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On the Draft-Budget of the Republic of North Macedonia for 2025

19. November 2024.

The Government of North Macedonia adopted **the Proposed Budget for 2025.** The Draft-Budget is adopted in conditions of mildly intensified dynamics of economic activity, but also in an economy that is still functioning below its potential growth rate, as well as in conditions of calming inflation that is still above the level that central banks identify with stable prices.

In that sense, the 2025 Draft-Budget projects GDP growth for 2025 of 3.7% and cost of living growth of 2.2%. **Finance Think estimates that the two projected rates – of GDP growth and of prices – are a reasonable reflection of current economic trends and represent a solid basis for projecting the Budget.** The GDP growth projection especially supports the start of effective implementation of key infrastructure projects, the announced investment cycle at the local level, and the enhanced support of private investments. However, the projected rate remains under pressure from uncertainties in the economic environment, mainly from recently revised expectations for lower performance in the economies of major trading partners, mainly the German economy. In the case of a more significant materialization of the risks for the growth of the European continent, including due to the announced changes in the trade policy by the USA, which may have a negative impact on trade and hence on growth and prices, **the realization of growth of 3.7% for the Macedonian economy will became impossible.**

However, **Finance Think estimates a greater risk in the segment of projecting budget revenues with a nominal growth rate of 12.8%,** that is, more than twice as high as the sum of the real GDP growth rate and the inflation rate. Such a projection makes one or more of the following assumptions:

1. That the economy will grow faster than expected;
2. That prices will rise faster than expected;
3. That tax rates and social contribution rates will increase;
4. That a comprehensive and uncompromising fight against the informal economy will begin.

Finance Think estimates that the first assumption is unrealistic, the second is undesirable, and the third is unannounced and partially unfeasible at this point in time. Hence, the fourth assumption remains realistic - the fight against the informal economy, which Finance Think continuously points out and offers evidence based on numbers and economic analysis - that it hides a fiscal potential that exceeds 700 million euros annually - as well as recommendations from where to start with the aim of greater effectiveness of that endeavor. However, even in the most optimistic scenario, our assessment is that the fight against the informal economy cannot bring such a large result in the first year of dealing with it. Even in retrospect, total budget and tax revenues achieved nominal growth rates higher than 10% only in the post-pandemic year 2021 (due to the low base the previous year) and in the crisis years 2022 and 2023 (due to the high inflation rate). **In that sense, a projection that budget revenues will grow by 12.8% in 2025 is ambitious.**

The Draft-Budget 2025 foresees an increase in budget expenditures by 10.3%, which is lower than the projected budget revenues and is an indicator of good intentions. **The review in the projected structure of the budget expenditures points to some fiscal consolidation.** For example, it is to be welcomed that the item 'goods and services', which typically hides gray areas such as temporary employment in the public administration, service contract employment, spending on food, drinks, furniture, travel, etc., is projected with a growth rate of only 2.6%, but it must be noted that it grew by 21.3% with the last Budget Supplement for 2024. Similarly, subsidies and transfers, which hide certain inefficiencies, for which Finance Think has offered empirical evidence in the past, grow more modestly, only 1.9%, but the Draft-Budget does not make any reference to possible structural changes within this item.

The growth of the salary and allowances item of 8.1% is lower than the projected growth of total expenditures, although that growth, which is driven by the anticipated salary increases in (segments of) the public sector, remains high. **The latter does not correspond with the productivity dynamics of the public administration, which is continuously negative and stagnant.** On the other hand, the growth of the costs of the Pension and Disability Insurance Fund of 14.8% is clearly driven by the realized (September 2024) and anticipated (March 2025) linear increase in pensions. **These two items are particularly significant as they weaken fiscal**

consolidation and remain a reflection of the expansionary nature of fiscal policy, and hence a major source of inflationary risk in 2025. Namely, although the monetary policy started to be gradually eased due to favorable global movements in prices, it is necessary to take into account that domestic sources of risk for prices are thus strengthening and may pose a threat to an expected more significant reduction of interest rates in the economy, being a context that would be unfavorable for both price growth and GDP growth.

In the same direction, interest payments grow by a significant 17.4%, although **this cost is a reflection of the management of the public debt in the last decade** and is difficult to introduce significant changes in the short term. Overall, the increases in all these costs further **undermine the development component of the Budget and it continues to remain trapped in the social needs of the economy and society as a whole.**

Capital investments are projected to grow by 13%, and that growth is more modest compared to previous years. **Although mild, this change may be structural, as Finance Think has been calling for for the past decade.** On the positive side, the focus on greater effectiveness of capital investments, the initiation and intensification of key infrastructure projects, can support such capital expenditure projection. However, on the other hand, the limited institutional capacity for the realization of public investments must still be taken into account, as evidenced by the fact that as of mid-November 2024, capital costs have only been realized up to 42.8%. According to these trends, the realization by the end of the year would amount to 500 million euros from the predicted 725 million euros. **This indicator is overwhelming.** Seen from that perspective, the projection of capital expenditures for 2025 at the level of over 800 million euros remains marked as 'overoptimistic' and with the known risk that they will be significantly cut with the first Budget Supplement. **Finance Think appeals that the funds that will not be realized from the capital expenditures planned for 2025, and which are not tied to dedicated loans and grants, should not be repurposed for current expenses, but only affect the lower realization of the budget deficit.** In the current year 2024, as a result of these tendencies, the budget deficit until mid-November 2024 has been realized to the extent of 75%, which is a positive externality.

With this projection of the Draft-Budget 2025, **the budget deficit is set at the level of 4% of GDP.** This decreasing level of the budget deficit is appropriate and reflects the fiscal consolidation to a certain extent, mentioned above, but at the same time its insufficiency, given that **it remains above the fiscal rule according to which the budget deficit must not exceed 3% of GDP.** The Draft-Budget document, on page 11, lists the following reasons for deviating from the fiscal rule:

1. **harmonizing salaries according to collective agreements in several branches,**

2. **covering the high amount of due and unpaid legal obligations,**

3. implementation of infrastructure and energy projects for a better quality of life for citizens and increased competitiveness of businesses,

4. digital transformation of the public sector,

5. better education and student standard, better healthcare,

6. encouraging balanced economic development,

7. financing of capital projects of local self-government units,

8. **realization of the Government's new policies for a better standard of living of the citizens through a linear increase in pensions,**

9. realization of financial obligations for previously agreed infrastructure projects.

Finance Think points out and strongly notes that points 1, 2 and 8 cannot be a basis for violating the fiscal rule. In fact, these points hide a risk of fueling aggregate demand, in conditions of low and stagnant productivity, which can significantly affect price dynamics. Additionally, according to own calculations in **Policy Study 53: Fiscal discipline and efficiency of fiscal rules in North Macedonia: The path to sustainability** (to be published on 22 November 2024), due and unpaid obligations can be a significant burden on the budget deficit and public debt, especially in conditions when their total amount - both reported and unreported - can be significantly higher than what is currently known (and which is expected at the end of 2024 to amount to one billion euros) and which is taken as the basis for calculations in the mentioned study.

In conclusion, **the Draft-Budget 2025 shows signs of slight structural shifts compared to previous years, greater realism of macroeconomic assumptions, as well as a certain but limited fiscal consolidation, while the critical points of the design require further effort that will optimize the development component and demonstrate solid fiscal discipline.** Budget revenues imply a strong and persistent fight against the informal economy and hide the risk of not being realized according to projections. On the expenditure side, fiscal consolidation in certain items is insufficient, especially in the context of the impact on inflation, but it is likely to be offset by a reduction in high-set capital expenditure with the first Budget Supplement during 2025.