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THE IMPACT OF POLITICAL INSTABILITY ON NORTH MACEDONIA'S GROWTH

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ABSTRACT

This study explores the obscure connection between political instability, patterns of public expenditure, and North Macedonia's economic growth. By examining the effects of both internal and external political crises on fiscal policies and GDP growth from 2003 to 2023, the research uncovers how turbulent political environments have reshaped the country's economic trajectory and influenced government expenditure decisions. Utilizing a Vector Autoregression (VAR) model, the study reveals the nuanced effects of political instability, demonstrating both immediate negative impacts and delayed positive adjustments. Findings indicate that political instability disrupts public expenditure, redirecting resources from growth-enhancing sectors like infrastructure and education toward crisis management and defense. This reallocation undermines long-term sustainable growth. Important factors like inflation, trade openness, and economic freedom are also examined, revealing intricate relationships with GDP growth. The study concludes that political stability and good governance are prerequisites for effective

public expenditure management and economic development. Recommendations include fostering institutional reforms, ensuring efficient allocation of public funds, and promoting socio-political stability to create an environment conducive to sustained growth. This research contributes to understanding the complex interplay between governance and economic performance in transition economies, with implications for both policymakers and scholars.

Key words: Political Instability, Economic Growth, Public Expenditure, North Macedonia, Vector Autoregression (VAR) model

INTRODUCTION

Economic stability and growth are often interlinked with a nation's political landscape, particularly in emerging economies where governance challenges can profoundly impact fiscal policy and public spending. For countries undergoing political transition or facing external and internal conflicts, like North Macedonia, understanding the degrees of this relationship is essential to inform policy aimed at sustainable development.

North Macedonia, a country that peacefully gained independence from the former Yugoslavia in 1991, has faced significant political challenges that have impacted its economic trajectory. From trade embargoes and ethnic conflicts to ongoing issues with neighboring countries, North Macedonia's journey towards economic growth and stability has been marred by both internal and external political crises. These crises have led to fluctuations in public spending, especially on defense and economic affairs, often at the expense of sustainable growth investments.

Few studies have explicitly looked at the economic impact of North Macedonia's distinct political history, despite earlier research investigating the consequences of political instability on economic performance in emerging nations. By examining the connection between political instability, public spending, and economic expansion in North Macedonia, this study aims to close this gap. It answers important questions: What effects has political instability had on the priorities and composition of public spending? And how much of an impact has this had on GDP growth?

This study's main goal is to examine how political instability has affected North Macedonia's economic development, with a particular emphasis on how instability has influenced public spending trends during the previous thirty years. Examining how crises affect various categories of public spending and figuring out whether political stability is a requirement for long-term economic growth are two specific goals.

This paper postulates that political instability in North Macedonia has hampered economic growth and caused public spending to shift to non-growth industries.

LITERATURE REVIEW

Political Instability and Economic Growth

Political instability is widely recognized as a significant impediment to economic growth, particularly in developing and transition economies. Slower growth rates result from its deterrent of investment and disruption of economic activity (Alesina & Perotti, 1996). This instability can stem from conflicts, governance issues, or changes in leadership, all of which can contribute to an unpredictable economic environment (Barro, 1991). Numerous studies have demonstrated the negative impacts of political instability on economic performance, making the rapport between political instability and growth a central topic of economic and political research. Political instability encompasses various forms of disruptions, including government changes, civil unrest, and policy uncertainty, which collectively create an environment of unpredictability detrimental to economic activities. Research indicates that

political instability negatively impacts economic growth primarily by increasing uncertainty, which deters investment. For instance, Murad and Alshyab highlight that political instability hampers the business environment, discouraging both domestic and foreign investments, which are crucial for economic growth (Abu Murad & Alshyab, 2019). Similarly, Aisen and Veiga noted that lower GDP growth rates per capita are associated with higher levels of political instability, mainly because of slower capital accumulation and productivity growth. (Aisen & José Veiga, 2011). This relationship is further supported by Nawaz et al., who argue that political instability can lead to a two-way relationship where economic downturns can also exacerbate political instability (Nawaz et al., 2021).

Moreover, the dimensions of political instability play a significant role in determining its impact on economic growth. According to Jong-A-Pin's findings, not all political instability is equally harmful because different types of instability have distinct consequences on long-term economic growth (Jong-A-Pin, 2009). This nuanced understanding is echoed by Hussain, who identifies specific political disturbances that have historically influenced economic performance in Pakistan (Hussain et al., 2023). Additionally, data indicates that the impacts of political instability vary by area. For example, studies focusing on South Asia indicate that while political instability's impact on growth on the short-run is minimal, its long-run effects can be profound, emphasizing the importance of stable political regimes for sustained economic development (Rathnayake, 2022). The notion that stable government is necessary for economic advancement is supported by research conducted in Central and Eastern Europe, revealing a clear negative correlation between political instability and economic growth (Gurgul & Lach, 2013). And there are many other ways that political instability impacts economic growth. Political instability can disrupt financial markets, reduce savings and investment, and lead to inefficient allocation of resources, as noted by Asteriou and Siriopoulos (Asteriou & Siriopoulos, 2000). They argue that instability affects corporate decisions and savings behavior, which are critical for economic development. Furthermore, Darby et al. talk about how political unpredictability might affect public spending, which makes the connection between governance and economic results even more difficult to understand (Darby et al., 2004). Some empirical research has shown that political instability and economic growth are negatively correlated. For instance, Aisen and Veiga argue that political instability undermines fiscal discipline, leading to unsustainable public debt levels and economic inefficiency (Aisen & Veiga, 2013).

The idea that political instability is a major barrier to economic progress is, in conclusion, continuously supported by the literature on the subject. The adverse effects manifest through reduced investment, increased uncertainty, and disrupted economic activities, with variations in impact depending on the specific context and type of instability. In order to establish an atmosphere that is favorable to economic progress, policymakers must acknowledge the necessity of promoting political stability.

Public Expenditure and Growth In Transition Economies

Public expenditure plays a critical role in economic development, particularly in transition economies where government investment can stimulate growth. According to the Keynesian view, increased government spending, especially in infrastructure and human capital, can boost demand and economic activity (Keynes, 1937). However, excessive or poorly allocated spending can lead to inefficiencies and may even hinder growth, especially when directed toward non-productive sectors (Barro, 1990). The connection between GDP and public expenditures, particularly in transition economies, is a complex interplay of various theoretical frameworks and empirical findings. Transition economies, characterized by their shift from centrally planned to market-oriented systems, present unique challenges and opportunities

regarding public expenditure. Several theoretical frameworks can be used to understand how public expenditure affects growth, including Wagner's Law, Keynesian economics, and endogenous growth models. Wagner's Law posits that economic growth leads to an increase in public expenditure, suggesting that as economies expand, the government has more resources to allocate towards public services and infrastructure, which in turn can further stimulate growth (Ahuja & Pandit, 2020). This perspective is supported by empirical findings indicating that in many developing countries, including those in transition, economic growth often precedes and facilitates increased public spending (Le & Vang, 2022). Conversely, the Keynesian paradigm places a strong emphasis on how government expenditure propels economic expansion, especially in times of economic contraction. This approach advocates increased public expenditure to stimulate demand and foster economic activity, especially in economies that are still developing their market structures. Moreover, the structure of public spending is crucial in determining its impact on economic growth. Research indicates that productive public spending—such as investments in infrastructure, education, and healthcare— tends to positively impact growth compared to unproductive spending. For instance, Lupu and Asandului highlight that public expenditures in Eastern European countries have varied impacts based on their classification into productive and non-productive categories, with productive expenditures being more conducive to long-term growth (Lupu et al., 2018; Lupu & Asandului, 2017). In a similar vein, Ahuja and Pandit stress that public spending's ability to promote growth depends on its distribution among industries that boost productivity (Ahuja & Pandit, 2020).

Transition economies also face unique challenges related to the quality of governance and institutional frameworks. The productive use of government resources can be strongly impacted by the level of bureaucracy and the existence of clientelism (Naseer, 2019). In environments where bureaucratic quality is low, public spending may not translate into economic growth due to inefficiencies and corruption, which can undermine the intended benefits of government expenditure. This highlights the importance of not only the amount of public spending but also its management and implementation. Furthermore, depending on the level of public spending in respect to GDP, the relationship between public expenditure and GDP growth may not be straightforward. For example, the impacts of government expenditure on economic expansion might differ greatly depending on the state of the economy and the share of public spending (Mittnik & Neumann, 2003). This complexity necessitates a nuanced understanding of how different types of public expenditure interact with economic growth dynamics, particularly in transition economies where structural adjustments are ongoing. Research on Eastern European and Balkan countries shows mixed results. For example, (Stoian & Vickerman, 2005) found that public investment in infrastructure positively influenced growth in Romania. Conversely, studies on the Western Balkans suggest that excessive spending on defense and public administration, often necessitated by political crises, can lead to negative growth (Kikoni et al., 2019).

In conclusion, the connection between fiscal policy and economic development in transitional contexts emerges from both academic theories and observed trends. While increased public expenditure can stimulate growth, its effectiveness largely depends on the structure of spending, the quality of governance, and the prevailing economic conditions. Policymakers in transition economies must therefore carefully consider these factors to optimize public spending for sustainable economic growth.

Political Instability and Public Expenditure Allocation

Political instability often necessitates a reallocation of public resources from productive investment to crisis management. This phenomenon, referred to as the "guns versus butter" trade-off, suggests that countries experiencing political unrest tend to increase spending on

defense and internal security at the expense of sectors like education and infrastructure (Blomberg & Hess, 2002). Such shifts can undermine long-term growth by diverting resources away from investment in human capital and public infrastructure. Political instability also significantly influences government spending priorities, often leading to a reallocation of resources from growth-oriented sectors to crisis management or defense. This issue is especially noticeable in North Macedonia, where it has been demonstrated that political volatility negatively impacts budgetary stability and disrupts economy. Studies indicate that political instability is a multidimensional issue that encompasses various factors, including law and order, socioeconomic conditions, and the quality of governance, all of which can exacerbate budget deficit volatility (Javid et al., 2022).

In North Macedonia, the need to deal with urgent problems (example the COVID-19 pandemic) has influenced the government's fiscal policy. The pandemic prompted a shift in budgeting principles, emphasizing crisis management over long-term growth strategies. This shift is reflected in the prioritization of health expenditures and social support measures, which, while necessary, divert funds from infrastructure and development projects that are crucial for sustainable economic growth (Espolov, 2023; Hoxhaj & Zhilla, 2021). The impact of such reallocations can be profound, as they limit the government's ability to invest in sectors that drive long-term economic development, such as education and infrastructure (Miftari & Ziberi, 2019; Nikoloski, 2020). Additionally, North Macedonia's political environment has been marked by a great deal of unpredictability, which makes budgetary decisions much more difficult. The presence of a hybrid system, where political leaders may not fully engage with citizen input, may result in fiscal policies that undermine long-term growth. (Abazi Imeri, 2023). This dynamic is evident in the government's approach to public debt, where increasing borrowing is often justified as a means to stimulate immediate economic activity, despite the potential long-term risks associated with rising debt levels (Bećiragić, 2023; Noveski et al., 2020). The effects of these changes in expenditure are especially noticeable when considering foreign direct investment (FDI), which is essential to the expansion of North Macedonia's economy. Political instability can deter FDI, as investors seek stable environments for their capital. The government's focus on crisis management rather than fostering a conducive environment for investment can lead to missed opportunities for economic development (Dobrota & Zornić, 2021). Consequently, the interplay between political instability and government spending priorities creates a cycle that undermines both immediate crisis response and long-term economic growth. In summary, political instability in North Macedonia has led to a significant reallocation of government resources from growth-oriented sectors to crisis management and defense. This shift not only impacts immediate fiscal health but also poses long-term challenges for economic development, as critical investments in infrastructure and human capital are sidelined in favor of short-term crisis responses.

In the Balkans, frequent political crises have led to increased spending on defense and public administration, as highlighted by (Dabla-Norris et al., 2015) in their study on fiscal policy responses to political instability in Eastern Europe. North Macedonia, for instance, has seen significant shifts in its spending priorities during periods of political unrest, a pattern observed in other conflict-prone regions (ICG, 1998).

North Macedonia’s Political and Economic Context

North Macedonia’s political journey, from its peaceful independence in 1991 to recurring disputes with neighboring countries, has been marked by frequent crises. Studies on the country indicate that political instability has adversely affected growth and has led to changes in public spending patterns. For example, (Daskalovski & Risteska, 2012) argue that political instability in North Macedonia has undermined efforts at fiscal discipline and economic reform, stalling its convergence with EU economies.

North Macedonia faces a unique set of political challenges and economic implications that are intricately linked to its historical context, regional dynamics, and ongoing reform processes. The political landscape has been characterized by instability. This alteration has significant implications for the country's democratization process and its aspirations for EU integration (Karišik, 2021). The legacy of the name issue with Greece, which has historically impeded North Macedonia's Euro-Atlantic integration process, adds to the political unrest. The resolution of this dispute, while a significant milestone, has not entirely alleviated the political uncertainties that continue to affect investor confidence and economic growth (Srbinoski et al., 2021). Economically, North Macedonia has been striving to enhance its foreign direct investment (FDI) landscape, which is viewed as a critical driver for job creation and economic development. Studies indicate that FDI has positively influenced domestic firms by enhancing productivity and fostering the establishment of new enterprises (Dobrota & Zornić, 2021). Nonetheless, the country faces several difficulties, especially for small and medium-sized businesses (SMEs), which must contend with obstacles like restricted financial access, high taxes, and onerous administrative duties (Blaževa, 2023). These challenges are exacerbated by the broader economic environment, which has been impacted by the COVID-19 pandemic, resulting in higher unemployment rates and a decline in growth (Xhaferi, 2022). Furthermore, health expenditure in North Macedonia has been linked to economic growth, demonstrating the importance of workforce development in promoting economic growth (Mitev & Trpeski, 2022). This relationship underscores the importance of stable governance and effective policy implementation in achieving economic resilience. In terms of regional integration, North Macedonia's participation in trade agreements, such as CEFTA-2006, has been identified as crucial for enhancing trade relations and economic growth. The findings suggest that deeper trade integration could positively influence mutual trade and economic stability (Toshevska-Trpchevska et al., 2022). However, the country must navigate the complexities of regional dynamics and external pressures, which often complicate its economic strategies. In conclusion, North Macedonia's political challenges and economic implications are deeply interconnected. The ongoing political instability poses significant risks to economic expansion and advancement. Stronger governance, increased FDI appeal, and regional cooperation are all necessary components of a complex strategy to address these issues and ensure stable economic growth.

METHODOLOGY

Hypothesis and Research Objectives

While existing research has established that political instability generally impacts economic growth, the complex relationship between political volatility, state spending, and economic expansion in North Macedonia is not well studied. Most literature on the Balkans provides regional analysis without delving into the unique, country-specific dynamics in North Macedonia. This study seeks to fill this gap by examining how political instability has influenced the structure of public expenditure and GDP growth in North Macedonia.

Building on the insights discussed in the literature review, this study aims to explore the impact of political instability on economic growth and public expenditure patterns in North Macedonia. Specifically, the research examines how political crises influence the allocation of public spending, potentially diverting resources from growth-enhancing sectors. This study hypothesizes that:

"Political instability in North Macedonia has a negative impact on GDP growth."

To test this hypothesis, the study will address the following objectives:

- *Examine Public Expenditure Patterns in Response to Political Crises* by evaluating how political crises influence the allocation of public expenditure, with a

focus on shifts toward defense, security, and crisis management at the expense of productive sectors.

- *Examine how political instability affects economic growth* by conducting an empirical analysis of the correlation between GDP growth and political instability in North Macedonia between 2003 and 2023. The reason why this period is taken into consideration is due to data limitation. There are a lot of missing variables before 1999. Because of the lags and because the index of economic freedom for North Macedonia is measured yearly since 2002, only data from 2003 seemed appropriate for the model.
- *Provide Policy Recommendations for Stability-Driven Economic Growth* by suggesting fiscal measures that support North Macedonia's sustainable growth and lessen the negative economic repercussions of political instability.

Description of Data and Variables

This study examines the connection between North Macedonia's political instability, GDP growth, and public spending using secondary data. The World Bank, International Monetary Fund (IMF), and North Macedonia's State Statistical Office were among the official databases from which information on GDP growth rates and public spending by category (such as defense, infrastructure, and education) was gathered. Information on political instability events was gathered from the World Bank, historical records, government reports, and publications. Key political events are coded based on their timing and severity to measure the impact on economic indicators.

North Macedonia's national budgets, which have been regularly published in the Official Gazette since 1996, serve as the source of *data for the budget study.* The dataset includes both functional and economic classifications of expenditures, providing a robust foundation for assessing public spending dynamics. Budget proposals from the Ministry of Finance were also reviewed when available, enriching the dataset with additional context. For each fiscal year, total expenditures under economic and functional categories were extracted, ensuring all relevant items were included. The final dataset spans 1996–2021, offering a comprehensive view of fiscal trends.

Data for the empirical model were gathered from World Bank. TWe employed a Vector Autoregression (VAR) model to investigate the connection between GDP growth and its possible drivers. When all variables are regarded as endogenous, the VAR model can be used to analyze multivariate time series data. This method captures dynamic interrelationships among variables without imposing prior causal structures. The key variables in our analysis include: GDP Growth (annual %) which is taken as indicator of economic performance; Political Stability and Absence of Violence Index from WB *(PolInstab*) which is taken as proxy for political instability; Inflation (differenced, annual %) as a measure of macroeconomic stability; Trade (% of GDP, differenced) as indicator of openness to international trade; Gross Fixed Capital Formation (% of GDP) taken as a measurement or for investment; and last Economic Freedom Index (lagged) taken as indicator of institutional quality.

The model covers a time span from 2003 to 2023. Stationarity was ensured after data was tested with dickey-fuller to check for stationarity. The non-stationary data *(inflation and trade)* were transformed to stationary through differencing. The VAR model is specified as follows:

$$GDPgrowthannual_{it} = \beta_0 + \beta_1 L.PolInstab_{it} + \beta_2 d_Inflation_{it} + \beta_3 d_Trade_{it} + \beta_4 GrossFixedCapitalFormation_{it} + \beta_5 EconFree_{it} + \epsilon_{it}$$

Where:

- $GDPgrowthannual_{it}$: Annual GDP growth rate for country i at time t.

- $L.PolInstab_{it}$: Lagged political instability index, reflecting the level of political uncertainty or instability.
- $d_Inflation_{it}$: First difference of inflation (consumer prices) to account for dynamic changes.
- d_Trade_{it}: First difference of trade as a percentage of GDP, capturing the openness of the economy.
- $GrossFixedCapitalFormation_{it}$: Share of gross fixed capital formation in GDP, measuring investment in productive assets.
- $EconFree_{it}$: Lagged Economic Freedom Index, representing the institutional quality and policy environment.
- ϵ_{it}: Error term capturing unobserved factors.

Granger causality tests were performed to identify causal relationships among variables.

ANALYSIS AND INTERPRETATION OF FINDINGS

Budget Expenditures of North Macedonia: An Analysis through the Framework of Economic Classification

North Macedonia's economic classification of its spending is based on the European System of National and Regional Accounts (ESA) 2010 and the IMF's Government Finance Statistics Manual (GFSM) 2014. Table 1 below illustrates the distribution of expenditures by economic category for the years 1994–2021, In general, current expenses account for about 90% of North Macedonia's budget, with capital expenditures making for the remaining 10%.

Table 1: National Budget: Economic Classification (North Macedonia, 1994-2021 Average).

Category	**Amount (Millions MKD)**	**Percentage of Total Budget**
CURRENT EXPENSES	106,478.1	79.7%
Wages and contributions	21,958.8	16.4%
Reserves and unspecified expenditures	21,699.0	16.3%
Goods and services	11,455.7	8.6%
Transfers to extra-budgetary funds (Pension, Employment and Health Fund)	8,572.0	6.4%
Transfer to local self-government units	4,121.3	3.1%
Repayment of interest (loans domestic and foreign)	2,322.7	1.7%
Subsidies and transfers (public enterprises, NGOs, others)	710.8	0.5%
Social benefits (social assistance, pensions, health and unemployment benefits)	35,637.8	26.7%
INVESTMENT SPENDING	11,591.7	8.7%
DEBT PRINCIPAL REPAYMENTS	15,500.4	11.6%
AGGREGATE GOVERNMENT OUTLAYS	**133,570.2**	**100.0%**

Note: MKD refers to Macedonian Denar. All values are averages for the period 1994-2021.

Source: Authors' own

From 2020 to 2022, the spending pattern exhibits a notable shift. Social benefit expenditure has risen significantly, now accounting for 53% of total government spending. Moreover, there has been an increased allocation of budgetary resources toward grants, transfers, and subsidies directed to municipalities.

Budget Expenditures of North Macedonia through the Lenses of Functional Classification

The functional classification of expenditures is crucial since it groups government initiatives according to their goals, including healthcare, education, and social security. This framework provides valuable insights into how public spending is distributed across sectors and its alignment with broader governmental priorities, which often focus on fostering economic growth. Additionally, historical data classified by function allows for a more detailed analysis of spending trends and key inflection points. North Macedonia adheres to the United Nations' Classification of the Functions of Government (COFOG), a widely recognized international standard comprising ten major categories (OECD and UNSD, 1999). The analysis of North Macedonia's budget is conducted in accordance with these COFOG categories, with any subcategories not included in the national budget being excluded from the following discussion.

Half of North Macedonia's public spending is allocated to economic concerns and social protection functions, according to an examination of the country's budgets and final accounts for the years 1996–2021.

Table 2: National Budget: Functional Classification (North Macedonia, 1994-2021 Average)

Category	**Amount (Millions MKD)**	**Percentage of Total Budget**
General public services	13,112,924	10.79%
Defense	6,330,872	5.21%
Public order and security	10,614,894	8.74%
Economic issues	27,440,087	22.59%
Protection of Living Environment	591,129	0.49%
Dwellings and community development	1,602,800	1.32%
Health services	9,517,196	7.83%
Recreation, culture and religion	2,781,263	2.29%
Education	16,080,119	13.24%
Social protection	33,412,651	27.50%
AGGREGATE GOVERNMENT OUTLAYS	**121,483,935**	**100.00%**

Note: MKD refers to Macedonian Denar. All values are averages for the period 1994-2021.

Source: Authors' own

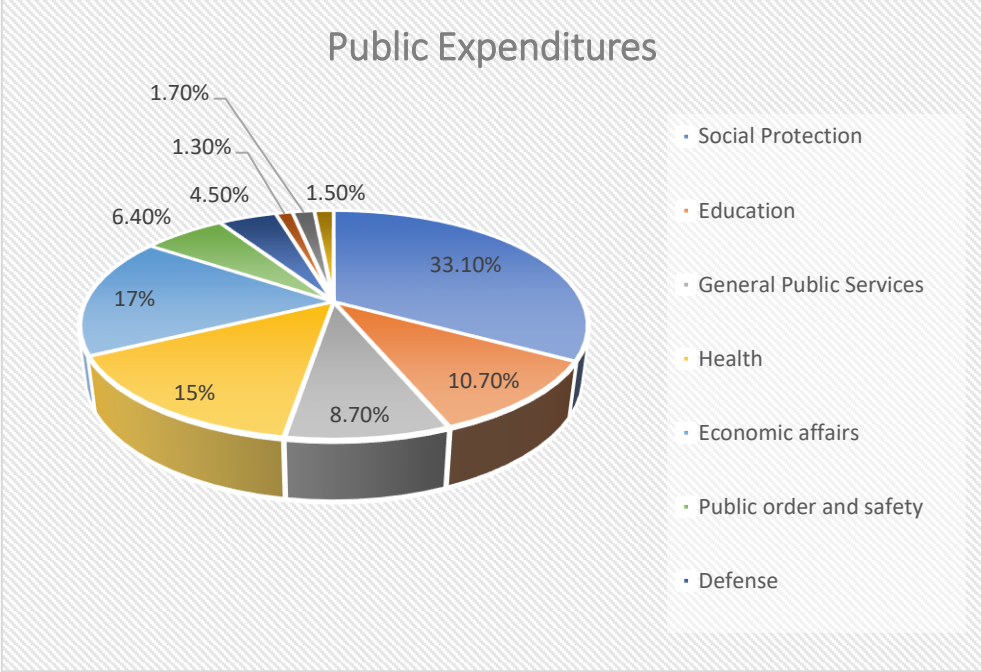


Figure 1: Expenditures of the Budget of the RNM for 2022 by functional areas (as % of total expenditures)
Source: (Ministry of Finance of RNM, 2021)

Empirical Model Results

The dependent variables, like *GDPgrowthannual* (R^2 = 0.7291) and L_PolInstab (R^2 = 0.8358), indicate that the model explains a substantial portion of the variance for these series. For others, *like EconFree_lag* (R^2 = 0.3688), the explanatory power is weaker, suggesting possible omitted variables or weak relationships with the included regressors. The VAR model demonstrates a strong fit for analyzing the relationships among GDP growth, political instability, and key macroeconomic factors. The chi-square test results, being significant at the 5% level, indicate that the model effectively explains the observed data. A low covariance determinant ($Det(Sigma_{ml}) = 0.1961$) highlights its robustness. Overall, the model effectively captures the dynamic interplay between these variables, providing valuable insights for analysis and forecasting.

VAR Results:

- *Lagged Political instability* (L2.PolInstab): Significant and positively associated with GDP growth (β=7.28, p<0.01).
- *Lagged economic freedom* (L1.EconFree): Negative and significant (β=−0.47, p<0.05) for GDP growth.
- *Lagged Trade openness* (L2.d_Trade): Negatively impacts GDP growth (β=−0.09), though not significant.

Granger Causality Wald Test:

- *Political Instability (L.PolInstab)*: Granger-causes GDP growth ($\chi2$=25.87, p<0.01) indicates that past values of political instability significantly predict GDP growth.
- *Economic Freedom (lagged)*: Granger-causes GDP growth ($\chi2$=11.84, p<0.01) indicates that Past levels of economic freedom are significant predictors of GDP growth. Effective public spending can contribute to economic growth, while inefficient spending could hinder it.
- *Public Expenditure (L.PubExpend)*: Granger-causes GDP growth (χ^2=18.52, p<0.05) indicates that public expenditure, particularly its allocation and efficiency, significantly influences GDP growth.

- *Inflation (L.Inflation):* Granger-causes GDP growth (χ^2=13.40, p<0.05) indicate that past values of inflation significantly predict GDP growth.
- *Trade Openness (L.TradeOpen)*: Granger-causes GDP growth (χ^2=9.72, p<0.10) indicate that lagged trade openness moderately predicts GDP growth.

Interpretation of Results

1. **Political Instability**: A lagged increase in political instability is associated with higher GDP growth, reflecting rebound effects or shifts in policy to stabilize the economy after political disruptions. The positive impact of political instability on GDP growth in the third lag (L3) suggests that its effects may be delayed. The third lag (**L3**) of political instability has a strong and positive effect on GDP growth (coefficient: **7.28**, p-value < 0.001). This suggests that instability three periods earlier might spur reforms, shocks, or adjustments that later contribute to growth. However, the second lag (L2) shows a negative impact, indicating that the long-term effects of political instability suppress growth.
2. **Economic Freedom**: A reduction in lagged economic freedom negatively impacts growth, indicating the importance of institutional quality and liberal economic policies. Lags of economic freedom have significant negative effects on GDP growth (L1: -0.47, p = 0.016; L2: -0.65, p = 0.003). This indicates that changes in economic freedom might initially create uncertainty or transitional challenges before yielding benefits. The results suggest that while economic freedom could promote long-term stability, in the short term (represented by lag 1 and lag 2), it could destabilize growth, which points to the need for balanced reforms.
3. **Trade and Inflation effects**: Although not consistently significant, the results suggest that trade has a complex relationship with growth, potentially dependent on external economic conditions and domestic trade policies. The influence of inflation is mixed, with the second lag having a positive impact, whereas the first lag was insignificant. Trade is positively related to growth in the second lag, underlining the importance of trade openness for economic expansion in the medium term.
4. **Investment in capital**: The significance of consistent investment in growth is demonstrated by the second lag, where the impact of capital accumulation is more apparent. However, the immediate impact (L1) is not statistically significant, which might suggest a delayed effect.

The VAR model successfully highlights the dynamic interdependencies among key macroeconomic and institutional variables giving information about the factors influencing economic success in North Macedonia.

Political Dynamics and Crises In North Macedonia

North Macedonia declared its independence on 08 September 1991. While North Macedonia is the only country that split from former Yugoslavia peacefully, the years following independence have been rather turbulent. Already from the early years following the independence, Greece refused to recognize the country under its official name posing problem not only in the bilateral, but also multilateral relations. Even though an interim agreement with Greece was reached and the country became a UN member state under the name "the former Yugoslav Republic of Macedonia" bilateral relations continued to be strained. In 1994, Greece enforced restrictions on trade, which occurred simultaneously with UN-imposed sanctions on Yugoslavia. The effects from the embargo were deeply felt in North Macedonia and some estimates say that the country lost around USD 2 billion. The trade embargo with Greece lasted for 18 months and the relations between the two countries were formalized in 1995. Yet, the name dispute continued to linger in the next steps the country was taking, taking its toll in 2008.

The early years following independence were not only difficult in the external relations front but also internally, given the multi-ethnic character of the country The second biggest ethnic community, the ethnic Albanians, already from the start expressed dissatisfaction with the foundations of the new state. In this context, the ethnic Albanians boycotted the referendum for independence and did not vote for the new Constitution of the independent North Macedonia, insisting that the ethnic Albanians are recognized as a constituent nation equal to the ethnic Macedonians. These tensions mounted in the following years, especially due to the refusal of the authorities to allow higher education in Albanian language peaking in 1994 (same year as the trade embargo from Greece was introduced). Following the establishment of a private university in their mother tongue in Tetovo in 1994, tensions peaked marked with police raids and sporadic violence. The escalating tensions culminated in inter-ethnic violence in 1997, when state authorities intervened in the city of Gostivar—located in the western region of the country—to remove the Albanian flag displayed by the ethnic Albanian mayor. The confrontation resulted in three fatalities and hundreds of injuries.

While tensions inside the country were high, in 1999 the war in Kosovo was considered as the peak of the iceberg. Given the close relations between the ethnic Albanians in North Macedonia and the Kosovars, the effects of the war were deeply felt in North Macedonia, which was the first entry point for the refugees from Kosovo, Sanctions that US and EU imposed on Yugoslavia for the aggression in Kosovo had additional negative effects on the economy of North Macedonia. Some estimates say that the economic cost for North Macedonia was more than USD 300 billion, and North Macedonia's economy represented over 60% of the total trade volume with Yugoslavia prior to the conflict (ICG, 1998).

In 2001, North Macedonia experienced a brief internal armed conflict, sparked by growing inter-ethnic tensions between the ethnic Albanian population and the country's security forces. The conflict, led on the Albanian side by the National Liberation Army, marked a critical juncture in relations between the two major ethnic groups—ethnic Macedonians and ethnic Albanians. Though short in duration, the crisis prompted significant political reforms. The resolution came with the signing of the Ohrid Framework Agreement (OFA) in August 2001, which laid the groundwork for a revised constitutional structure. This agreement granted expanded rights to the ethnic Albanian community and other minorities, including the official use of mother tongue, fair representation in public administration, and increased decentralization. Over time, the key elements of the OFA were systematically integrated into North Macedonia's Constitution and legal framework to ensure effective implementation.

The effective implementation of the OFA and the preservation of domestic stability positioned North Macedonia to formally apply for European Union membership. North Macedonia was far ahead of all countries in the region when it came to reforming its institutions, especially in building a solid public finance management system, so the Euro-Atlantic integration path seemed like a logical step in its development course. However, at the moment a window of opportunity to join NATO was provided, the problem with Greece on the name dispute re-emerged leading to a Greek veto of North Macedonia's invitation for NATO membership back in 2008 at the NATO Summitt in Bucharest. In the subsequent year, despite a favorable recommendation from the European Commission, Greece obstructed the initiation of North Macedonia's EU accession negotiations. After 2009, with two doors linked to the overarching strategic goal of the country being blocked for entry, North Macedonia begins to note backsliding in reforms, especially in democratic governance and rule of law.

In 2015, and new internal political crisis erupts as a response to eroded democracy and governance in the country. Following the revelations by the opposition party of massive wiretapping of more than 20.000 citizens illustrating misuse of the secret service for political gains, people took the streets demanding elections. The crisis lasted for two years culminating with storming of Parliament in April 2017.

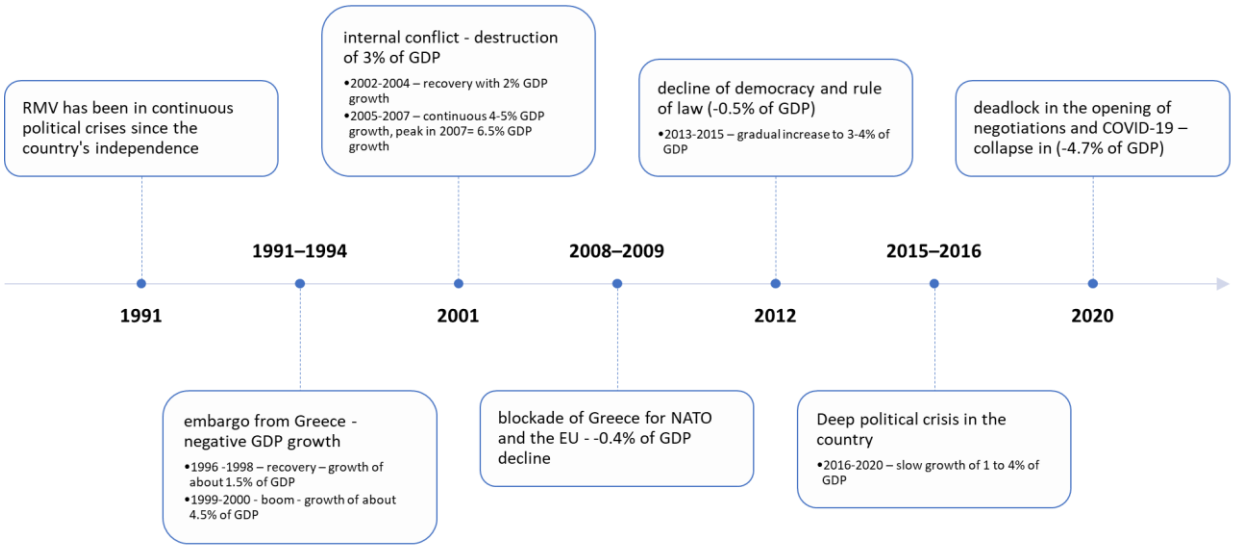


Figure 2: Political crisis in North Macedonia throughout the years (Source: Authors own)

After the establishment of a new government in 2017, North Macedonia began a period marked by renewed hope and positive outlook. In 2018, the country signed the Prespa Agreement with Greece, resolving the long-standing name dispute and officially adopting the name 'North Macedonia.' This agreement enabled the country to join NATO, with membership becoming official in 2020. However, its path to EU accession faced new obstacles, as Bulgaria blocked progress over disagreements related to language and national identity. As a result, North Macedonia's accession talks remain stalled, contingent on constitutional amendments to address the dispute.

Consequences of Crises on Economic Growth and Government Expenditures in North Macedonia

The protracted crisis has influenced North Macedonia's economic development and growth Both, the GDP growth rate and public expenditures illustrate this. Negative growth rates coincide with the years political crisis and other external and internal shocks in North Macedonia. This related to the period after the independence and the Greek trade embargo which led to the first and last devaluation of the Macedonian Denar in 1997. The same goes for year 2001 when the country found itself in an internal conflict, while in 2009 the growth rates reflect a period of disappointment following the decision not to invite \north Macedonia join NATO and the refusal of the EU to open accession talks. In 2020 the Covid-19 crisis is the main external shock factor which affected growth. The public expenditure throughout these periods follows a similar trend to the GDP, indicating a positive correlation as illustrated in figure 4 and 5.

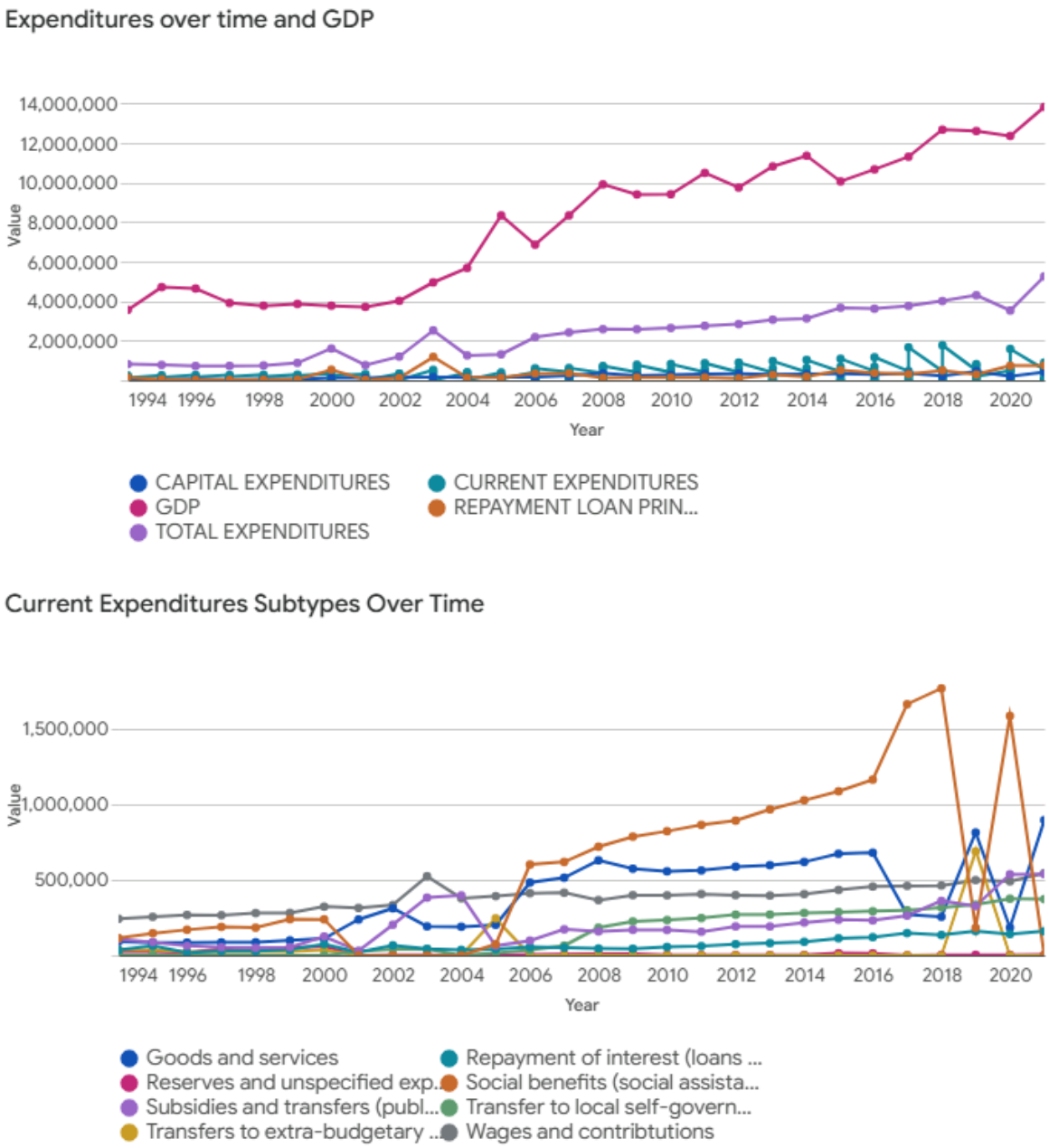


Figure 3: Economic Classification of Public Expenditures and GDP Trends from 1994 to 2021- RNM. Source: Authors' own work

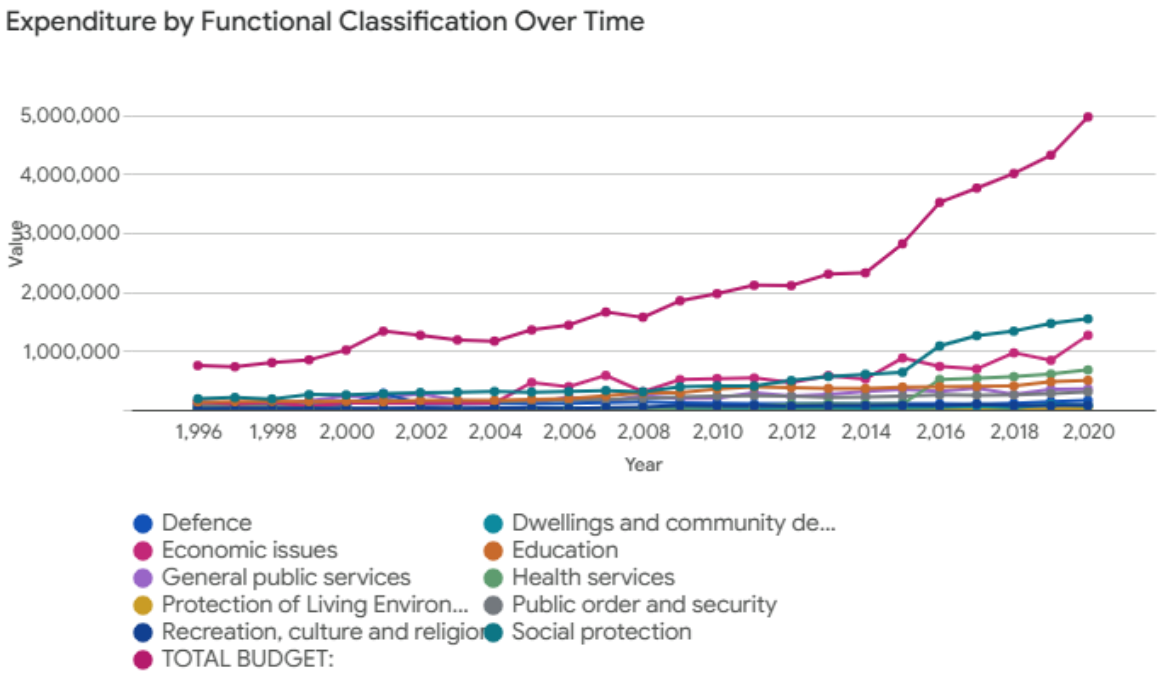


Figure 4: Functional Classification of Public Expenditures and GDP Trends from 1996 to 2021 - RNM
Source: Authors own work.

North Macedonia experienced four years of negative growth following its independence, primarily due to the trade embargo imposed by Greece and the UN sanctions on the former Yugoslavia. In the following years, North Macedonia's economy gradually recovered, reaching a peak growth rate of 4% of GDP in 1999 and 2000. However, this upward trend was disrupted by the internal conflict in 2001, causing GDP growth to decline to -3.1%. During times of crisis, public expenditures on defense and goods and services tend to rise significantly. In 2001 alone, these expenditures increased by 245 and 113 percentage points, respectively, highlighting an inverse relationship between spending on defense and goods and services and economic growth.

North Macedonia’s recovery following the internal conflict lasts for 2 years, with the economy picking up in 2005, reaching a historic high in 2007, when growth peaked at 6.5% of GDP. This period also marked significant reforms in public finance management, the rule of law, and governance, which bolstered the country's Euro-Atlantic aspirations. However, North Macedonia's inability to secure a NATO invitation at the 2008 summit in Bucharest resulted in disappointment, which intensified when the EU declined to begin accession talks despite the European Commission's positive recommendation in 2009. This setback, coupled with the global financial crisis of 2008— which had a minimal impact on the economy— led to a GDP contraction of -0.5%.

After 2009, North Macedonia begins to backslide on the reform agenda, focusing on internal market and support for the economy. This is best illustrated with the sharp increase of public spending on economic issues (functional classification) by over 250% and an increase of more than 60% in police, health and dwellings. Once again, spending on security/police, similarly to 2001, shows a negative correlation with GDP growth.

In terms of growth, North Macedonia never managed to recover its economy to the pre-2009 levels. Growth started to pick up in 2010 and 2011 but slumped to -0.5% in 2012, which correlates to a period when serious deterioration in democratic governance and rule of law was noted. This situation led to a deep political crisis in 2015 when a massive wiretapping scandal revealing misuse of office for personal and political gains as well as misuse of the security

services for political gain came out in public. This leads to further drop in growth, which only manages to pick up in 2017 when a new Government takes office.

The following years North Macedonia opens a new chapter. It signs a Friendship Treaty with neighboring Bulgaria and reaches a historical agreement on the name dispute with Greece laid down in the Prespa Agreement. Such steps resulted in an invitation by NATO for membership. However, the standstill in the EU track combined with the COVID-19 crisis brought North Macedonia's growth rates to 25 years back i.e. growth dropped to -4.7% in 2020. The public spending in this period is oriented logically on health and there is a spike in capital expenditures with more than 150% increase to accommodate for the construction of modular hospitals.

The significant link between crisis periods and low growth rates suggests that both internal and external shocks, along with political instability, have a detrimental impact on economic growth. Therefore, it can be inferred that political stability and effective governance are essential for sound public finance management and consistent economic growth.

CONCLUSION AND RECOMMENDATIONS

North Macedonia has experienced ongoing political instability since gaining independence. From the trade embargo imposed by Greece in the 1990s to internal conflicts that escalated into war in 2001, the country has faced significant obstacles on its path to Euro-Atlantic integration, compounded by the major wiretapping scandal of 2015. Additionally, the country's economy has been significantly impacted by two major external shocks: the global financial crisis of 2008 and the COVID-19 pandemic in 2020. Issues such as weak governance, high levels of corruption (as reflected in the Corruption Perception Index), and crime have delayed North Macedonia's economic growth. The relationship between particular spending categories and GDP growth would look different if these factors were not taken into account.

The analysis of the VAR models shows that political stability is a significant variable when predicting economic growth. The results indicate that while political instability has both negative and positive effects depending on the lag, it is important to consider the delayed nature of these effects. The significant role of lagged political instability in growth suggests that policymakers need to be mindful of the medium-term effects of political unrest. While immediate policy responses to instability may mitigate negative effects, long-term strategies should focus on stabilizing the political environment to ensure sustained growth. It is not practical to base policy decisions in North Macedonia only on financial and economic data. A more comprehensive approach is required, one that simultaneously strengthens democratic governance and the rule of law through a well-defined reform agenda, while aligning economic policy and the allocation of public expenditures

This study emphasizes how North Macedonia's economic growth is impacted by political instability. The hypothesis *"Political Instability in North Macedonia has negative impact on GDP growth"* is analyzed with qualitative analysis of the political situation in North Macedonia since its independence in 1991, with analysis of the budged expenditures for the same period, as well as with empirical model. In addition, external and internal crises that have led to political instability have been analyzed in a timeline visa-a-vis budget expenditures and growth rates based on local and international reports. To accurately represent the VAR results, the relationship between political instability and GDP growth does not unambiguously support the hypothesis of a negative impact. Instead, the findings suggest a more nuanced or complex dynamic, potentially involving lagged effects and adjustments.

Without a strong legal foundation, government spending may be undermined by uncertainty. Combatting corruption is also essential, as it damages public institutions and misdirects resources. Effective use of public funds and a corruption-free environment promote growth. Policymakers must recognize that sustainable development requires more than fiscal

tools—broader socio-political stability is key. Political stability fosters long-term planning, investor confidence, and an environment favorable to growth.

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APPENDIX: STATA OUTPUT

VAR MODEL

. var GDPgrowthannual L.PolInstab d_Inflationconsumerpricesannua d_TradeofGDP Grossfixedcapitalformation EconFree_lag

Vector autoregression

Sample: 2003 - 2023 No. of obs = 21

Log likelihood = -161.6814 AIC = 22.8268

FPE = 1155.725 HQIC = 23.66879

Det(Sigma_ml) = .1961196 SBIC = 26.70646

Equation	Parms	RMSE	R-sq	chi2	P>chi2	
GDPgrowthannual	13		2.04242	0.7291	56.52064	0.0000
L_PolInstab	13	.256801	0.8358	106.9036	0.0000	
d_Inflationcon~a	13	3.042	0.7548	64.63186	0.0000	
d_TradeofGDP	13	7.48324	0.8040	86.14733	0.0000	
Grossfixedcapi~n	13	1.70048	0.6498	38.95786	0.0001	
EconFree_lag	13	2.43886		0.3688	12.26784	0.4244

	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
GDPgrowthannual						
GDPgrowthannual						
L1.	-.4069398	.1911612	-2.13	0.033	-.7816089	-.0322707
L2.	.0288044	.1616317	0.18	0.859	-.287988	.3455968
PolInstab						
L2.	-1.708131	1.240257	-1.38	0.168	-4.138991	.7227284
L3.	7.283252	1.571215	4.64	0.000	4.203727	10.36278
d_Inflationconsumerpricesannua						
L1.	.0131573	.2026207	0.06	0.948	-.3839719	.4102865
L2.	.2755156	.2119928	1.30	0.194	-.1399827	.6910138
d_TradeofGDP						
L1.	.0371247	.0627483	0.59	0.554	-.0858596	.1601091
L2.	-.0902087	.0818328	-1.10	0.270	-.250598	.0701807
Grossfixedcapitalformation						
L1.	-.1789947	.3031735	-0.59	0.555	-.7732037	.4152144
L2.	.3833901	.2542273	1.51	0.132	-.1148863	.8816665
EconFree_lag						
L1.	-.4663289	.194429	-2.40	0.016	-.8474027	-.085255
L2.	-.6484206	.2145556	-3.02	0.003	-1.068942	-.2278993
_cons	-2.73093	6.403418	-0.43	0.670	-15.2814	9.819539
L_PolInstab						
GDPgrowthannual						
L1.	.0220429	.0240354	0.92	0.359	-.0250657	.0691515
L2.	-.0535973	.0203226	-2.64	0.008	-.0934288	-.0137657
PolInstab						
L2.	.8784467	.1559424	5.63	0.000	.5728052	1.184088
L3.	-.0358661	.1975551	-0.18	0.856	-.4230669	.3513348
d_Inflationconsumerpricesannua						

```
                L1. | -.       0417615   .0254763    -1.64   0.101    -.0916941    .0081711
                L2. | -.       0915145   .0266547    -3.43   0.001    -.1437567   -.0392723
                    |
          d_TradeofGDP |
                L1. | -.       0016314   .0078896    -0.21   0.836    -.0170947    .0138319
                L2. |  .       0341557   .0102892     3.32   0.001     .0139893     .054322
                    |
 Grossfixedcapitalformation |
                L1. |  .       0069172   .0381192     0.18   0.856     -.067795    .0816295
                L2. |  .       0553109    .031965     1.73   0.084    -.0073394    .1179611
                    |
          EconFree_lag |
                L1. | -.       0217236   .0244463    -0.89   0.374    -.0696375    .0261903
                L2. | -.       0612903    .0269769    -2.27   0.023    -.1141641   -.0084165
                    |
               _cons | -       1.358577   .8051269    -1.69   0.092    -2.936596    .2194431
------------------------------+------------------------------------------------------------------
d_Inflationconsumerpricesannua |
          GDPgrowthannual |
                L1. | -.       3968333   .2847176    -1.39   0.163    -.9548695    .1612029
                L2. | -.       0565143   .2407361    -0.23   0.814    -.5283483    .4153197
                    |
            PolInstab |
                L2. | -       5.641757   1.847253    -3.05   0.002    -9.262306   -2.021209
                L3. |          3.328136   2.340185     1.42   0.155    -1.258543    7.914815
                    |
d_Inflationconsumerpricesannua |
                L1. | -.       8435156   .3017854    -2.80   0.005    -1.435004    -.252027
                L2. |  .       4276316   .3157444     1.35   0.176    -.191216    1.046479
                    |
          d_TradeofGDP |
                L1. |  .       2816345    .093458     3.01   0.003     .0984603    .4648087
                L2. | -.       1552236   .1218827    -1.27   0.203    -.3941092     .083662
                    |
 Grossfixedcapitalformation |
                L1. |  .       1228335   .4515498     0.27   0.786    -.762188    1.007855
                L2. | -.       7144914   .3786489    -1.89   0.059     -1.45663    .0276469
                    |
          EconFree_lag |
                L1. | -.       8177126   .2895847    -2.82   0.005    -1.385288   -.2501371
                L2. | -.       3281824   .3195615    -1.03   0.304    -.9545115    .2981467
                    |
               _cons |         16.08805   9.537321     1.69   0.092    -2.604754    34.78086
------------------------------+------------------------------------------------------------------
d_TradeofGDP                  |
          GDPgrowthannual |
                L1. | -       1.128225    .700398    -1.61   0.107     -2.50098     .24453
                L2. |  .       1491894   .5922046     0.25   0.801    -1.01151    1.309889
                    |
            PolInstab |
                L2. |  -       10.3679   4.544194    -2.28   0.023   -19.27436   -1.461446
                L3. |          7.240957   5.756796     1.26   0.208    -4.042156    18.52407
                    |
d_Inflationconsumerpricesannua |
                L1. | -.       4683268   .7423844    -0.63   0.528    -1.923374     .98672
                L2. |          1.020401   .7767232     1.31   0.189    -.5019486    2.54275
                    |
          d_TradeofGDP |
                L1. | -.       0188689   .2299042    -0.08   0.935    -.4694729    .431735
                L2. | -.       7573722   .2998282    -2.53   0.012    -1.345025   -.1697196
                    |
 Grossfixedcapitalformation |
                L1. | -       1.681006   1.110801    -1.51   0.130    -3.858136    .4961244
                L2. | -.       3237296   .9314667    -0.35   0.728    -2.149371    1.501912
                    |
          EconFree_lag |
                L1. |  -       1.12757   .7123709    -1.58   0.113    -2.523791    .2686517
```

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                L2. | -        2.857198   .7861132    -3.63   0.000    -4.397952   -1.316445
                    |
              _cons |         58.5835   23.46157     2.50   0.013     12.59967    104.5673
------------------------------+----------------------------------------------------------------
Grossfixedcapitalformation    |
          GDPgrowthannual |
                L1. | -.       0801165   .1591573    -0.50   0.615    -.3920592    .2318261
                L2. |  .       1219081   .1345716     0.91   0.365    -.1418475    .3856637
                    |
            PolInstab |
                L2. | -        2.545303   1.032616    -2.46   0.014    -4.569193   -.5214141
                L3. |            2.418205   1.308165     1.85   0.065    -.1457519    4.982162
                    |
d_Inflationconsumerpricesannua |
                L1. |  .       1778441   .1686983     1.05   0.292    -.1527985    .5084866
                L2. |  .       2216853   .1765014     1.26   0.209     -.124251    .5676216
                    |
          d_TradeofGDP |
                L1. | -.       0015155   .0522431    -0.03   0.977     -.10391     .100879
                L2. | -.       0844598   .0681325    -1.24   0.215    -.2179971    .0490774
                    |
  Grossfixedcapitalformation |
                L1. |  .       6715748   .2524167     2.66   0.008     .1768471    1.166302
                L2. | -.       2942684    .211665    -1.39   0.164    -.7091242    .1205875
                    |
          EconFree_lag |
                L1. | -.       0043806    .161878    -0.03   0.978    -.3216557    .3128946
                L2. |  .       0356032   .1786351     0.20   0.842    -.3145152    .3857216
                    |
              _cons |         14.29767   5.331369     2.68   0.007     3.848383    24.74697
------------------------------+----------------------------------------------------------------
EconFree_lag                  |
          GDPgrowthannual |
                L1. |  .       0552779   .2282667     0.24   0.809    -.3921166    .5026724
                L2. |   .       223901   .1930054     1.16   0.246    -.1543826    .6021846
                    |
            PolInstab |
                L2. |            2.159482   1.480998     1.46   0.145    -.7432215    5.062185
                L3. | -.       6744997   1.876197    -0.36   0.719    -4.351779    3.002779
                    |
d_Inflationconsumerpricesannua |
                L1. |  .       1945143   .2419505     0.80   0.421     -.2797    .6687285
                L2. |  .       1000207   .2531418     0.40   0.693    -.3961282    .5961696
                    |
          d_TradeofGDP |
                L1. | -.       0254053   .0749281    -0.34   0.735    -.1722617     .121451
                L2. | -.       1338866    .097717    -1.37   0.171    -.3254084    .0576352
                    |
  Grossfixedcapitalformation |
                L1. | -.       3569993   .3620212    -0.99   0.324    -1.066548    .3525491
                L2. |   .       489108   .3035743     1.61   0.107    -.1058867    1.084103
                    |
          EconFree_lag |
                L1. |  .       1921207   .2321688     0.83   0.408    -.2629218    .6471632
                L2. |  .       1288072   .2562021     0.50   0.615    -.3733397    .6309542
                    |
              _cons | -3.      630725   7.646358    -0.47   0.635    -18.61731    11.35586
------------------------------------------------------------------------------------------------
```

Granger Causality Wald tests

Equation	Excluded	chi2	df	Prob>Chi2
GDPgrowthannual	L.PolInstab	25.871	2	0.000
GDPgrowthannual	d_Inflationcons~a	3.433	2	0.180

GDPgrowthannual	d_TradeofGDP	2.385	2	0.303
GDPgrowthannual	Grossfixedcapit~n	2.331	2	0.312
GDPgrowthannual	EconFree_lag	11.840	2	0.003
GDPgrowthannual	ALL	56.420	10	0.000
L_PolInstab	GDPgrowthannual	7.543	2	0.023
L_PolInstab	d_Inflationcons~a	13.524	2	0.001
L_PolInstab	d_TradeofGDP	13.452	2	0.001
L_PolInstab	Grossfixedcapit~n	4.637	2	0.098
L_PolInstab	EconFree_lag	5.244	2	0.073
L_PolInstab	ALL	23.756	10	0.008
d_Inflationcons~a	GDPgrowthannual	2.042	2	0.360
d_Inflationcons~a	L.PolInstab	9.828	2	0.007
d_Inflationcons~a	d_TradeofGDP	15.770	2	0.000
d_Inflationcons~a	Grossfixedcapit~n	4.276	2	0.118
d_Inflationcons~a	EconFree_lag	8.050	2	0.018
d_Inflationcons~a	ALL	53.887	10	0.000
d_TradeofGDP	GDPgrowthannual	2.620	2	0.270
d_TradeofGDP	L.PolInstab	5.280	2	0.071
d_TradeofGDP	d_Inflationcons~a	7.320	2	0.026
d_TradeofGDP	Grossfixedcapit~n	4.094	2	0.129
d_TradeofGDP	EconFree_lag	13.603	2	0.001
d_TradeofGDP	ALL	47.904	10	0.000
Grossfixedcapit~n	GDPgrowthannual	1.025	2	0.599
Grossfixedcapit~n	L.PolInstab	6.194	2	0.045

Grossfixedcapit~n	d_Inflationcons~a	1.614	2	0.446
Grossfixedcapit~n	d_TradeofGDP	1.756	2	0.416
Grossfixedcapit~n	EconFree_lag	0.047	2	0.977
Grossfixedcapit~n	ALL	7.939	10	0.635
EconFree_lag	GDPgrowthannual	1.442	2	0.486
EconFree_lag	L.PolInstab	2.696	2	0.260
EconFree_lag	d_Inflationcons~a	0.732	2	0.694
EconFree_lag	d_TradeofGDP	1.912	2	0.384
EconFree_lag	Grossfixedcapit~n	2.623	2	0.269
EconFree_lag	ALL	12.152	10	0.275