Fiscal Discipline and the Efficiency of Fiscal Rules in North Macedonia: The Path to Sustainability

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CONTENTS

LIST OF CHARTS AND TABLES

1. INTRODUCTION

Fiscal rules serve as a fundamental mechanism for maintaining fiscal discipline and supporting macroeconomic stability. They provide a structured approach to public financial management by setting long-term constraints on budget deficit, public debt, and expenditures (Kopits & Symansky, 1998). The concept of fiscal discipline and the restrictions imposed by fiscal rules have deep roots in economic theory and practice, especially during times of economic instability, such as the Great Depression. However, the real need for fiscal rules became particularly evident at the end of the 20th century when, following multiple crises, it became clear that long-term constraints on fiscal policy were necessary to control public debt and prevent politically biased decisions that lead to irrational public spending. In theory and practice, fiscal rules are justified by the need to curb populist policies, overcome the time inconsistency of political decisions, and maintain a long-term focus in public financial management.

Generally, fiscal rules have two main objectives. First, to mitigate or avoid the tendency and inclination to overspend, and second, to prevent the need for painful cuts to public expenditures during economic downturns. For this reason, fiscal rules should be set and regulated cyclically rather than based on a calendar. Ultimately, fiscal rules play a crucial role in supporting economic growth and long-term fiscal sustainability, primarily through automatic stabilisers and the countercyclical nature of fiscal policy (Baunsgaard & Symansky, 2009).

In recent decades, the application of fiscal rules has become a global trend, especially among European Union member states, which established key criteria for budget deficit and public debt through the Stability and Growth Pact (European Council, 1997). Countries in the Western Balkans, including North Macedonia, are also following this trend and are gradually introducing core principles to limit budget deficits and public debt, marking a significant step towards alignment with European fiscal sustainability standards. In North Macedonia, the Budget Law of 2022 introduced formal fiscal rules to ensure budget compliance with the fiscal strategy, including provisions for budget deficit and public debt (Budget Law, 2022). North Macedonia faces significant challenges in maintaining fiscal discipline and managing public finances. Although fiscal rules have been introduced, their implementation is marked by weaknesses. Frequent revisions of the fiscal strategy and inconsistent planning reduce confidence in the set objectives, while the prevailing procyclical policy, which uses expansionary measures even during periods of economic growth, further increases public debt and reduces fiscal manoeuvring capacity in times of crisis. This underscores the need for stronger fiscal discipline, improved planning, and alignment of fixed costs with long-term fiscal goals to ensure long-term stability and readiness to address future economic challenges. = This analysis examines the role of these rules, compliance with established standards, and key challenges, such as maintaining long-term fiscal discipline and stability in the face of economic shocks.

2. LITERATURE REVIEW

The Need for and Role of Fiscal Rules

The sustainability of public finances and sound fiscal policies are at the core of achieving macroeconomic stability. Fiscal rules help ensure sustainable public finances by imposing long-term constraints on fiscal policies. According to the definition by Kopits and Symansky (1998), a fiscal rule is a permanent constraint on fiscal policy expressed through an indicator of overall fiscal performance, such as the government budget deficit, borrowing, debt, or a significant component thereof. Fiscal discipline, as a principle, has a long history in guiding fiscal policies across world economies. Deviations from fiscal discipline have been observed, especially during the Great Depression in the 1930s. However, apart from crises, in many developed countries, discretionary powers have allowed a continued rise in expenditures, which exceeded revenue-raising capacities, partially due to political biases. Thus, deviations began to increase, and starting from the 1980s, awareness of biased deviations and of fiscal discipline grew. This imposed the need to introduce a simple rule for budget balance, which will function as an automatic stabiliser, while the use of discretionary measures would be rare and only for long-term structural objectives such as ensuring social security and implementing tax reforms aimed at fiscal sustainability, intergenerational equity, or efficiency (Kopits, 2012). A common feature of all fiscal rules is that they aim to increase credibility in implementing macroeconomic policies by eliminating discretionary interventions. Empirical research on the application of fiscal rules indicates that countries that have established independent fiscal institutions and apply fiscal rules show significantly better fiscal outcomes.

The need for fiscal rules is also great due to the nearly constant demand for increased public spending through an expanded role of the state, known as Wagner's Law (Wagner, 1883), especially evident during crises. Once public expenditures are increased, it is difficult to return them to their original level, even when the initial reasons for the increase are removed. In an idyllic world, politicians would prefer spending without additional taxation, which typically leads to fiscal unsustainability and macroeconomic instability. Thus, fiscal consolidation is necessary. There is a well-known adage by Dixit from Princeton University who says: "In good times, one should save for the bad times to have sufficient fiscal space. But good times are an illusion to policymakers who believe that bad times will never return" (Dixit, 2011).

The arguments justifying fiscal rules span multiple areas. The first argument relates to political economy, indicating that fiscal rules are needed to prevent irrational decisions, especially on policies aimed at satisfying the electorate but which may introduce biases toward higher spending and creating larger budget deficits (Buchanan and Wagner, 1977). The second argument for the superiority of rules over a discretionary approach is the time inconsistency of political commitments and their mandate for implementation (Kydland and Prescott, 1977). The third broad set of arguments is related to the role of fiscal rules in macroeconomic stability, economic growth, and long-term sustainability.

Fiscal Rules and Macroeconomic Stability

The role of fiscal rules, particularly public debt and budget deficits, and sustainable economic growth is a widely analysed topic in literature. The European Central Bank study by Annicchiarico and Giammarioli (2004) examines the linkage between fiscal rules (public debt and primary budget deficit) and the dynamics of economic growth rate through a process of adjustment towards the steady state. The results show that fiscal rules impact the dynamics of economic growth rates. The larger the initial public debt relative to GDP, the larger the fluctuations in the economic growth rates. How quickly fiscal convergence toward the set goals is achieved depends on the adjustment tools used by the policymakers. The study thus identifies that reducing the share of social benefits instead of increasing tax rates has a positive impact on growth and thereby accelerates the convergence of public debt towards the target level. However, it is also found that if the government aims to stabilise the economic growth while meeting the fiscal rule requirements for convergence, it should use both available tools (social benefits and taxes) at the same time.

If the fiscal space is fully exhausted, the need for strong fiscal rules becomes even more important due to the necessity of fiscal consolidation. Ostry et al. (2010) and Aizenman and Jinjarak (2010) particularly emphasise this need when public debt has surpassed the formal limit, leaving no room for intervention on public revenues and expenditures.

Azariadis and Reichlin (1996) show that with an initial public debt, the economy may fall into a low development trap. In their model, public debt is considered an asset without intrinsic value and represents a liability of the government, which is assumed to have no expenditure and introduce no taxes. Diamond (1965) examines the effect of public debt on the long-term competitive equilibrium of the economy and concludes that in a dynamically efficient economy, debt accumulation has a negative impact, since it reduces capital reserves and resources available for future generations. However, in a dynamically inefficient economy (where there is excessive capital accumulation), public debt can be beneficial, encouraging spending and enhancing overall utility.

Apart from the aspect of permanent deficits and debt, the literature also analyses the sustainability of permanent bond-financed deficits. Results have shown that an economic growth rate larger than the interest rate is a necessary but not sufficient condition to ensure the sustainability of a permanent budget deficit. The current state and accumulation of deficit and debt must also not be “too large” (Chalk, 2000).

Countercyclical Fiscal Policy and Fiscal Rules

The literature on counter-cyclical fiscal policy and fiscal rules is extensive, exploring the use of automatic stabilisers and discretionary fiscal measures, as well as findings on trends in both developed and developing countries. Countercyclical fiscal policy refers to government fiscal measures that counteract the economic cycle: during economic downturns, the government increases its spending or cuts taxes to stimulate the economy, while in periods of economic growth, it reduces spending or raises taxes to prevent the economy from overheating (Jalles et al., 2023). This policy aims to stabilise the economy by buffering the effects of economic cycles. Research by Romer (2017) and Romer (2019) on fiscal expansion during economic downturns econometrically confirms that stimulating the economy is necessary as it yields significant economic effects, in addition to social benefits.

Countercyclicality is an important aspect of fiscal policy as it is linked to its ability to provide macroeconomic stabilisation. Countercyclical "automatic stabilisers", such as progressive taxation or social assistance, automatically mitigate economic instability (Baunsgaard and Symansky, 2009). Even passive policies, like maintaining a fixed level of budget expenditures, can have a stabilising effect, while discretionary fiscal measures (active government interventions) may sometimes lead to procyclical bias and increase instability (van den Noord, 2000).

Literature on countercyclical fiscal policy shows that countries with stronger automatic stabilisers have less need for discretionary measures during recessions. For example, research indicates that in highly developed economies with advanced social systems, automatic stabilisers are sufficient to absorb part of the economic shock (Dolls et al., 2012). However, in most developing countries, fiscal stabilisers are still underdeveloped, making these economies more reliant on discretionary fiscal policies during economic shocks.

The study by Jalles et al. (2023) identifies several key findings. First, countercyclicality of the fiscal policy has increased in many economies over the last two decades. Second, both discretionary and automatic countercyclicality are more pronounced in developed economies, while in less developed ones, fiscal policy tends to be more acyclical or even procyclical at times. Third, countercyclical action is most often achieved through the public spending channel, particularly through social benefits. The study also found that better financial development, government size and development, and higher-quality and stronger institutional frameworks are associated with stronger countercyclical effects of fiscal policy.

The role of fiscal stabilisation also depends on the degree of economic openness. Economies open to trade and capital flows are more inclined to use fiscal policies for stabilisation due to their exposure to external shocks (Rodrik, 1998). In developing countries, this openness, combined with weaker institutions and fiscal rules, makes these economies more vulnerable to economic shocks despite efforts to introduce countercyclical fiscal measures.

Research indicates that fiscal rules, especially those related to debt, help reduce fiscal procyclicality (Jalles, 2018). This is particularly true for developed countries, where institutions are stronger and fiscal rules more effective. The study by Bova et al. (2014) shows that despite increased use of fiscal rules, fiscal policy in developing countries remains procyclical even after the introduction of fiscal rules. In developing countries, the lack of fiscal rules and weaker financial systems make these economies less resilient to shocks, emphasising the need to strengthen institutions and improve financial development to enable more effective fiscal stabilisation. However, a link is found that some features of the "second-generation" fiscal rules, such as cyclically adjusted targets, well-defined exception clauses, and stronger legal and implementation mechanisms, may contribute to reducing procyclicality. Moreover, literature notes that developing countries that have achieved progress in reducing procyclicality have primarily done so by improving the capacity of fiscal institutions (Frankel et al., 2013; Lledo et al., 2011).

Design of Fiscal Rules and Challenges

Fiscal rules are self-imposed rules by the government or independent fiscal authorities aimed at limiting discretionary behaviour and short-term tendencies of fiscal authorities, instead of the predominance of long-term developmental and stabilisation perspectives in the design and implementation of fiscal policy.

The design of fiscal rules takes into account the goal intended to be achieved. Countries with high public debt often set a public debt ceiling as a fiscal rule. However, in terms of effectiveness, results have shown that medium-term targets and their achievement are better indicators of fiscal sustainability compared to annual targets, which may deviate from the rule and are not always controllable (Kopits, 2001).

Fiscal rules can be established autonomously by the national government or imposed by supranational entities, such as the IMF, EU, etc. Countries aspiring for EU membership, as part of the convergence process, must adopt the fiscal rules applied in the EU. According to a World Bank study on the fiscal rules in the Western Balkans, meeting the fiscal rules is challenging (Kikoni et al., 2019). When fiscal rules are self-imposed, the risks include the possibility of them being ignored, not followed, or circumvented through creative accounting practices (Kikoni et al., 2019). This suggests that fiscal rules on paper do not inherently ensure the achievement of objectives if they are not implemented or are set too restrictively. Thus, the International Monetary Fund study on the usefulness of fiscal rules points to three principles to be incorporated in the design of fiscal rules: they should be simple to operationalise; flexible or acting as automatic stabilisers to allow cyclically adjusted balance; and growth-oriented, i.e. avoiding cuts to investments and infrastructure spending that are essential for growth (Kopits, 2001).

3. OVERVIEW OF FISCAL RULES, GOALS, AND TYPES

3.1 TYPES AND INTRODUCTION TRENDS

A fiscal rule imposes a long-term constraint on fiscal policy through numerical limits on budgetary aggregates. The goal is to limit pressures to overspend and ensure fiscal responsibility and debt sustainability. The set fiscal rules can be modified, although frequent changes are discouraged, that is, they should reflect a long-term intent in fiscal policy. Fiscal rules are classified into 4 main groups, specifically:

Debt Rules. These set an explicit limit on the level/amount of public debt in GDP.

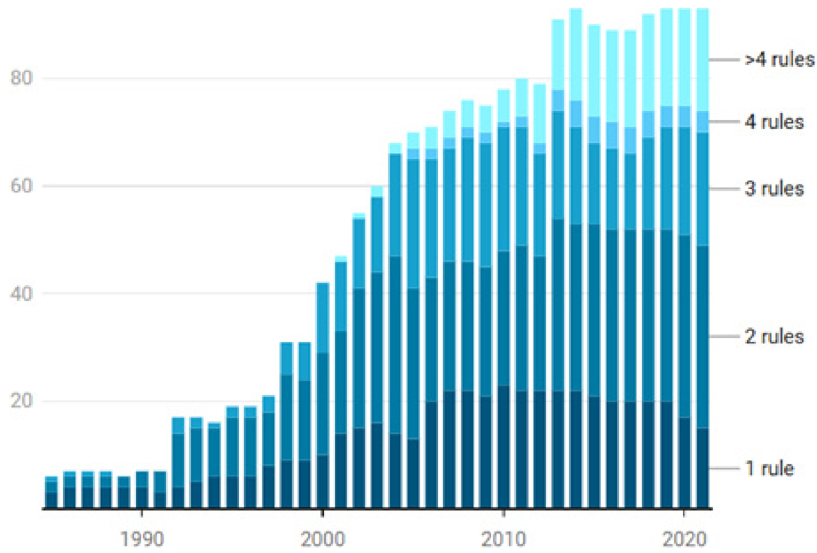
Budget Balance Rules. They constrain the amount of deficit, thereby controlling the growth of the debt-to-GDP ratio. This type of rules may consider business cycles: structural budget balance rule.

Expenditure Rules. These limit total/primary/current spending by setting a cap on their growth or their respective ratio to GDP.

Revenue Rules. These establish upper and lower limits on revenues or set rules for the use of unexpected revenues.

According to the International Monetary Fund›s database on fiscal rules, the global introduction of fiscal rules began to intensify in the 1990s (see Chart 1). By the early 1990s, fewer than ten countries had introduced fiscal rules, including: Australia, Germany, the United States, Japan, Malaysia, Indonesia, and Singapore. Later, other developed countries adopted fiscal rules, and that trend is also followed by emerging markets and developing countries. In 2021, 105 countries had adopted fiscal rules. This trend has been driven by several factors: in the early 1990s, the number of countries with fiscal rules was a result of the Maastricht Treaty signed in 1992, which established public debt and budget deficit criteria for countries in the European Economic and Monetary Union. In the early 2000s, the increase was stimulated by the adoption of national rules in developing economies, as well as supranational rules in low-income countries. Later, fiscal rules were adopted to commit governments to fiscal adjustments post-crisis, to solidify reform gains, or to avoid procyclical spending due to volatile natural resource prices (Davoodi et al., 2022).

Chart 1: Number of countries with fiscal rules, in the period from 1985 to 2021



Source: FAD Fiscal Rules database.

As the number of countries adopting fiscal rules grows, so does the number of fiscal rules implemented. In the 1980s, half of the countries had only one fiscal rule, and less often two or three rules. In the 1990s, half of the countries had adopted two fiscal rules. Over the past two decades, it remains most common for countries to have two fiscal rules (30%), although there has been an increase in the adoption of a third and fourth fiscal rule, and, since 2005, some countries now have more than four fiscal rules (Chart 1).

In terms of the types of fiscal rules, the results from the IMF's fiscal rule database show that the most commonly applied fiscal rules are a combination of a debt rule and operational limits on expenditures and/or a budget deficit rule. Around 70% of countries with fiscal rules have a debt rule combined with limits for the annual budget indicators (deficit and expenditure ceiling). Rules on spending and expenditure limit are increasingly common, often defined as a ceiling on the annual expenditure growth. Revenue rules are less common, partly because governments have less control over annual revenues (Davoodi et al., 2022).

3.2 FISCAL RULES IN THE EU AND THE WESTERN BALKANS

The application of fiscal rules in the countries of the European Union mainly intensified with the Maastricht Treaty and the Stability and Growth Pact (SGP), which set precise fiscal convergence targets for the public sectors of each EU member state. According to this treaty, the two key rules are: the general government deficit in relation to GDP must not exceed 3%, and public debt ratio to GDP must not be higher than 60%. In this context, the golden budget rule requiring member states to achieve a budget that is in balance or in surplus in the medium run is considered crucial.

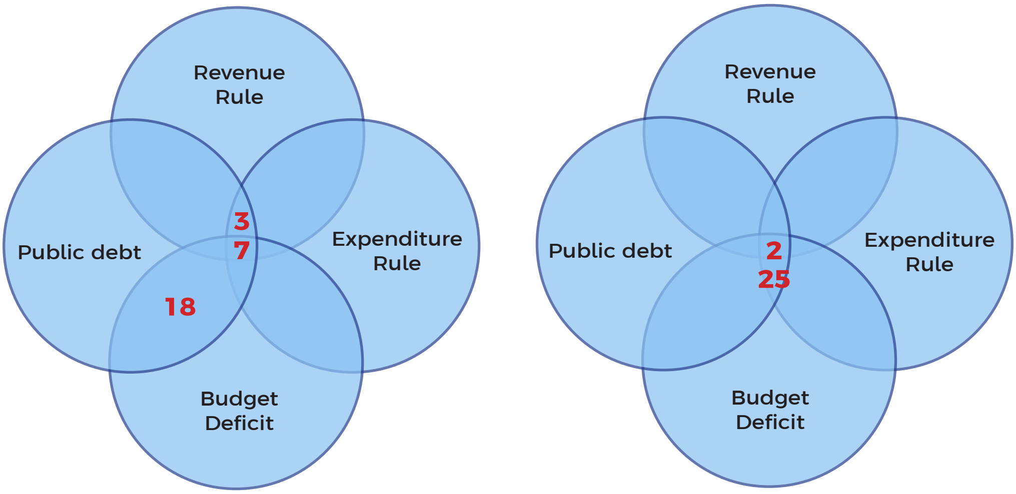
With the SGP reform in 2005, medium-term objectives were introduced for member states to gradually fulfil. This provides leeway to avoid breaching the three percent budget deficit limit. Further loosening and adjustment to this rule was added in 2015, allowing flexibility in light of structural reforms and capital investments, by adding clauses for temporary deviations from the medium-term objective. The 2011 SGP reform, which took effect in 2012, introduced the “1/20” requirement for the debt reduction pace as a corrective rule demanding an annual debt reduction pace of no less than one-twentieth of the difference between the current debt level and the 60% threshold.

This reform also introduced an expenditure rule used in combination with the budget deficit rule to achieve alignment with the medium-term objectives. According to this rule, the annual expenditure growth should not exceed the reference medium-term potential GDP growth if the country has a medium-term objective, or a portion of that growth if the country is moving towards the medium-term objective. Under the 2012/2013 Fiscal Compact, EU member states are required to incorporate a structural budget deficit rule into national legislation with specific constraints. Automatic correction mechanisms and enforcement rules were introduced, as well as stricter rules for countries with debt exceeding 60% of GDP.

Changes in the development of fiscal rules throughout the years and their implementation are illustrated in Chart 2. The results clearly show the trend of introducing a third rule in combination with the two most commonly used rules – public debt and budget deficit. Thus, in 2010, the combination of the two fiscal rules was applied by 18 EU member states, and only seven also had the third expenditure rule within this combination, while in 2021[1], 25 member states had the combination of all three rules. Countries that have all four rules (including the revenue rule) remain exceptions: in 2021, only two countries, France and the Netherlands, applied all four rules.

1 Во споредба со 2010 година, во 2021 година Обединетото Кралство на Велика Британија и Северна Ирска го повлече своето членство во Европската унија, а Хрватска стана дел од Европската унија

Chart 2: Number of EU countries by types of fiscal rules, in 2010 (left) and 2021 (right)



Source: FAD Fiscal Rules database

Although awareness of the simultaneous use of multiple fiscal rules increased over the years, along with the imposed need for additional rules due to frequent crises, the COVID-19 crisis led to breaches of fiscal rules. This, in turn, imposed the need for greater flexibility. For the first time in 2020, the European Commission activated the general escape clause, introduced in 2011, allowing temporary deviations from the fiscal rules in the event of a severe economic downturn, provided it does not threaten the medium-term fiscal sustainability.

Correction Mechanism for Compliance with Fiscal Rules

The European Commission is the body responsible for coordinating national fiscal policies and for negotiating and implementing corrective measures. A key coordination document are the national medium-term fiscal plans, negotiated with the European Commission on a bilateral basis. The timeframe for fiscal strategies spans four to seven years, depending on the need for correction and balancing of fiscal policies. The Commission publishes a net expenditure path for each country individually. This path is used to assess the country's compliance with fiscal rules. The annual budgets of the country must be in compliance with the published path. The fiscal adjustment requirement is based on the level of the structural segment of the primary budget deficit (the fiscal deficit adjusted for interest payments).

> Ensuring public debt sustainability requires a reduction in public debt relative to GDP by at least 1 percentage point if public debt exceeds 90% of GDP, and by at least 0.5 percentage points if it is between 60% and 90% of GDP.
>
> Maintaining a manageable deficit requires an adjustment of at least 0.4 percentage points of GDP (0.25 percentage points in the case of

an extension) in conditions of a structural primary deficit, as long as the primary deficit balance is at or above -1.5% of GDP.

The first national plans are due to be submitted to the European Commission by 20 September 2024.

Fiscal Rules in the Western Balkan Countries

Western Balkan countries follow the trends in fiscal policy management and maintaining fiscal discipline. Inspired by EU fiscal rules, all six countries (Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Serbia, and Montenegro) have introduced fiscal rules. The deficit and public debt rules mainly apply to the general government. Table 1 summarizes the fiscal rules in the Western Balkan countries.

Table 1: Overview of Fiscal Rules in the Western Balkan Countries

Country	Budget deficit (% of GDP)	Public debt (% of GDP)	Expenditure limit	Local level rules
Albania	2	To reduce it to 45		
Bosnia and Herzegovina				
Federation of BiH		60		
Republika Srpska	3	55		
Kosovo	2	40	Public sector wage growth cannot exceed GDP growth.	A ceiling on the real annual growth of current expenditures of 0.5% annually for municipalities.
North Macedonia	3	60		
Serbia	1,7964[2]	45	The share of wages in the general government sector is limited to 7% of GDP, and the share of pensions to 11% of GDP.	
Montenegro	3	60 And 15 % of GDP State-issued guarantees	The rate of expenditure growth for the central budget (excluding interest payments, donor project expenditures, and natural disasters) is limited to the projected GDP growth rate: nominal current spending cannot grow faster than real GDP, while nominal capital expenditures and budget reserves can grow up to the level of the nominal GDP growth rate.	The deficit of each Local Government Unit (LGU) cannot exceed 10% of the municipality's revenues unless the Ministry of Finance approves additional capital expenditures.

Source: Ministries of Finance of the WB countries, International Monetary Fund, World Bank

2 The maximum budget deficit as a share of GDP in year t is calculated as: d(t)=d(t-1)-0.3[d_(t-1)-d*]-0.4[g(t)-g*]d(t)= d(t-1)– 0.3 [d_((t-1))– d^*] – 0.4 [g(t)– g^*]d(t)=d(t-1)-0.3[d_(t-1)-d*]-0.4[g(t)-g*] Where: d(t) = maximum fiscal deficit as a percentage of GDP in year t; d(t-1) = fiscal deficit as a percentage of GDP from the previous year t-1.; d* = medium-term target for the fiscal deficit (set at 1% of GDP); g(t) = real GDP growth rate in year t.; g* = medium-term target for GDP growth (set at 4%).

The Western Balkan countries predominantly have a combination of two key fiscal rules: limits on public debt and budget deficit as percentages of GDP, with country-adjusted variations. Public debt thresholds range from 40% of GDP in Kosovo to 60% of GDP in North Macedonia, Montenegro, and the Federation of BiH. In Kosovo, debt is defined as the direct debt of the general government plus guarantees issued by the general government. Similarly, in Montenegro, debt pertains to the general government, with an additional rule limiting guarantees granted by the state which must be less than 15% of GDP. In Albania, the definition is more complex, aiming to reduce public debt, defined as both direct and guaranteed debt of the general government, to 45% of GDP, where each budget has to provide an annual debt reduction, save in exceptional cases. Additional rules exist, including restrictions on cash deficit if economic growth exceeds 5%, a golden rule for financing investments, and limits on deficit increases during election years.

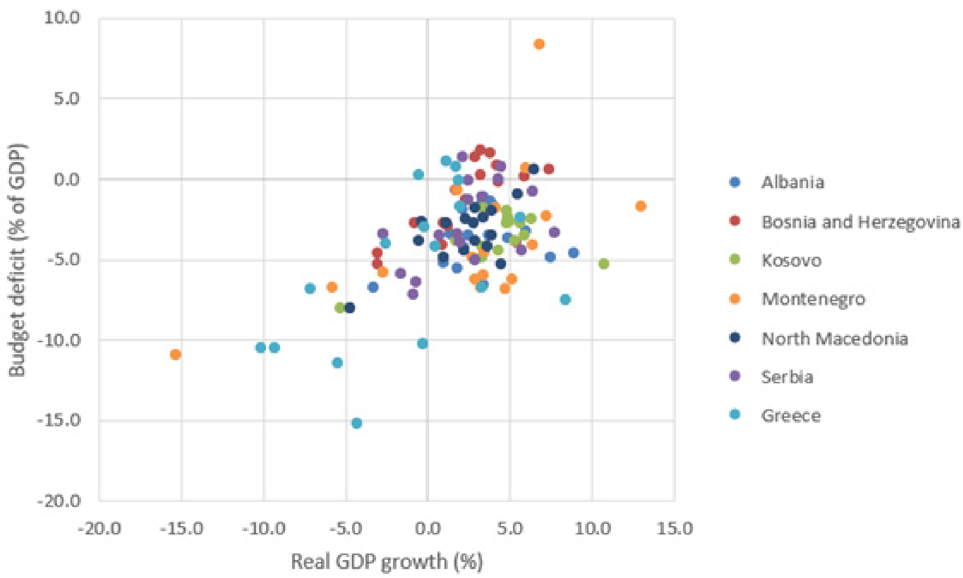
The budget deficit limit is set at 2-3% of GDP. In Serbia, the budget deficit is a more complex formula that considers the fiscal deficit from the previous year and the medium-term objective, providing an opportunity to adjust the deficit from the current year based on the deficit from the previous year. If the deficit from the previous year exceeded the target, this narrows the deficit for the current year. Also, the budget deficit formula incorporates automatic stabilisers based on economic growth. This means that in times of slower economic growth (below 4%), the rule allows for a higher deficit, and vice versa. For both key rules, (some of the) countries have also established clauses allowing flexibility and deviations for investment projects. However, they have also included limitations preventing additional borrowing if the country exceeds certain deficit and public debt thresholds.

In recent years, Western Balkan countries have also started to introduce the expenditure rule (Serbia and Montenegro), which limits growth of public sector wages, pensions, and current expenditures. Additionally, in Kosovo and Montenegro, there are local-level rules that restrict the growth of current expenditures by local self-government units.

3.3. FISCAL RULES AND ECONOMIC GROWTH

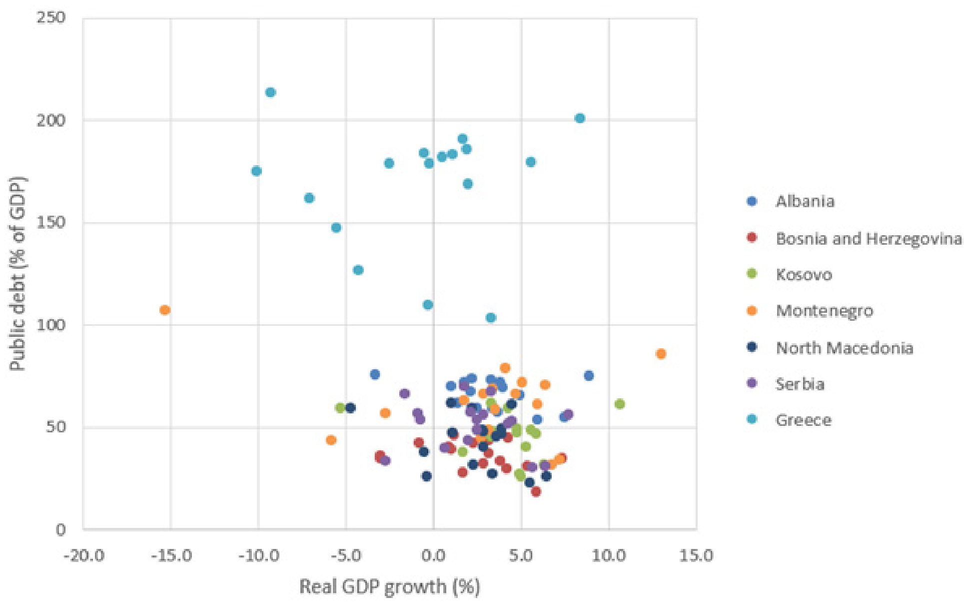
The trends in budget deficit, public debt, and real GDP growth for Western Balkan countries and Greece from 2007 to 2023 are shown in the following two charts. Although clear conclusions cannot be drawn due to the simplicity of the overviews, the two charts, however, suggest that higher GDP growth is often associated with a lower budget deficit and lower public debt. In addition to the Western Balkan countries, the charts deliberately also include Greece, which since the European sovereign debt crisis of 2012-13 onwards has continuously faced high public debt levels and, in some years, particularly high budget deficits, often positioning it on the negative side of the growth axis. While these relationships are less pronounced in the Western Balkan countries, correlations still exist. Differences in borrowing strategies and economic policies among the countries in the region may explain the variations in these relationships, and they will be the subject of a more in-depth econometric analysis later on.

Chart 3: Budget deficit and real GDP growth



Source: IMF and World Bank.

Chart 4: Public debt and real GDP growth



Source: IMF and World Bank.

4. FISCAL RULES IN NORTH MACEDONIA

Fiscal rules in North Macedonia were first introduced in Article 10 of the Budget Law of 2022. As in most countries, these fiscal rules set limits on the budget deficit and on the public debt of the general government, defined as follows:

Budget compliance with the Fiscal Strategy;

Budget deficit: the general government deficit must not exceed 3% of the nominal GDP; and

Public debt: total general government debt must not exceed 60% of the nominal GDP, while guaranteed debt must not exceed 15% of the nominal GDP.

If public debt exceeds the established limit, the Government must prepare a strategy for reducing it within 5 years. Exceptions to the fiscal rules are allowed in cases of natural disasters, crises, economic shocks, or for investment projects with a positive impact on GDP, with a limitation of up to 0.5% of GDP annually. In cases of deviations from the rules, the Government is obliged to explain the reasons and corrective measures to the Parliament, along with a plan to achieve compliance within 5 years (an approximation to the EU requirement for debt reduction).

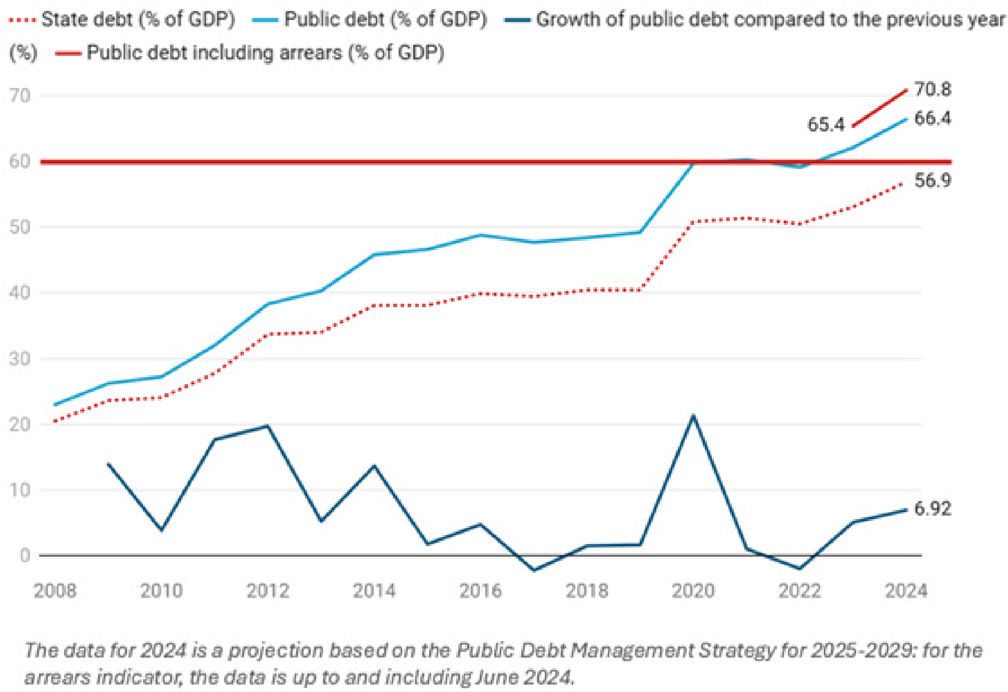
4.1 COMPLIANCE/FULFILMENT OF FISCAL RULES

4.1.1 Gap in Meeting Fiscal Rules Between Legal Targets / Budget Projections and Execution

The total public debt of North Macedonia as of 2023 exceeds the fiscal rule limit according to which the debt should not exceed 60% of GDP (Chart 5). At the same time, the total public debt does not include arrears of state institutions and public enterprises. At the end of June 2024, those amounted to 4.4% of GDP. For EU countries, the public debt methodology also includes these liabilities. If this methodology were applied, the public debt of North Macedonia would reach 70% of GDP. The public debt trend analysis indicates that the debt was in continuous accumulation during the analysed period, with positive growth in nearly all years, and an average annual growth of 7.1%. This trend limits the scope for countercyclical fiscal policy actions and for building buffers against potential medium-term crises.

Adding arrears and losses of public institutions to the budget deficit and public debt is a standard prescribed by the European System of Accounts 2010 (ESA, 2010). One of the first steps for North Macedonia in joining the EU is implementing this standard in fiscal statistics. “Significant further efforts are required to improve the quality, consistency, coverage, and timeliness of statistical tables and public finance statistics in line with ESA 2010 standards. Furthermore, compliance with ESA 10 standards in sectoral classification is necessary, without further delay, within the public sector of major state-owned companies, which significantly impact the fiscal deficit and public debt" (European Commission, 2023).

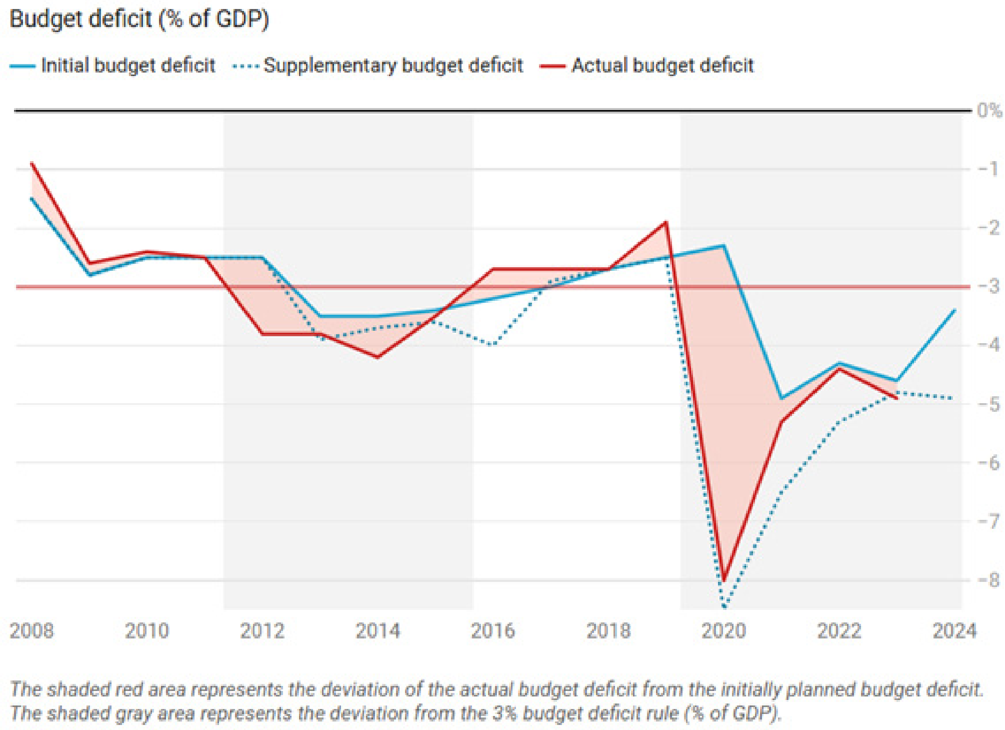
Chart 5: Public and state debt (% of GDP) from 2008 to 2024



Source: Ministry of finance

Regarding compliance with the fiscal rule for budget deficit, in half of the analysed years, the budget deficit exceeded 3% of GDP, with one year having a budget deficit at the 3% limit, and only seven years of compliance with the rule, that is, where the budget deficit was below 3% of GDP (Chart 6). The first wave of deviation (grey-shaded area from 2012 to 2015) from the fiscal rule followed a decline in economic growth to 0.5% in 2012, associated with the Great Financial Crisis and the European Sovereign Debt Crisis, while the second wave from 2020 to the present followed the COVID-19 pandemic. Besides deviations from the fiscal rule, there are noticeable deviations from the self-set annual budget deficit plans in the budget plan (red-shaded areas in Chart 4). Thus, very often (in half of the analysed years), the initially set budget deficit was projected at a lower level, often in line with the fiscal rule, but later upward adjustments were made in the Supplementary Budget, and the actual budget deficit ended up higher than planned. This suggests several potential weaknesses and risks: insufficient precision in planning, inconsistency with self-set plans, potentially "artificial" increase of planned revenues, and inability to reduce total planned expenditures.

Chart 6: Deviations in budget deficit execution (% of GDP) from initial and supplementary budget plans, 2008–2024



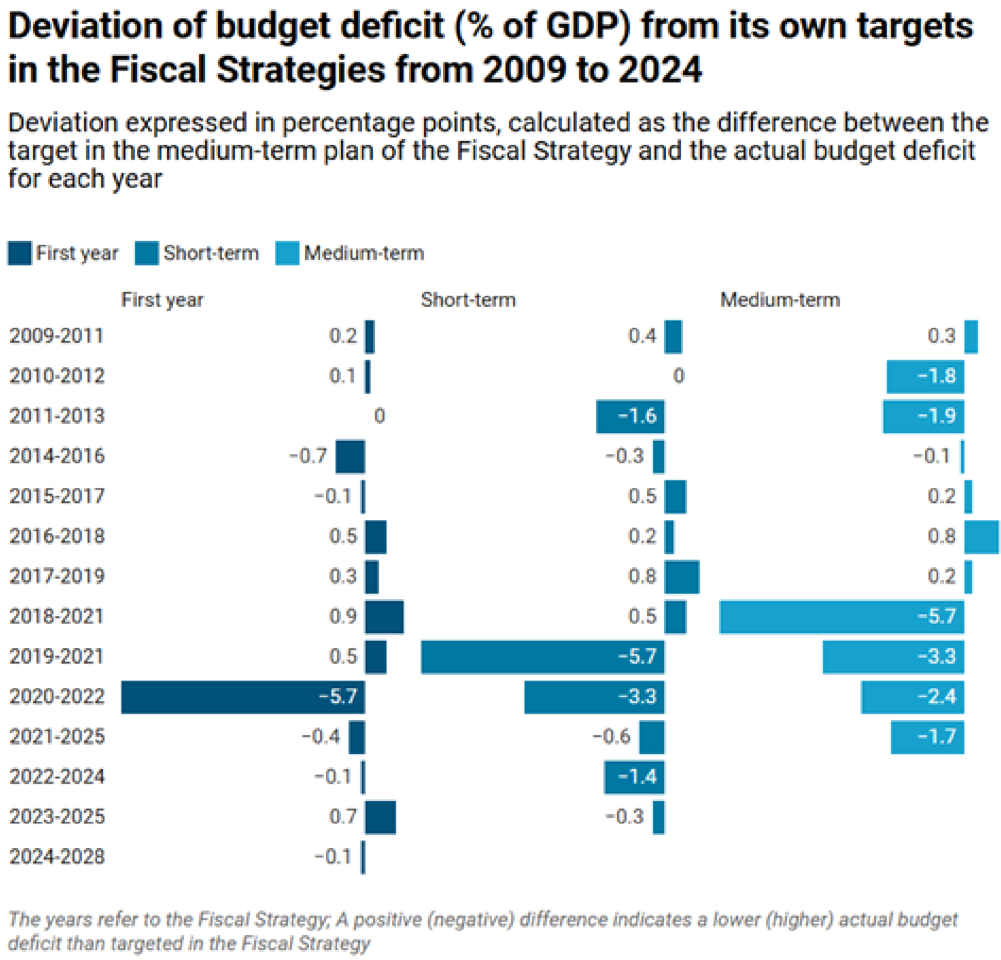
Source: Ministry of Finance of the Republic of North Macedonia: Budget, Supplementary Budget, and Final Budget Account from 2008 to 2024 • Created with Datawrapper

4.1.2 Gap in the Compliance with the Medium-Term Budget Framework and Fiscal Strategy Goals

Although fiscal rules were formally introduced in 2022, medium-term projections and goals for the budget deficit, and later for public debt, have been established in Fiscal Strategies since 2009. Significant numerical fiscal targets were defined in the Fiscal Strategy 2019–2021, which included medium-term targets to limit growth in total expenditures, the total and primary budget deficit, and public debt. Although the Fiscal Strategy is a medium-term document, in the case of North Macedonia, it is prepared (almost) every year with targets for the following three years, and from 2024 onward, with targets for the next four years. Additionally, since 2019, each Fiscal Strategy has a revised version, which further undermines the medium-term focus.

To determine the extent to which the targets set in Fiscal Strategies have been met, Chart 7 presents the deviations of the actual budget deficit from the targets set in the Fiscal Strategies. Deviation from self-set targets is the norm rather than the exception. Thus, in more than half of the analysed periods, self-set targets were not met. Moreover, these deviations increase the further out the target year is, meaning that deviations from the target for the third year in an adopted Fiscal Strategy are greater than for the first year. This only confirms the weaknesses (or absence) in medium-term budget planning and undermines the credibility of the intentions stated in this document.

Chart 7: Compliance with fiscal targets set in the Medium-Term Framework of Fiscal Strategies, in the period from 2009 to 2024



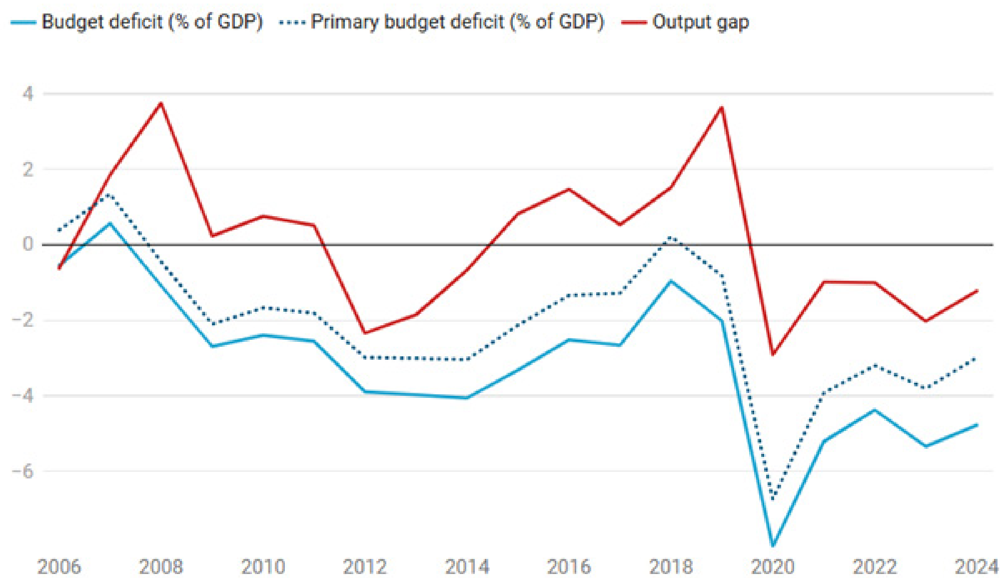
Source: Fiscal Strategies for the period 2009-2020; Revised Fiscal Strategies for the period 2021-2024; Ministry of Finance, Final Budget Account 2009-2023 година

4.2 WHAT UNDERMINES COMPLIANCE WITH FISCAL RULES?

4.2.1 Countercyclical or Procyclical Fiscal Policy?

Fiscal policy also has a stabilising function. Countercyclical fiscal policy enables economic stabilisation by increasing demand during economic downturns and reducing inflation pressures during growth periods. Chart 8 shows the dynamics of the output gap and budget deficit in North Macedonia. In periods with a negative output gap, the budget deficit increases, and vice versa; when the output gap is positive, the budget deficit decreases. This points to the countercyclical function of fiscal policy. However, it is noticeable that regardless of whether the economy is above or below its potential, the budget deficit only slightly reduces without shifting towards a restrictive fiscal policy.

Chart 8: Budget deficit and output gap

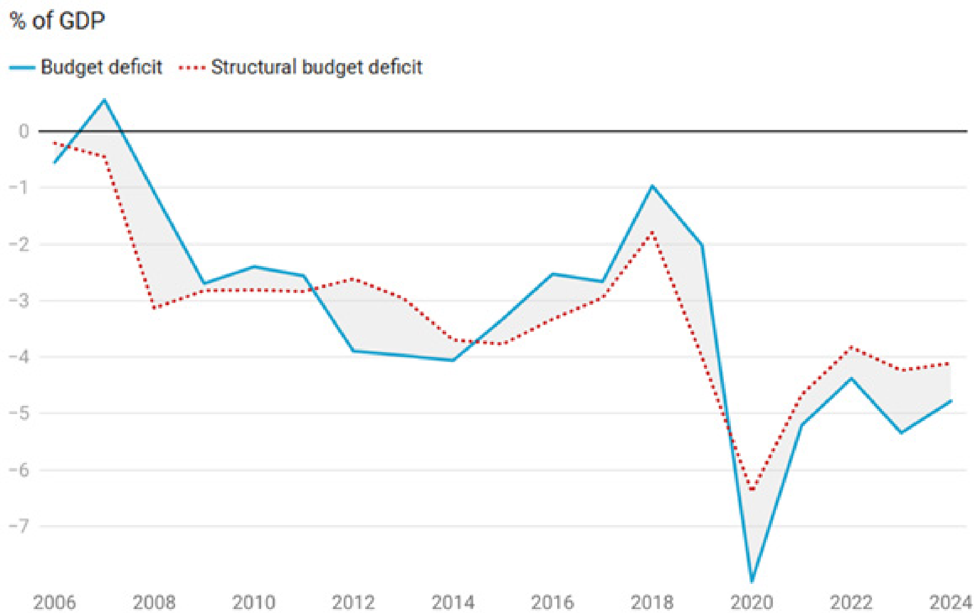


Source: World Bank Strengthening Fiscal Governance in the Western Balkans

To determine the extent to which the deficit was generated for stabilisation and to correct cyclical fluctuations, versus how much was due to discretionary actions, we decompose the budget deficit into total and cyclically adjusted or structural deficit. In the analysed period, the total budget deficit responded to economic shocks and crises (Chart 9). This response was most evident in 2020, when there was a significant widening of the budget deficit, reflecting the impact of the pandemic crisis when public spending sharply increased as revenues declined. This led to a large deficit of nearly 8% of GDP.

Conversely, the total deficit decreased in years of economic recovery. However, the structural deficit, adjusted for the economic cycle, indicates that despite economic turbulence, deeper budgetary imbalances existed. The structural deficit remained between 3% and 4% until 2018, worsened during the crisis, and improved post-crisis but still stayed higher than prepandemic levels. This trend in the structural deficit clearly shows that, independent of economic cycles, there is a budget imbalance not driven by the cycle but rather by discretionary powers and procyclical expansionary policy, presenting challenges in managing public finances.

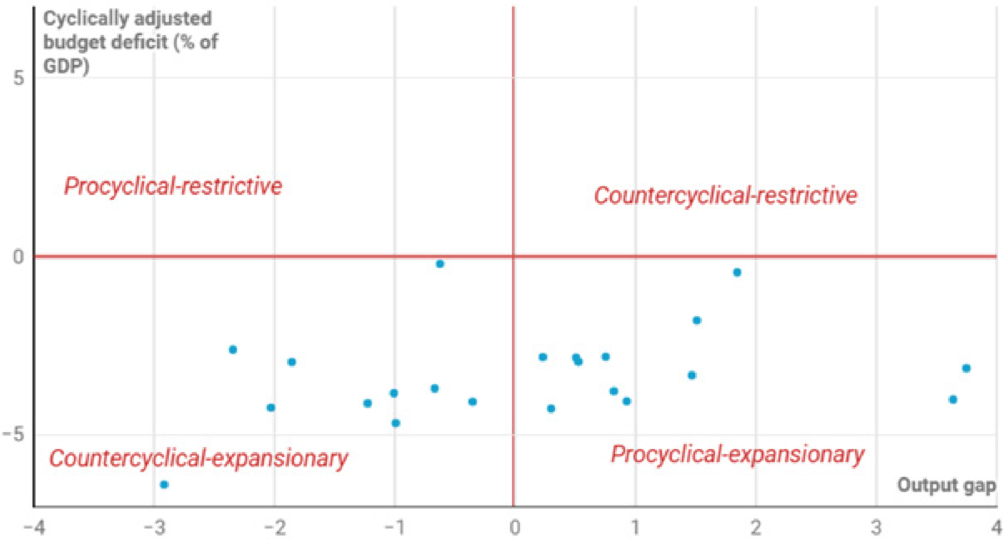
Chart 9: Cyclically adjusted budget deficit



Source: World Bank Strengthening Fiscal Governance in the Western Balkans

Chart 10 depicts the types of fiscal policy in North Macedonia from 2006 to 2024, linking the output gap (horizontal axis) with the cyclically adjusted budget deficit as a percentage of GDP (vertical axis). The quadrants represent the fiscal policy: procyclical or countercyclical, expansionary or restrictive. Throughout the analysed periods, the fiscal policy has been expansionary, almost evenly split between countercyclical and procyclical. A countercyclical-expansionary policy (bottom left) means increasing expenditures or lowering taxes to stimulate the economy during periods of economic downturn. Almost half of the points in the chart fall within this quadrant, indicating that fiscal policy was corrective and employed expansionary measures during economic downturns to stimulate the economy. However, in over half of the periods, a procyclical expansionary policy was applied, meaning that during positive output gaps, expansionary measures were implemented, stimulating public spending or maintaining low taxes.

Chart 10: Fiscal policy in North Macedonia from 2006 to 2024



Source: World Bank Strengthening Fiscal Governance in the Western Balkans

While countercyclical fiscal policy is the preferred form for public financial management, procyclical policy should be the exception rather than the rule. Although it may be applied in the short term, in the long term, it brings significant risks, two of which are critical: overheating of the economy and long-term unsustainability of public finances. The risk of economic overheating is currently limited (2024), but increasing consumption or reducing certain taxes could drive up demand, potentially causing inflation pressure, hindering price growth reduction, and keeping interest rates at a higher level for an extended period.

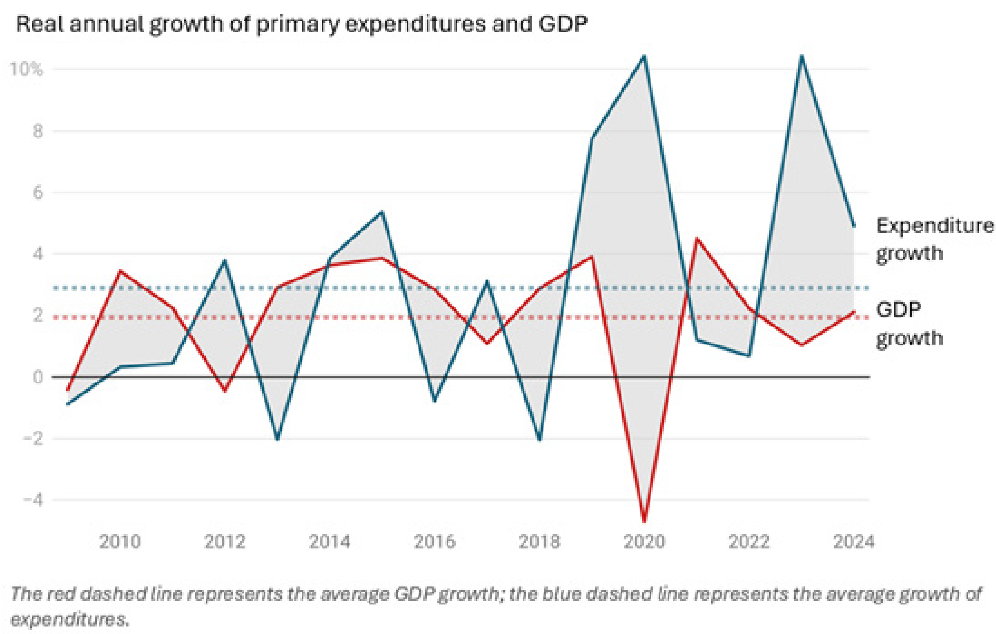
However, the greater risk lies in long-term fiscal discipline and sustainability. During economic growth, effective fiscal policy should generate surpluses and/or stabilise the economy. Procyclical expansionary policy can lead to larger budget deficits and higher public debt, worsening the country's fiscal position and delaying structural adjustments and reforms. Therefore, in the long run, procyclical fiscal policy can reduce the potential economic growth and result in high public sector indebtedness. This could limit the government›s ability to respond to future crises. Simultaneously, procyclical expansionary policy may create a dependency on high public spending, making it difficult for the government to reduce expenditures in the future, even when the economy cannot generate strong growth. Some of the procyclicality in fiscal policy can also be attributed to pre-election spending, where expenditures are often directed towards short-term political interests rather than long-term investments in infrastructure or human capital. This limits the effectiveness of public finance spending.

4.2.2 Overambitious Expenditures?

Expenditure rules are a key fiscal instrument used by governments to maintain budgetary discipline and align public spending with the economic capacity of the country. The general expenditure rule of the EU prescribes that the annual growth of public spending shall not exceed the medium-term potential GDP growth. This indicator ensures that public expenditures grow in line with the economy›s capacity to generate resources, thereby preventing unsustainable fiscal policies and protecting against deficits that could undermine economic stability.

Chart 11 shows the annual real growth of primary expenditures and GDP for North Macedonia in the period from 2010 to 2024. Countercyclical fiscal policy is more pronounced in periods of crises: during the pandemic in 2020, public spending significantly increased while GDP fell. This points to the use of fiscal policies as a tool to stabilise the economy, with substantial expenditure growth during economic downturns. However, in terms of the sustainability of public spending, over a 14-year period, the average real growth of primary expenditures is one percentage point higher than the real GDP growth, raising questions about the compliance with fiscal expenditure rules. In addition, this trend also explains the procyclicality of fiscal policies. In such a situation, where expenditure growth exceeds GDP growth over a prolonged period and, at the same time, if it is not supported by specific revenues or cuts elsewhere, it poses a risk of increasing the budget deficit and slowing budget deficit consolidation.

Chart 11: Real growth of primary expenditures and economic growth, for the period from 2010 to 2024



Source: Ministry of Fiannce, authors' calculation

In addition to the rule of limiting expenditure growth in line with the growth potential of the economy, restrictions in some countries (e.g., Germany) are also tied to revenue growth. This rule stipulates that, on average, expenditures must not grow faster than revenues. This rule ensures that the increase in government spending is backed by sustainable revenue growth. If expenditures grow faster than revenues, this leads to a rising deficit and the need for borrowing, which is contrary to the goal of fiscal stability. In North Macedonia, the average growth of real primary expenditures exceeds the average growth of real total revenues (Chart 12). This trend also opens the discussion on the need for introducing a third fiscal rule, which is linked to the direct limiting of expenditures.

Chart 12: Deviation of expenditure growth from revenue growth

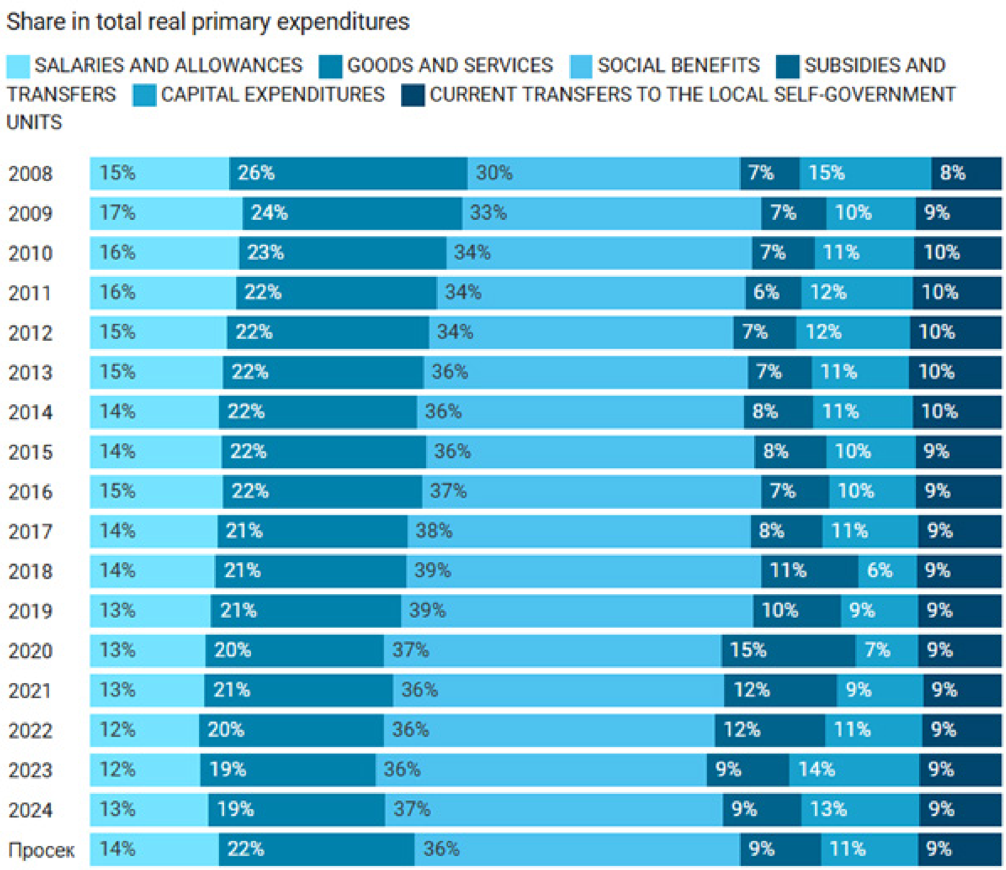
Source: Ministry of Fiannce, authors' calculation

4.3 ANALYSIS OF EXPENDITURES BY BUDGET CATEGORY, CYCLICALITY, AND DYNAMICS OF AUTOMATIC STABILISERS

To identify the dynamics of spending priorities and deeper sources of the budget deficit, we analyse the structure of budget expenditures, cyclical trends, and the extent of participation of the categories that serve as automatic stabilisers versus discretionary spending.

Chart 13 analyses the structure of budget expenditures by key categories. The spending structure shows a strong priority towards social protection throughout the period, with a slight increase in the participation during economic crises, indicating a reliance on automatic stabilisers. Capital expenditures are discretionary and exhibit greater variability. The level of these expenditures rises during economic recoveries (e.g., after 2009 and after 2013), but remains relatively low in recent years, especially after 2020. This suggests that during recessions, discretionary spending on capital projects is less prioritised compared to maintaining or increasing social benefits. Wages and goods/services remain relatively stable, which points to consistent support for the public sector regardless of the cycle. This suggests that these categories function as a fixed component.

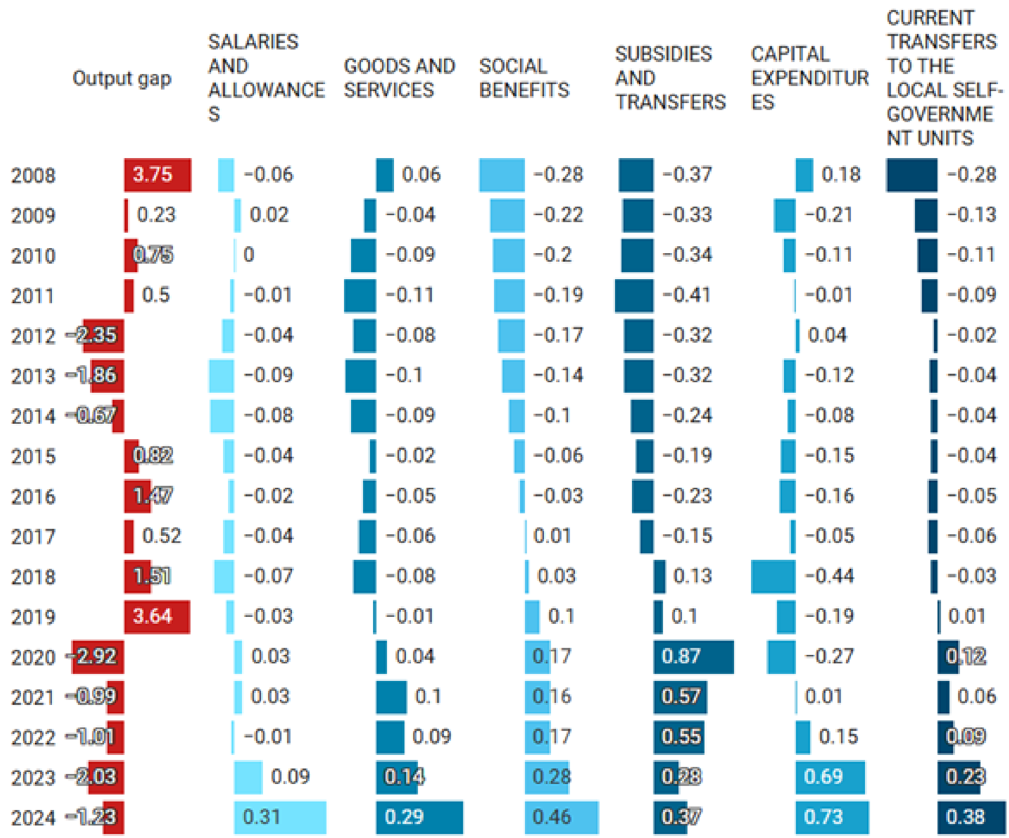
Chart 13: Structure of budget categories



Source: Ministry of Fiannce, authors' calculation

Chart 14 shows annual deviations from the long-term trend of various budget categories, according to the output gap. Automatic stabilisers, such as social benefits and subsidies, clearly increase during recessions, confirming their importance in supporting the economy during crises. Subsidies and transfers, while moving countercyclically and taking on characteristics of automatic stabilisers, are largely due to discretionary measures, which were especially pronounced during the pandemic and energy crisis, when several anti-crisis packages in the form of subsidies were introduced. Discretionary spending, especially capital expenditures, also displays countercyclical characteristics, with increased spending in recessive periods to stimulate economic growth. On the other hand, wages, allowances, and transfers to local self-government units show little variability and do not respond to the economic cycle. This suggests that these categories are less susceptible to cyclical fluctuations and more reflective of structural costs related to the public sector.

Chart 14: Output gap and annual deviation of budget categories from the long-term trend



Real expenditures; annual deviation from the average for the period 2008-2024

Source: Ministry of Fiannce, final accounts, Supplementary Budget for 2024

Social benefits in North Macedonia play a significant countercyclical role during economic crises. However, most of these expenditures are structural, as they remain constant and mandatory over the years, regardless of the economic cycle (Chart 15). This means that such expenditures are caused by demographic changes (an aging population) and long-term state obligations, such as pensions and health insurance, which do not significantly fluctuate with economic conditions.

Chart 15: Dynamics of social benefits

% of GDP (blue columns) and % of primary real expenditures (red columns)

	Payments of benefits from the Pension and Disability Insurance Fund	Payments of compensations from the Employment Service Agency	Payments of compensations from the Health Insurance Fund	Social benefits	TOTAL	Payments of benefits from the Pension and Disability Insurance Fund	Payments of compensations from the Employment Service Agency	Payments of compensations from the Health Insurance Fund	Social benefits	TOTAL
2008	7.2	0.4	0.3	0.8	8.7	24.1	1.3	1	2.8	29.2
2009	7.7	0.5	0.4	0.9	9.4	26.3	1.6	1.3	3.1	32.2
2010	7.4	0.5	0.4	0.9	9.2	26.4	1.7	1.5	3.3	32.8
2011	7	0.4	0.4	0.9	8.8	26.4	1.6	1.5	3.5	33.1
2012	7.2	0.4	0.4	0.9	8.9	26.3	1.6	1.3	3.4	32.6
2013	7	0.3	0.3	0.9	8.6	28.2	1.3	1.4	3.7	34.5
2014	7	0.3	0.3	0.9	8.6	28.7	1.1	1.3	3.8	34.8
2015	6.8	0.2	0.3	1	8.4	28.2	1	1.4	4	34.6
2016	6.7	0.2	0.3	0.9	8.2	29.5	0.7	1.5	4	35.8
2017	6.7	0.2	0.3	0.9	8.1	29.6	0.8	1.5	4.1	36
2018	6.4	0.2	0.3	0.9	7.8	30.7	1.1	1.6	4.1	37.5
2019	6.4	0.3	0.3	0.9	7.9	30	1.2	1.6	4.3	37.2
2020	6.9	0.3	0.4	1.1	8.7	28.3	1.2	1.6	4.7	35.7
2021	6.3	0.3	0.3	1	8	27.9	1.1	1.5	4.6	35.1
2022	5.8	0.2	0.3	0.9	7.3	28.2	1	1.5	4.4	35.1
2023	6.2	0.2	0.3	0.9	7.6	28.3	0.8	1.5	4.3	34.9
2024	7.2	0.2	0.4	1	8.8	28.8	0.9	1.5	4	35.2

Real GDP and real expenditures; for 2024, the data is from the Supplementary Budget

Source: Ministry of Finance, final account

When we add the structural component of wages and transfers to LGU, it clearly explains the structural part of the budget deficit, which is primarily generated by long-term commitments and structural weaknesses in the fiscal policy. The large structural component within categories that should serve as automatic stabilisers reduces the flexibility of fiscal policy, increases the risk to public debt, and lowers the effectiveness of stabilising measures during economic downturns. This highlights the need for fiscal reforms that provide greater expenditure flexibility.

5. CONCLUSION AND RECOMMENDATIONS

Fiscal rules in North Macedonia were introduced by the Budget Law of 2022. The limits set for the budget deficit (a maximum of 3% of GDP) and general government public debt (a maximum of 60% of GDP) are designed to ensure budget stability and prevent excessive debt accumulation. However, despite the potential for positive impact, implementing these fiscal rules comes with certain challenges.

Although the fiscal rules are recent, the initial steps toward setting targets for the budget deficit and public debt can be found in the Fiscal Strategy, a document with medium-term objectives. The projection of the Fiscal Strategy, rather than being a medium-term plan with fixed objectives for a longer period, is brought down to a document that is being revised annually, and sometimes even more frequently, which diminishes the medium-term fiscal vision. **While the Fiscal Strategy sets the objective for the budget deficit and public debt, frequent revisions undermine the credibility of these objectives and prevent consistent adherence to the fiscal targets.** Consequently, annual planning encourages the focus on short-term measures, making budget projections vulnerable to political and economic pressures and weakening the foundation for long-term fiscal stability.

An analysis of compliance with fiscal rules or informally set targets in the period from 2008 to 2024 showed that North Macedonia faces limitations in meeting them. Although the state debt remains below the fiscal rule of 60% of GDP, total public debt exceeds this threshold, with an average annual growth of 7.1%, **narrowing the room for countercyclical policy and buffer for medium-term crises.** In more than half of the analysed years, the deficit exceeds the fiscal rule of 3% of GDP, and frequent revisions of initially set objectives indicate **weaknesses in accurate planning, excessive revenue projections, and challenges in limiting expenditures.** This highlights the importance of stronger fiscal discipline and better alignment with established rules to achieve sustainable economic stability.

Compliance with fiscal rules in North Macedonia is undermined by a prevailing procyclical fiscal policy, which often employs expansionary measures even during periods of economic growth. Countercyclical policy, intended to provide stability through increased spending during crises and restrictions during growth phases, is not consistently applied. During periods of economic growth, measures are taken that further increase public debt and create dependency on high public spending, which reduces budget flexibility in future economic crises. Procyclicality is further heightened during election years, with spending directed toward short-term political goals, thus diminishing the efficiency of public spending and threatening long-term economic development.

In the long run, average expenditure growth, particularly primary expenditures, remains above real GDP growth and revenue growth, which creates a risk of structurally increasing the budget deficit and the need for borrowing. The structural component of spending, which includes long-term obligations such as social benefits and public sector wages, limits the flexible capacity of fiscal policy. These fixed costs do not decrease during economic downturns and reduce the effectiveness of stabilisation measures, underscoring the need for additional fiscal rules to limit expenditure growth. These measures would enable greater spending flexibility and better preparedness to address future crises.

To ensure compliance with fiscal rules and strengthen fiscal discipline, the study identifies the following recommendations:

1. **Medium-Term Fiscal Strategy:** To enhance long-term fiscal discipline, it is advisable to adopt a medium-term fiscal strategy with specific targets for expenditures, revenues, and deficit. **Instead of annual revisions, the strategy should cover plans for three to five years, increasing the predictability and credibility of fiscal policy.**

2. **Improving the accuracy and precision of revenue and expenditure projections: Policies should rely on realistic revenue and expenditure projections.** This entails careful revenue assessment to avoid "artificially" inflating planned expenditures and consistency in achieving initially set budget deficit objectives.

3. Regulated fiscal policies based on economic cycles are needed rather than relying on political cycles distorting fiscal efficiency. To that end, **maintaining countercyclical fiscal policy is recommended and avoiding procyclical fiscal policy.** To achieve fiscal stability, it is recommended that countercyclical fiscal policy be promoted, which increases spending during economic downturns and restrains increasing the expenditures during economic growth. This would prevent deficit creation during periods of growth and strengthen fiscal reserves.

4. **Increasing fiscal discipline in the regular reporting of arrears,** along with strict sanctions for the responsible persons in budget users who assume public liabilities outside of the projected budget or without previously securing the financing sources.

5. **Reducing dependency on structural spending:** Expenditures for pensions, salaries, and transfers to local self-government units represent a significant portion of expenditures and are characterised by low flexibility. It is recommended to consider ways to reform these expenditures, thereby enabling a gradual decrease of their share in the primary expenditures and a greater budget flexibility during economic shocks.

6. **Debate and further analyses on introducing a fiscal rule for limiting public expenditure growth and efficiency:** In line with recent trends among EU member states, and to limit annual public expenditure growth to the level of potential GDP growth, a public debate and further analyses on introducing a third fiscal rule should be initiated. This would align fiscal policy with economic capacity and prevent excessive spending and the use of discretionary powers that could lead to debt accumulation and deficit increases.

7. Supporting capital expenditures during growth phases: Capital expenditures should be prioritised during economic growth, rather than focusing primarily on social transfers. This would foster long-term economic development and strengthen the country›s infrastructure and competitiveness.

8. Review of fiscal priorities before election periods: To minimise politically motivated spending, it is recommended to consider restrictions on additional expenditures before election periods, thereby ensuring consistency and strengthening fiscal discipline.

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