WB (2016), reforming the amount and targeting the pensions and social benefits is crucial for an effective medium-term fiscal consolidation. Priorities should be established, in terms of capital expenditures, while public investments should be directed toward large infrastructural projects (roads, modernizing the railroads, gasification), which significantly lowers business costs, and toward research, development and education, which encourages growth;

• The low tax rates attract investments and create jobs. Since the maintaining of low and flat tax rate is a Government's strategic decision, the increase of budget revenues can be achieved by creating a fiscal policy for structural and tax reforms: the expansion of the tax base and its coverage, as well as improving the efficiency of tax collection (further decrease of the shadow economy and its coverage by tax regulations);

• Good coordination between fiscal and monetary policy is needed. Fiscal policy cannot achieve the required goals without the support by the monetary policy; but when determining the course of action and the measures taken, the monetary aggregates should also be taken into account;

• Since the largest share of the debt is in foreign currency and abroad, in order to maintain the value of the denar, reforms are needed to stimulate exports, which are a key factor for improving the growth dynamics, and also bring a larger inflow of foreign exchange;

• The expectations of economic subjects should be considered, because if they expect larger fiscal contraction in the future (or perceive the fiscal policies are unsustainable in the long term) as a result of today's increased public expenditures, they will react by saving more and investing less;

• The sustainable level of debt also depends on the succesful implementation of more effective macroeconomic policies and strucutral reforms that encourage economic growth, a more fiscal transparency and good management of public debt, through a prudent fiscal framework.

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