

The Center for Economic Analyses (CEA) is a think tank of economists who share a common vision for the Republic of Macedonia as an emerging new European economy integrated in the regional and worldwide market.

The Mission of CEA is to continuously research economic development and economic policy in the Republic of Macedonia and to offer recommendations, suggestions and measures where it is deemed appropriate.

PRESS RELEASE

In the last year CEA conducted numerous projects with relevant findings for the Macedonian economy. Some of the projects are listed below together with excerpts from the reports prepared. All reports are available from www.cea.org.mk.

1. CEA prepared the third report to USAID with a title: *"The new face of the IMF"*

The report gives an overview of the IMF sponsored seminar at the JVI and gives a brief overview of the Macedonia-IMF cooperation. Available at: www.cea.org.mk

In a conclusion, it is evident that the overall macroeconomic parameters of the Southeast Europe show that this region is in phase of rapid convergence and the national economies will continue to grow rapidly, as expected, in the years to follow. Although second-generation (structural and institutional) reforms are underway in Southeastern European economies, the unprecedented levels and large variations of external imbalances occupy relatively high positions on the policymaker's agenda. Widening external imbalances reflect either rapid capital formation or private consumption booms, but there are country-specific thresholds beyond which market participants are unwilling to finance these deficits.

Even if the growth potential of these economies justifies the large and persistent deficits, in case of sudden shift in the market sentiment, the inevitable adjustment could have devastating macroeconomic implications. The ensuing reduction of current account deficits could lead to a slowdown in medium term growth and reduction of long run per capita income. Hence, despite the strengthened macroeconomic management, SEE economies must continue their cooperation with the Fund, particularly in terms of regular surveillance of macroeconomic and financial market developments.

Since its independence and membership renewal, Macedonia has undergone 124 months (or roughly 10 years) in formal arrangements with the Fund. Initial stabilization programs (the Structural Transformation Facility and the Stand-by Arrangement) in the mid 1990s have been successfully completed and resulted in

rather stable macroeconomic environment. Unfortunately, the subsequent adjustment programs (Enhanced Structural Adjustment Facility and the Poverty Reduction Growth Facility) have had mixed record.

There are a number of reasons on both sides for the insufficient progress in the implementation of second-generation reforms:

- (i) the Fund has insisted on very detailed matrices of measures and performance indicators which sometimes were not crucial for the success of the program;
- (ii) lack of national ownership of the IMF-supported programs, as seen by the weak commitment and implementation capacity by the Macedonian authorities
- (iii) very weak institutional capacity for preparation of macroeconomic adjustment programs and insufficient political support for the painful, but needed reforms (treatment of the Fund as alibi for the implementation of politically unpopular reforms).

There are indications that during election years the establishment in Macedonia was not really keeping to the agreed with the IMF arrangements. Election-driven expenses have frequently led to serious incompliance with the structural benchmarks and performance criteria, undermining the Fund's confidence in the Government commitment. Unfortunately, this has led to much harsher measures in the post-election periods. Such stop-and-go policies have resulted into sluggish economic growth and undermined credibility.

Achievements:

- Macroeconomic and financial stabilization
- Medium-term current account sustainability
- Knowledge transfer and institutional capacity building
- Fiscal and public debt sustainability
- Substantial mobilization of donor support
- Improved fiscal transparency

Failures:

- Continuation of the soft budget constraints (SBC) practices
- Severe fiscal swings and insufficient financial consolidation of the extra-budgetary funds (particularly, the Health Insurance Fund)
- Lack of ownership of reform agenda
- Imported IMF credibility for "Domestic Government programs".
- Moral hazard of having IMF programs

2. CEA prepared a creditworthiness tool for the municipalities in Macedonia and implemented that tool to analyze the municipality of Veles and Strumica. The documents are available at the: www.cea.org.mk

The main goal of this Manual is to adapt a credit worthiness tool as a mean of preparing Local Governments for borrowing as of July 2007 according to the Law on Financing of the LSG in Macedonia. This Manual was developed by also taking into account the criteria of the international credit rating agencies.

The process of decentralization in Macedonia is at its threshold if we take into account that the LG in Macedonia is allowed to generate debt as of July this year, the second stage of the process of decentralization will start and the new program for implementation of the process for the period 2008-2010 will be prepared. Last but not of least importance is the context of the new Law on balanced regional development that should (together with the draft Law on Municipal Cooperation) give ground for regional cooperation and utilization of scale economies for conducting more ambitious capital projects.

Still, one should take into account that the fiscal gap at the subsovereign level in Macedonia is still an unknown as there are no an all encompassing cost of services estimation and the pioneering work on estimating the fiscal capacities of LG is not yet representative enough for using it for policy recommendations as the statistical/financial system is still not at representative place in time and structure, among others.

Yet, the interested and viable municipalities for generating debt will not be constraint with the shortcomings of the general set up. The capable managers/mayors will grab the opportunity as soon as they are allowed by the law and will provide to its citizens the benefit of higher quality services at more efficient management of the LG budget. That is why this Manual aims at the financial managers to better understand the credit condition of their LG and to use it as a tool for a diagnosis of current conditions and to analyze the factors that can improve their financial health and viability.

This Manual is developed to follow, explain and to teach the Microsoft Excel model developed to evaluate the financial condition of the LG and is best to learn it together with presenting the model. This is not a Microsoft Excel manual and the model requires basic knowledge of and Microsoft Excel and of financial accounting.

3. CEA also upgraded its CEA Macro model with a LSG module and now policy simulations can be estimated within the macro framework. The report is available at the: www.cea.org.mk

For the purpose of building the LSG module we took the budget data for the LSG in Macedonia for the period of 2000 – 2006. The source of data is the Ministry of Finance, reclassified according to the IMF methodology on the Government Finance Statistics (GFS). The budget items presentation is illustrated in the next table:

Table 1 - LSG budget categories in accordance with the GFS classification

Total LSG Revenue	Total LSG Expenditure
Tax revenue	Wages and allowances
<i>Personal income tax</i>	Goods and non-labour services
<i>Other tax revenue</i>	Current transfers
Non-tax revenue	Interest payments
Capital revenue	- on non-resident debt
Transfers from other levels of government	- on domestic debt
	- on other levels of government
	Capital expenditure
	Acquisition of capital assets
	Capital transfers
LSG overall balance	
LSG Financing	
Inflows	Outflows
Domestic borrowing	Repayment of principal
<i>Bank borrowing</i>	
<i>Sale of securities</i>	
<i>Other domestic financing</i>	
Foreign borrowing	

The Macedonian LSG and mid term CEA forecasts. by using the CEA Macro model.

Local Self-Government		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total LSG Revenue		4388	4871	5559	8114	8254	8399	8550	8707	8869	9037	9211
Tax revenue	71	2888	3196	3293	3520	3660	3805	3956	4113	4275	4443	4617
Personal income tax			0	100	203	214	226	238	250	262	274	287
Other tax revenue			3196	3193	3317	3446	3580	3719	3863	4013	4169	4331
Non-tax revenue	72	156	310	189	1132	1132	1132	1132	1132	1132	1132	1132
Capital revenue	73	50	83	6	85	85	85	85	85	85	85	85
Transfers and grants	74	1294	1282	2071	3376	3376	3376	3376	3376	3376	3376	3376
Total LSG Expenditure		4109	4741	2491	4895	5066	5231	5390	5549	5715	5888	6069
Salaries and allowances	40	545	563	698	1202	1202	1202	1202	1202	1202	1202	1202
Goods and services	42	1460	1324	1554	3461	3632	3796	3955	4115	4280	4454	4635
Current transfers	44	279	195	3	0.2	0	0	0	0	0	0	0
Interest payments	45	8	3	0	0	0	0	0	0	0	0	0
- on non-resident debt	451			0	0	0	0	0	0	0	0	0
- on domestic debt	452			0	0	0	0	0	0	0	0	0
- on other levels of gov	453			0	0	0	0	0	0	0	0	0
Capital expenditure	48	1816	2656	236	233	233	233	233	233	233	233	233
Purchase of capital assets		1788	2643	236	233	233	233	233	233	233	233	233
Capital transfers		28	13	0	0	0	0	0	0	0	0	0
LSG overall balance		280	130	3068	3218	3188	3168	3161	3158	3154	3149	3142
LSG Financing		-280	-130	-3068	-3218	-3188	-3168	-3161	-3158	-3154	-3149	-3142
<i>Inflows</i>		-251	-114	-728	-950	-950	-950	-950	-950	-950	-950	-950
Domestic borrowing		-251	-114	-728	-950	-950	-950	-950	-950	-950	-950	-950
Bank borrowing	75	51	45	14	14	14	14	14	14	14	14	14
Other domestic financing		-302	-184	-742	-964	-1047	-1135	-1230	-1324	-1413	-1495	-1572
Sale of securities	77		25	0	0.2	0	0	0	0	0	0	0
Foreign borrowing	76			0	0	0	0	0	0	0	0	0
<i>Outflows</i>		30	15	2340	2268	2155	2047	1945	1848	1755	1667	1584
Repayment of princip	49	28	15	2340	2268	2155	2047	1945	1848	1755	1667	1584
Equity		1	0	0	0	0	0	0	0	0	0	0

4. CEA prepared analyses of the impact of the capital investments of LSG in Macedonia to the macrostability. Report is available at: www.cea.org.mk

This report explains how fiscal decentralization may carry risks in terms of sizeable horizontal fiscal imbalances across sub-national governments, which may fuel inflation or increase macro-vulnerability. Even so, policymakers have usually embarked on some form of transfer of fiscal authority from central to local governments without sound assessment of the effects on macroeconomic stability. Therefore, an investigation of these relations in the context of further fiscal decentralization in Macedonia is highly desirable.

Information on medium-term investment needs of Macedonian municipalities is very scarce. Our methodology rests on analysis of the development strategies and action

plans of 13 Macedonian municipalities (Berovo, Demir Hisar, Delcevo, Gostivar, Skopje, Kicevo, Kocani, Kumanovo, Radovis and Konce, Resen, Strumica, Veles and Vinica) that decided to publicize and /or share with us their data and documents and we thank them all.

Their number of inhabitants represents nearly half of the total Macedonian population. However, only 7 out of 13 municipalities have defined medium-term capital expenditure framework with explicit estimates of their fiscal needs. Table 1 presents the details on municipal investment needs. Most projects are focused on improvement of the infrastructure, employment creation, agricultural and tourism development, support of local businesses and entrepreneurship, social inclusion activities, etc. Since their strategic documents refer to different medium-term horizons, we calculated the estimated annual investment needs for these areas.

Table 1- Assessment of the annual investment needs of 7 Macedonian municipalities

No.	Municipality	Types of investment projects	Annual investment needs (in mln EUR)	Estimated investment needs in the development strategy (in mln EUR)	Available funds (in mln EUR)	Population	Official sources
1.	Berovo	63 projects in infrastructure, sustainable development, education and training	4.16	20.81	4.10	13941	Sustainable Development Strategy 2007 - 2011
2.	Demir Hisar	40 projects for tourism development, small and medium enterprises, infrastructure, agriculture, social services, institutional strengthening	0.77	3.09	-	9497	Strategic and Action Plan for Local Economic Development 2006-2009
3.	Delcevo	43 projects in business climate improvement, tourism, agriculture, urban development, education and civil sector strengthening	-	-	-	17505	Strategic Plan for Local Economic Development 2007-2012
4.	Gostivar	Reduction of employment, education, environment, infrastructure, economic development	-	-	-	81030	Strategic Plan for Development 2007-2011
5.	City of Skopje	261 projects in economic development, export promotion, FDI promotion, strengthening competitiveness.	-	-	-	506,926	Strategic Plan for Local Economic Development 2006 - 2009

6.	Kicevo	Tourism, natural resources protection, enhancement of private sector competitiveness, local infrastructure	0.27	1.09	0.50	30138	Strategic Plan for Local Economic Development 2005-2009
7.	Kocani	68 projects for improvement of the education, agricultural development, tourism development	8.12	40.61	-	38092	Strategic Plan for Local Economic Development 2003-2007
8.	Kumanovo	Employment creation, foreign investment promotion, infrastructure, reduction of grey economy, environment protection	-	-	-	105484	Strategic Plan for Local Economic Development 2006-2008
9.	Radovis i Konce	7 priority projects in healthy food protection, education, infrastructure, culture, health and employment creation	-	-	-	31780	Strategic Plan for Local Economic Development 2007-2011
10.	Resen	Projects for improved environment, infrastructure, local business support, agricultural development, tourism development	0.88	5.30	-	16825	Strategic Plan for Local Economic Development 2007-2012
11.	Strumica	94 projects for improvement of infrastructure, education, tourism, industry, business climate, etc.	25.09	150.52	0.28	54676	Strategic Plan for Local Economic Development 2006-2011
12.	Veles	Job creation, social inclusion, education	337.28 (0.08 actual figure for 2006)	6745.61	-	55108	Economic Development Study 2001-2020
13.	Vinica	Environment protection, local business support, agricultural development, tourism development, trade facilitation	-	-	-	14200	Strategic Plan for Local Economic Development
Reported investment needs			376.6	6,967.0	4.9	975,202	
Revised investment needs			39.4	226.4			

Source: Municipal websites and information provided upon authors' request.

It is a conventional fact that LGU investments are well below what is required to meet EU infrastructure standards over the pre-accession period. Currently, most of local infrastructure is obsolete and a large amount of effort is required for its replacement and modernization. Services such as water, sewage and solid waste systems involve

large unit costs. To increase the level of such services will require considerable investments. It is evident that large part of development, replacement, and renewal of local assets will need to be financed out of LGU budgets. EAR-funded project on strengthening the capacity of the Ministry of Environment and Physical Planning has prepared estimates for meeting the capital and operational costs of the investments required to comply with European Union directives and policies in the “heavy investment” areas of environmental management. Within this project, the indicative estimates for the cost of accession in the heavy investment areas have been estimated. Table 2 presents the assessed additional investment needs for environmental protection.

Table 2- Assessment of the additional investment needs for approximation of Macedonia, Romania and Bulgaria to EU environmental legislation (In millions of EUR and per capita in EUR)

<i>Investment areas</i>	<i>Macedonia</i>		<i>Romania</i>		<i>Bulgaria</i>	
	Millions of EUR	Per capita (EUR)	Millions of EUR	Per capita (EUR)	Millions of EUR	Per capita (EUR)
Urban waste water treatment, sewerage	229	113	1,385	63	2,056	267
Large combustion plants	274	136	402	18	1,627	211
Municipal waste management, landfills	80	40	n/a	n/a	n/a	n/a
Municipal waste management, other installations	120	59	n/a	n/a	n/a	n/a
IPPC-air emissions	381	187	806	36	3,261	424
TOTAL	1,084	537	10,593	475	6,944	902

Source: EAR 2002-2003 and WB 2005.

If we assume that Macedonia may achieve full compliance with the EU environment legislation in twenty years, then the annual investment needs for environmental protection would be approximately 54.2 Millions of EUR.

Concluding remarks by using the CEA Macro model and the data:

- Investment-induced increases of local government budgets are expected to exhibit only short-term impact on real GDP growth (increase of the real GDP growth rate by 1.29 percentage points in 2008, 0,32 percentage points in 2009 and 0.11 percentage points in 2010);
- Given the relatively low degree of revenue and expenditure decentralization in Macedonia this would lead to mild increase of the domestic inflation rate (0.1 percentage points *per annum*);
- Due to the relatively high import content of most investment projects in Macedonia, the increased local government capital expenditure would induce moderate growth of real imports of goods and services (increased imports of goods and services (in real terms) by 1.66 percentage points in 2008, 0.39 percentage points in 2009 and 0.13 percentage points in 2010);

- Cross-country experiences reveal that there is no systematic relationship between fiscal decentralization and long-term economic growth. More precisely, the degree of fiscal decentralization does not affect long-term economic growth and this is in line with the existing body of empirical literature;
- Cross-country empirical results are fully consistent with the simulated effects of permanent investment-led increase of local government budgets by 93.3 Millions of EUR, as the growth-conducive effects wipe out after the third year.

5. CEA prepared an analysis of the determinants of the decisions made by the Macedonian companies to raise funds through loans versus equity. The report is available at the: www.cea.org.mk

Some of the conclusions:

It seems that the knowledge of the capital markets in Macedonia is at low level. The need for training, information, improvement of governance at companies' level must be priority for the GoM as well. The GoM is taking the right step with the initiative to teach the top managers how to manage but also the financial managers should be targeted as well. The need for basic knowledge of market economy shows lack of efficient education system in Macedonia in the science of economy and finance thus, raising once again the issue of Macedonian citizens paying twice for education system: once through the taxes (transfer to universities that do not produce knowledge) and second again through taxes but this time as GoM intervention for business to learn basic functions of how to run companies. This is a sad story of lost decade and a half in Macedonia in implementing market economy. CEA urges GoM to make the necessary reforms in the high education system as well.

Another story of lost energy in inefficient debates (sometimes supported by the IFIs as well) is that there are anecdotic problems for doing business that are not supported with this study as problematic like the exchange rate, inflation, labor market flexibility; but on the other side some are supported like the costs for Internet, telephone services and communications are seen as problematic for doing business. Hopefully the new measures taken from the GoM in that regards should make the positive changes.

There are indications of interesting relationships between banks and businesses supported by the paradox that companies even though complaining of high interest rate of bank loans still prefers loans to equity in raising capital. In the same time they are not much concerned of the credit rating of their company as for them the least important obstacle to approach the banking sector is the credit rating of its company.

Thus, this is an indication that at least two problem areas occurs that the GoM should tackle: first, the businesses (people from the finance departments) lack basic knowledge of risk in capital market and second, they don't expect market forces to operate the capital market but possible the relationship with bank's management in order to raise loan/capital for their operations/investment decisions even though complaining of high interest rate still prefers loans to equity in raising capital.

Finally, this situation leads to lower competitiveness of Macedonian economy, not efficient labor market (the companies don't have incentives to hire competitive skilled labor force), higher costs of capital, thin capital market, lower than potential economic growth.

CEA conducted the projects in cooperation with the USAID BEA and MDW projects.

The American people, through USAID, have invested more than \$450 million in Macedonia since 1993. More than 20 projects worth over \$20 million a year are currently being implemented. These projects are designed to support Macedonia's transition to a free market-based, multi-ethnic democracy. They include initiatives to accelerate economic growth, develop democratic institutions, and educate citizens for a modern economy. USAID provides economic and humanitarian assistance in more than 100 countries. For more information please visit <http://macedonia.usaid.gov>.

The seminar in Vienna was organized and sponsored by the IMF.

The reports were prepared by CEA members.