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An Assessment of Fiscal Decentralization in Macedonia

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ABBREVIATIONS

AETR	Average Effective Tax Rate
CIT	Corporate Income Tax
DPTCR	Detailed Plan for Transfer of Competences and Resources
DWG	The Decentralization Working Group
EU	European Union
FAM	Factor Assessment Method
GDP	Gross Domestic Product
GEB	Gross Expenditure Base
GPRA	Government Performance and Results Act
GEP	Gross Economic Product
LGU	Local Government Unit
LSG	Local Self Government
MKD	Macedonian Denar
MoF	Ministry of Finance
MoLSG	Ministry of Local Self Government
NGO	Non Governmental Organization
OECD	Organization for Economic Co-operation and Development
OPDP	Operational Programme for Decentralization of Power
PIDP	Programme for the Implementation of the Decentralization Process
PIT	Personal Income Tax
PRO	Public Revenue Office
RRS	Representative Revenue System
TCCT	Trilateral Committee for Coordination of Trainings
TFF	Territorial Formula Financing scheme
TTR	Total Taxable Resources
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value Added Tax
ZELS	Association of Local Self Governments

EXECUTIVE SUMMARY

In this report we highlight some of the progress that has been made in the reform of the system of intergovernmental fiscal relations in Macedonia, but we dedicate more space and attention to those areas of the system where challenges still remain. The report is structured along the main pillars of the decentralization system and provides an assessment of the main challenges and issues the Government of Macedonia faces in each of these areas. The main areas covered include: vertical structure and scope of the government sector, expenditure assignments revenue assignment, intergovernmental transfers, and borrowing. In the final section, we outline a possible agenda for reform.

Our assessment acknowledges considerable progress that has been already made in the decentralization process in Macedonia. The government has put in place a comprehensive legal framework for decentralization in accordance with the European Charter on Local Self Governments and the Ohrid Agreement. Although far from perfect, the current legal framework provides as a whole a solid basis for continuing building Macedonia's decentralization system. Moreover, several important milestones have been reached in implementing the legislated system of decentralized government. Notably, the territorial division of municipalities has been rationalized while giving more revenue-raising and fiscal management powers to the municipalities. As a result, local government expenditures as a share of GDP increased by almost forty percent between 2004 and 2006.

Despite the considerable progress made to date in many fronts, the decentralization process in Macedonia still faces considerable challenges. At the present time, there is a lack of a unified and coordinated reform strategy but instead reform would appear to proceed on a piecemeal basis. This is part due to the current fragmentation in the assignment of responsibility for decentralization reform among various stakeholders. There is no single body providing a comprehensive vision and guidance for all the involved commissions, working groups, and so on. There is also lacking a clear "reform champion" at the highest level of government and a concrete vision of where Macedonia's decentralized system should be in a period of say three to five years and what should be the right sequence of reforms to get there.

At a more specific level, there are some other serious challenges: the assignment of functional responsibilities at the central and local levels remains unclear and the system lacks an objective transparent method for arriving to the expenditure needs associated with the assigned competencies; on the side of revenue assignments, the municipalities lack revenue sufficiency, which detracts from the overall accountability of the system; the transfer system does not sufficiently equalize; and municipal borrowing still remains a problem area.

An important feature of the current process of devolving responsibilities is its focus on the transfer of facilities, the operation and maintenance of these facilities and personnel. Currently, the wording used in the laws and regulations does not clearly delineate responsibility for the outcome of service provision. A possible reason for the lack of clarity in responsibility assignments is that the current delineation of competencies in the decentralization laws was not preceded nor informed by the development of comprehensive policy frameworks in each of the sectoral areas to be decentralized.

Another consequence of the approach is that municipalities that did not have any of those facilities in their territories continue to be deprived or unfunded for the full exercise of the assigned competencies. The allocation formula of the sectoral grants in many cases just takes into consideration the existence of a physical facility and other physical features such as useful space. This is highly problematic because of the unfair results it produces across municipalities and because it sends the wrong message to the local authorities that what counts is less the needs of their constituency and more the existence of a facility.

Thus, rural municipalities do not receive earmarked grants for any of the assigned functions except primary education. While urban municipalities outside Skopje receive earmarked grants for each activity within the four sectors (education, social protection, culture, fire-fighting), the per capita amount is less than in Skopje with the exception of child day care and transport for primary school students. Thus there is a clear anti-rural bias in the allocation of earmarked grants.

There are also concerns about the set of criteria being used to qualify municipalities for having their earmarked grants transformed into block grants in the selected sectors. An important issue that needs addressing in this exercise is a pro-active plan from the central government, customized for each of the municipalities that have failed to qualify, for how to help those municipalities qualify in the future. For those municipalities, which for issues of size, etc, will probably never qualify the plan should lay out alternative options, such as the inter-municipal cooperation, to provide particular services. Apparently, an appropriate legal framework for inter-municipal cooperation is still lacking.

There are also challenges in the area of locally-raised revenues. It should be acknowledged that since 2005 revenue from all municipal own sources have increased with the exception of communal charges dominated by construction permit fees. However, these increases, notably in property taxes, were outweighed by the revenue drop from communal charges resulting in an overall decline in municipal own revenue. Because, among other things, of administration difficulties and because of its structure, mainly low rates, the annual property tax is still underperforming as a local source of revenue. The average percent of GDP collected in developing and transitional countries from the annual property tax is about ten times of what is currently collected in Macedonia

The design of revenue assignments in Macedonia faces the constraint of very significant fiscal disparities. These disparities impose a limit on how much to rely on increases in tax autonomy and tax revenue retention, and more importantly, these disparities highlight the important role to be played by an equalization grant system.

The allocation of general purpose grants is still in transition and still lacks explicit equalization criteria that would equalize disparities in fiscal capacity and expenditure needs. The current VAT revenue transfer presents problems in both the determination of the pull of funds and the formula (or criteria) used for the distribution of the funds. Using the VAT as the source leads to claims from particular jurisdictions where the VAT is raised, which probably explains setting aside a share of the revenue pool for the City of Skopje and its municipalities. The criteria for the allocation of funds from the VAT revenue transfer do not take into account disparities in the revenue-raising capacity while they take into account disparities in expenditure needs only in an approximated fashion. The current VAT revenue transfer has equalizing features but for a variety of reason falls short of functioning as an equalization grant system.

While each of the aforementioned challenges needs to be addressed, the likelihood of successful reform will increase with the proper sequencing of the reforms. There is, for example, no point in reforming revenue assignments until there is much more clear definition of what are the actual responsibilities and expenditure needs of sub-national governments. In addition, allowing sub-national governments to borrow should be preceded by enhanced revenue autonomy, more transparent budgeting procedures and increased accountability by sub-national officials.

The most important step in the way forward is to come up with a unified and coordinated reform strategy and a clear “reform champion” within the central government. The strategy should provide a policy vision with respect to key reform choices that need to be agreed on through consultations involving all relevant stakeholders. Once the consensus on the overall system has been reached and documented in a comprehensive policy document, the proper sequencing of the implementation steps should be as following:

- In the short term, the two most immediate steps for the reform of the intergovernmental systems are, first, to reform and clarify expenditure assignments at all levels of government and develop per client expenditure norms to quantify expenditure needs flowing from the new expenditure assignments, and second, to reform the system of equalization grants.
- The reform of the system of equalization grants should encompass the introduction of a funding rule based on general central government revenues to determine with more predictability the funds available for equalization and a distribution formula based on the difference between expenditure needs and fiscal capacity. These reforms of the grant system can be carried out in parallel with the reform of expenditure assignments.

- In the shorter term it should also be feasible to increase horizontal accountability, through “yardstick competition” among all sub-national governments, by publishing more recently updated and more extensive sub-national government data for budgets and basic performance indicators.
- Concerning local capacity, individualized diagnostic should be performed for every municipality and individual solutions found, be they capacity building or voluntary cooperative arrangements or contracting out service delivery. There is no option for the central government but to actively address those deficiencies in local capacities rather than just putting the legal framework in place and waiting for the “invisible hand” to do the rest.
- In the medium term, it will be desirable to reform revenue assignments to provide more revenue-raising powers to sub-national governments, which might include a piggyback flat rate for the personal income tax and other tax sources, such as a local vehicle tax or a presumptive simplified levy on small businesses. The new revenue instruments should provide sufficient own-revenues to the richest sub-national governments.
- In the medium term, it will be also desirable to re-structure the system of conditional or earmarked grants. The formula for the distribution of the sectoral grants should be based on potential number of clients and differences in the costs of provision of standardized services and not on physical capacity criteria or outdated historical costs. The conditional grant program should be conceived as supporting major thrusts in central government policies. Using matching fund arrangements more often should help leverage additional local resources.

An Assessment of Fiscal Decentralization in Macedonia

I. INTRODUCTION¹

Macedonia is currently involved in a rapid process of decentralization with active participation of the central and local governments. As in many other countries, one main goal being pursued with the decentralization process in Macedonia is to improve the overall efficiency of the public sector and to increase the quality and quantity of local services so to improve the lives of all citizens wherever they reside in the country. But in addition, the decentralization process in Macedonia has the promise of strengthening democratic representative institutions and of significantly contributing to national solidarity and the political cohesiveness of the country. There is, therefore, a lot in stake for Macedonia in the successful development of the decentralization process.

Considerable progress has been already made in the decentralization process. The government has put in place a comprehensive legal framework for decentralization in accordance with the European Charter² on Local Self Governments and the Ohrid Agreement. The law on Local Self Government (adopted in January 2002) defines the composition, organic structure and competencies of the municipalities, and regulates municipal operations in a comprehensive manner. The law on Local Self Government is supported by other laws including the Law on Territorial Organization (August 2004), the Law on Financing of the Units of Local Self Government (July 2004), defining the financial sources at the disposal of the municipalities, and the Law on Property Taxes (September 2004). Functional responsibilities assigned to the municipalities are further regulated by sectoral laws. Although far from perfect, the current legal framework provides as a whole a solid basis for continuing building Macedonia's decentralization system as envisioned in the Programme for the Implementation of the Decentralization Process of March 2004.

Another very positive aspect of decentralization reform in Macedonia is the active involvement of several key central government ministries in the process and the design and operation of several intergovernmental commissions for the implementation process with wide representation of the local governments. The reforms are spearheaded by the Ministry of Local Self

¹ The materials and information in this report were gathered in a two week mission in Macedonia in July 2007. We are grateful to the Ministry of Local Self Government, the Ministry of Finance, and to the Local Government Association (ZELS) and individual mayors for all their cooperation and support for the task of putting together this report. We are especially grateful to Ms. Snezana K. Miloska, Finance State Secretary for her overall support in the preparation and the strategic partnership throughout the mission.

² Macedonia signed the Charter in 1996 and the Parliament ratified it in 1997

Government MoLSG, with responsibility for the overall coordination and monitoring of the implementation of competency transfer to the municipalities, and the Ministry of Finance (MoF), with responsibility for revenue assignment issues and the intergovernmental transfer system. Several intergovernmental bodies with representation from central government agencies and the Association of Local Self Governments (ZELS) are charged with the actual planning and implementation of the decentralization process. These include the:

- The Decentralization Working Group (DWG), composed of civil servants from central government ministries and ZELS, and charged with the preparation of analyses, plans and other documents for the practical implementation of the process including sectoral developments in ten sectoral subcommittees.
- Commission for Monitoring the Development of the System of Municipal Financing, composed of five representatives from ZELS and four from the Government, charged with monitoring the development of the financing system for the municipalities.
- Trilateral Committee for Training Coordination, composed (consisting of MoLSG, ZELS and the Civil Servants Agency) –coordination and monitoring of training.

Despite the considerable progress made to date in many fronts, the decentralization process in Macedonia still faces considerable challenges. At the present time, there is a lack of a unified and coordinated reform strategy but instead reform would appear to proceed on a piecemeal basis. This is part due to the current fragmentation in the assignment of responsibility for decentralization reform among various stakeholders. At the present time, there is no single body providing a comprehensive vision and guidance for all the involved commissions, working groups, and so on. This overall guidance was meant to be provided by the Coordinating Body for Decentralisation – composed of State Secretaries from all ministries, the Secretary of the Legislative Secretariat, the Head of Sector for European Integration and the Secretary General of the Association of the Units of Local Self-Government (ZELS) and chaired by the Minister of Local Self-Government—as was envisioned in the Operational Programme for Decentralization of Power 2003-2004 (OPDP) of January 2003. However, the Decentralization Working Group (DWG) that took over this role from the Coordinating Body for Decentralization with the adoption of the PIDP of March 2004 lacks state-secretary-level representation and thus is not in a position to provide authoritative guidance to other stakeholders (reportedly ministerial representation at the DWG has been deputized to a very junior level). Moreover, there are no procedures in place for routine sharing of information between the DWG and the Commission for Monitoring the Development of the System of Municipal Financing.³

³ For example, the latter Commission was not involved in the development of formulae for sectoral grants but only for the distribution of VAT transfers.

There is also lacking a clear “reform champion” at the highest level of government and a concrete vision of where Macedonia’s decentralized system should be in a period of, for example, three or five years and what should be the right sequence of reforms to get there. At a more specific level, there are some other serious challenges: the assignment of expenditure responsibilities at the central and local levels remains unclear and the system lacks an objective transparent method for arriving to the expenditure needs associated with the assigned competencies; on the side of revenue assignments, the municipalities lack revenue sufficiency , which detracts from the overall accountability of the system; the transfer system does not sufficiently equalize and a formula-driven equalization grant still remains to be developed; and municipal borrowing still remains a problem area.

The main goals of this report are: first, to take stock and to highlight the main features of Macedonia’s system of intergovernmental fiscal relations; a serious diagnostic of the system and clear direction for reform need to be based on a solid understanding of how the current system works. Second, the report focuses on the issues and challenges in each of the main areas of the current system. Third the report discusses the way forward with an agenda for reform. The stock taking of the current system and the discussion of the issues and challenges is carried in Section II of the report. The discussion of the way forward is in Section III.

Finally, there are some issues that are very important to the success of decentralization reform, but which, because of their complexity and the separate careful attention and space required, will not be addressed in this report. These are the central versus local land ownership issue and the reform of the civil service. Other issues of significance to the success of decentralization are health insurance reform and education system reform. All these issues will require separate study and reports.

II. CURRENT STRUCTURE OF THE DECENTRALIZATION SYSTEM AND MAIN CHALLENGES

This section of the report reviews the current structure of the main pillars of the decentralization system in Macedonia and provides an assessment of the main challenges and issues the Government faces in each of these areas. The main areas covered include: vertical structure and scope of the government sector, expenditure assignments, revenue assignments, intergovernmental transfers, and borrowing.

II. 1 Vertical Structure and Scope of the Government Sector

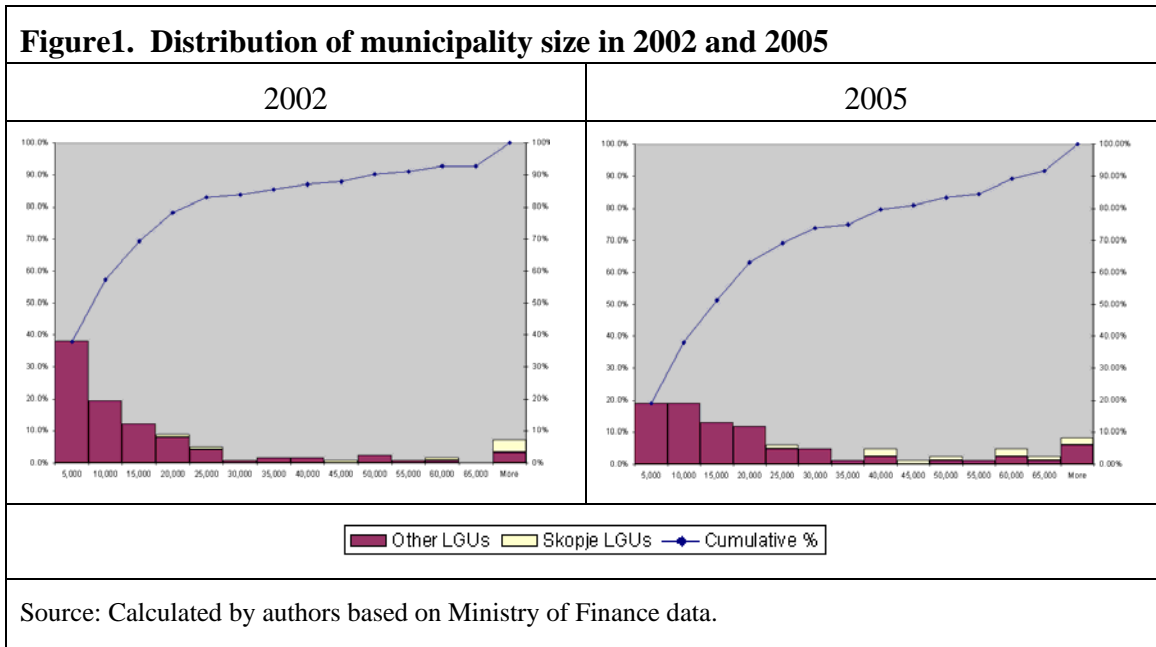
The vertical structure of government and the scope of each level of government condition the overall performance of a decentralized system. In this section we review the current organization of government activities and the main challenges it presents for the efficient operation of the system.

II.1.1 Current Structure

Territorial Organization

Macedonia is divided into two levels of administration: the central level and the local self governments. The country's multi-ethnic dimension is typically reflected in the territorial organisation.

The local self government in Macedonia is comprised of the municipalities and the city of Skopje, overlapping municipalities of the metropolitan area. Rural settlements are integrated into their municipalities, but the settlements have never had their own separate budgets. The 2004 Law on territorial organisation consolidated 123 post-1996 municipalities into the present 84 municipalities. In this same reform, two of the municipalities integrating the City of Skopje were split into four; this increased to ten the total number of municipalities encompassed by the City of Skopje. In addition, the City of Skopje serves as a special city-wide local government.



As can be seen from Figure 1, the 2004 territorial reorganization significantly reduced the fragmentation of local governments. If before 2005, 40 percent of local government units had less than 5 thousand residents and 60 percent had less than 10 thousand residents, these figures were reduced to 20 percent and 40 percent, respectively after the reform.

Nevertheless, there are still significant disparities in population in Macedonia’s municipalities. The size of the municipalities range from 1,322 persons for Vranestica (which is made up of 15 rural settlements) to 105,484 for Kumanovo (which is made up of 47 settlements in addition to its urban seat).⁴

Administrative Organization

The governance structure of a municipality is comprised of the Municipal Council and the Mayor. The Municipal Council is the legislative body while the Mayor is the head of the executive organ and the manager of the municipal staff, although according to the Law on Civil Servants, the Secretary of the Municipality has managerial competencies over the staff as well. Both organs are elected directly by the citizens for a four year term. The law on Local Self Governments defines the responsibilities and the distribution of power among these two organs. Currently, the Law on Local Self Government allows for an asymmetric relationship between the Council and the Mayor. While councilors can only send proposals to the mayor but not hold

⁴ Municipal disparities are further discussed in section II.4.

him/her accountable for his/her acts, the mayor can suspend the enactment of the council resolution by sending it back with his/her objections. However, if the council overrules the mayor's objections by a simple majority, the mayor has to promulgate it meanwhile having an option to further appeal to the Constitutional Court.⁵

The responsibilities of the Municipal Council include the adoption of the municipal charter (statute), the approval of annual budgets, the establishment of public institutions and communal enterprises, the appointment of managers upon the mayor's proposal, the establishment of the municipality's administrative organs and so forth. The Mayor signs and proclaims the acts of the Council and is responsible for the implementation of the Council decisions, execution of the budget, managing the municipal administration and its employees and property.

In terms of organizational structure, the Law on Financing of the Units of the Local Self Government requires the municipalities to establish a department of budget and accounting composed of at least two financial officers (one of them being chief accountant), an internal audit function (can be one person), and a tax department of at least three employees. In addition, the municipalities can create other administrative organs to perform specific administrative functions. Thus, a high degree of diversity exists in respect of the organizational structure of the municipalities. While formally the personnel structure of municipalities has to be approved by the Civil Servants Agency, reportedly this agency does not place excessive constraints on local discretion in this area but only check whether the organization structure of a local entity is internally sound in terms of lines of accountability and so on.

One important issue is that many municipal employees require additional skills to perform the new competences assigned to the local governments. Recognizing the gap in term of capacity faced by the municipalities and the need for exchange of information, coordination and decision-making in the area of professional development and training of the civil servants in the municipal administrations in October 2003 the Trilateral Committee for Coordination of Trainings (TCCT) was established. According to the Memorandum of Understanding the Trilateral Committee harmonizes, the Trilateral Committee harmonizes, coordinates and decides upon all activities in the area of professional development and training of civil servants in the municipal administration, including the mobilization and allocation of financial assistance from national and international institutions and organizations.⁶

⁵ See Article 50 of the Law on LSG.

⁶ In the deployment of its tasks the Trilateral Committee is supported by the Training Support Facility (TSF). Indeed, this mechanism has been established as a technical support to the activities of the Committee, and with technical and financial assistance from UNDP. On the basis of a Training Needs Assessment of civil servants in the

In accordance with the 2005 Action Plan for European Partnership, a Strategy for Training in the Local Self Government in 2006–2010 was adopted by the Government of the Republic of Macedonia in March 2006.

Monitoring, supervision and intergovernmental coordination

The Government of Macedonia (including the competent line ministries) supervises the legality of the operations of the municipalities. The competent central authority has the right to appeal respectively to the Constitutional Court to challenge an alleged illegal decision and to the regular court for appraisal of the compliance of the local self governments' decision with previous or consecutive approvals or dispositions of the competent state organ. In addition, the Ministry of Finance monitors the financial operations of the municipalities and the State Audit Office performs external annual audits of all municipal financial statements in accordance with internationally accepted standards.

In terms of collaboration and relationship between the municipalities and the Central Government, the Law on Local Self Government determines that cooperation is foreseen for drafting laws concerning the municipalities and their sources of financing and in particular the amount of fiscal transfers. The municipalities shall be consulted on planning and decision making issues that refer to them. The cooperation between the two tiers of the government is enhanced by the Association of Local Self Government Units (ZELS), which was established as far back as 1972 and reconstituted in 1995. The Association's basic aim is the collaboration and promotion of the municipalities' interests, and so far it has been quite effective as an interlocutor with the central authorities.

II.1.2 Main Issues with the Vertical Structure and Scope of Government

Although recent reforms have been unfolding in the right direction and the current vertical structure of government is largely adequate in many aspects, some important issues remain. Among the most important are:

local self government units conducted in 2005 and 2007 quarterly training plans have been elaborated and timely submitted for consideration and financing to the national and international institutions.

- **Great diversity and disparities among municipalities in their capacity to perform specific functions.** The different population sizes of the municipalities continue to pose some important dilemmas. While one fifth of municipalities are too small even to efficiently provide the most basic municipal services, at the other end there is another one fifth that are well above the “minimum efficient scale” for public services commonly provided by local governments throughout the world. Assigning a single scope of functions to all municipalities thus risks substandard provision of decentralized functions in some localities while failing to utilizing capacity existing in some other municipalities. Cooperative arrangements, for example through inter-municipal cooperation, among smaller municipalities could mitigate these disparities in administrative capacity. However, so far cooperation has been partial and mostly limited to urban planning, communal services and infrastructure and, financial management. The lack of cooperation in the areas of key social services, such as education and social protection, could be partly explained by a rigid system of earmarked financing that leaves under-capacitated municipalities completely out not even allowing them to purchase these services from municipalities that have those facilities let alone establishing joint facilities with other municipalities. This is an important distortion in the system that leads to serious inefficiencies in service provision.
- **Relationship between the Mayor and the Council at the municipal level.** On paper, the current structure and division of authority in the municipalities is clear but in practice it is exposed to legislative or executive political gridlock especially when the Mayor and the majority of the Counselors belong to opposing political parties. This situation is possible because the Mayor and the Council are elected separately as opposed to the systems where the head of the executive, the Mayor, being appointed by the Council. On the other hand, the current system may provide for more checks and balances in the operation of the municipalities, although this could also be enhanced by providing an instrument for a more balanced relationship between the Council and the Mayor.
- **Information, supervision and monitoring.** Good decentralization requires a strong central government, with a good ability to monitor. Without regular, systematic information on local government performance, it would be impossible for the central government to monitor local government finances and to provide a reference for the performance of individual municipalities for promoting “yardstick competition” among them. In addition, without access to such information on comparable municipalities (benchmarks) it would be impossible for local communities -through NGO and private sector organizations- to hold local officials accountable.

Currently systematic monitoring only exists with respect to inputs to local government activities mostly through quarterly financial reports submitted to the Ministry of Finance. However, decentralization, especially in the second phase of the Macedonian reforms, should allow substantial discretion of local governments with respect to using financial resources. Thus, financial monitoring would be essentially limited to monitoring that local governments are executing their budgets as planned and are adhering to the central government financial guidelines.

Rather than “monitoring” financial reports on a one-by-one basis, these reports should be aggregated into a database at the center, allowing for more systematic analysis of the performance of municipalities. Moreover, if these data are imported into a common database format, they can be easily shared with all stakeholders within the central government, research community, and the citizenry at large. In the latter case it would promote horizontal accountability so that local citizens would not only be informed about the finances of their own locality (as currently required by law) but also that of other localities to serve as a benchmark of how their local government performs relative to comparable localities. Moreover, what local citizens need to know is not so much dry budget figures but performance indicators, such as how the reading test results at the local school compare to that of a comparable municipality.

Thus, in the near future it should become more important to monitor outcomes rather than inputs to local government activities. Currently this kind of supervision by line ministries is only limited to sporadic inspections. While indicators for monitoring the performance of the transferred competences have been discussed by the DWG sub-groups, currently there is no system in place to ensure some minimum standard of service outcomes in the decentralized sectors.

- **The central government does not always keep the rules it makes.** Smoothly functioning relationships between the central government and the municipalities depend critically on both sides complying with the rules of the game as set forth in the laws and regulations framing the decentralization system. So it does not help or set good example when central government agencies fail to respond on a timely fashion to municipalities’ requests or initiated procedures. For example, reportedly master urbanization plans prepared by local governments in some cases have not been reviewed and approved by the central government within the legally set time frame. Given that some of these municipalities are governed by opposition parties, it might create an impression of some political motives even when it is not the case. Although this situation might have understandable reasons, such as lack of resources and transitional issues in the newly

decentralized area, an official response explaining the delays should be forthcoming. This type of incident combined with the existing mistrust going along partisan and ethnic lines may unnecessarily poison the much needed cooperation among the two levels of government in the area of concurrent responsibilities and others.

II. 2. Assignment of Expenditure Responsibilities

The first and most important step for successful fiscal decentralization is the clear assignment of expenditure responsibilities. Without certainty and transparency in “who is responsible for what” there is no accountability in the system and further, there is no point in discussing or defining revenue assignments or transfers since it would be impossible to identify the revenue needs of local governments. In this section we look at the state of the current assignment of expenditure responsibilities and identify the main issues that need to be addressed in this area.

II.2.1 Review of Current Expenditure Assignments

The Law on Local Self Government adopted in January 2002 broadly defines the functional responsibilities of the municipalities. In doing so, the law distinguishes between: 1) the general competency to perform activities of local importance (Art 20); 2) a list of specific competencies assigned to municipalities (Art 22), and 3) delegated competencies, which can be entrusted for the execution or implementation by an individual mayor. (Art 23).

The competency to “to perform activities of local importance,” as in group 1) above, is envisioned to be “as a rule comprehensive and exclusive,” allowing municipalities to “independently regulate and perform activities of local importance...within the legal framework.”⁷ These provisions combined with the definition of the general competency as covering activities “not under the competency of the organs of the state administration” imply the exclusive assignment to municipalities of the first category of activities.

However, this provision for exclusivity does not seem to apply to the specific competencies listed in Article 22 or group 2) above. Indeed the requirement for these twelve specific areas of local competence is to “be performed in accordance with the standards and procedures determined by law.” This may be interpreted to be more restrictive than the wording of “within

⁷ Municipalities are also set to be responsible for those activities meaning a liability “to compensate for the damage caused to third parties by the procedures or flaws during the performance of [local] competencies.”

the legal framework” used for the first category of competencies. In addition the key social services listed in article 22, such as education, social welfare and environment protection, do not seem to fall under the “activities of local importance,” that figure in the exclusivity clause. As we explain later in this section, the impact of these competencies spills over the local boundaries thus making them unsuitable to be assigned exclusively to the local level. To the extent that some of these competences have national concerns, the national government has to co-share responsibility for such functions. Therefore, the ongoing interpretation and the one we follow here is that the assignment of specific competences in article 22 is one of concurrent or shared responsibilities. Reportedly, the current interpretation of these legal provisions by government officials is that with respect to functions of article 22 local competences are exclusive only in specific sub-functions further defined by subsequent legislation.

These concurrent responsibilities are performed in the following areas:

- Urban and rural planning
- Protection of the environment and nature
- Local Economic Development
- Communal activities
- Culture
- Sports and recreation
- Social welfare and child protection
- Education
- Healthcare
- Execution of preparations and undertaking of activities for protection and rescuing of citizens and goods in case of destruction in war, natural disasters and other accidents
- Firefighting and
- Other activities assigned in separate legislation.

In the delegated functions or group 3) above, the central government can transfer the execution of certain functions to the municipalities taking into account their specificities (e.g. the size, the number of inhabitants, general administrative capabilities, etc.). Delegated responsibilities are financed by the central government, who keeps local authorities accountable for delivery of services but retains subsidiary responsibility for the outcomes.

With the exception of the possibility of delegated functions, all municipalities have the same expenditure responsibilities. While the City of Skopje has special legal provisions for sharing the competencies with its constituent municipalities, the municipal and city governments of Skopje as a whole are assigned the same package of functions as other municipalities.

The law provides municipalities with sufficient flexibility to seek more efficient modes of service delivery. Thus municipalities can establish municipal companies for public services or outsource actual delivery to private companies. In addition, some municipalities are making use of inter-municipal cooperation agreements with neighboring municipalities for the implementation of some functions requiring certain scale of provision to achieve minimum costs. Notwithstanding these developments, an appropriate legal framework for inter-municipal cooperation is still lacking.⁸

Since the adoption of the Law on Local Self Government, the Government of Macedonia has been working to better define the legal and regulatory framework required for the actual transfer of responsibilities, including the clarification of the content of these competencies and the related resources to the municipalities.

The discharge of the transferred competencies by municipalities is heavily dependent on the content, quality and timeliness of the legislative and regulatory framework. The new legislation and amendments required to guide the transferred competencies were outlined in the Operational Programme for Decentralisation of Powers (OPDP) 2003-2004 and subsequently detailed in the Plan for Transfer of Competencies and Resources in the Process of Decentralisation adopted in 2005. Furthermore, the Sub Groups of the Decentralisation Working Group have identified additional legislative initiatives.⁹ Table 1 summarizes the current situation in terms of legislative and regulatory framework for the implementation of the transferred competencies. Overall, ten laws and forty seven by-laws still have to be adopted.

⁸ UNDP provided assistance in drafting a law on inter-municipal cooperation law currently submitted to the Ministry of Local Self Government for review and subsequent approval.

⁹ The thematic sub-groups were set up by the Decentralization Working Group in November 2005 in correspondence with the sectors for the transfer of competences. The main role of the sub-groups is to support and monitor the transfer of competences to the municipalities.

Table 1. Progress with the legal and regulatory frameworks for transferring functions (as of December 2006)

Sector	Identified in OPDP & DPTCR		Identified by the Sub-Groups	
	Laws (Adopted/Total)	By-laws* (Adopted/Total)	Laws (Adopted/Total)	By-laws (Adopted/Total)
Urban Planning	6/6	17/27	3/5	-
Local Economic Development	4/5	¼	4/7	3/3
Culture	4/4	5/8	1/1	-
Education	3/3	5/16	-	-
Protection and rescue of citizens and goods ¹⁰	2/2	4/7	-	39/39
Environmental protection	4/5	21/29	0/2	-
Communal services	3/3	3/5	11/12	3/7
Social and child protection	2/2	8/9	1/1	2/2
Sport and recreation	1/1	1/3	-	-
Health care	2/2	-	-	-
Total	31/33	65/108	20/28	47/51
<i>Outstanding</i>	2	43	8	4

* Some laws were mentioned in the OPDP though the accompanying by-laws were identified only after the adoption of the DPTCR, e.g. in the sectors of Urban Planning and Environmental Protection.

Source: *Decentralisation Review, EU CARDS TAD Project, November 2006*

The transfer of responsibilities has been facing other problems. It appears that developments in the legislative and regulatory framework for the transferred competences are being followed independently by the municipalities through the Official Gazette, and that subsequently these responsibilities are implemented without specific follow-up from the line ministries. This process is far from desirable in terms of quality and standards and it is particularly difficult for small municipalities, which are more likely to lack the tools to timely monitor and appropriately comply with the legislative changes.

Regarding the actual process of transferring competencies to the municipalities, the Detailed Plan for Transfer of Competences and Resources (DPTCR) foresaw the transfer of institutions, employees, movable and immovable property and documents to the municipalities in the respective areas of competence. Most of this has already been transferred. However, the full transfer of immovable assets has been delayed for a complex set of reasons including the

¹⁰ The protection and rescue sector of competence comprises the firefighting area as well.

existence of disputed ownership titles. Table 2 summarizes the status for “the content of transferred functions.”

Table 2. Status of the content of transferred competencies

Sectors	Content of the transfer	Transfer Status
Urban Planning (regional branch offices of the Ministry of Transport and Communication)	Decision-making authority; title of movable and immovable goods; employees; working means and documentation	Over 280 employees, movable properties and documentation through individual agreements ¹¹ have been transferred. Title of immovable goods of the 34 regional units of the Ministry of Transport and Communication yet to be transferred due to disputed ownership rights.
Local Economic Development	Decision making authority	
Culture (institutions in culture such as museums, libraries, theatres and homes of culture)	Decision-making authority; founding rights of the public institutions; title of immovable goods; employees; working means and documentation	The founding rights have been transferred in 2004. A total of 48 institutions located in 28 municipalities out of which 40 are municipal and 8 are of the City of Skopje. Title of immovable goods of 28 out of 48 institutions yet to be transferred due to disputed ownership titles. Contracts or individual agreements have been signed by 26 municipalities and 3 are still to be signed.
Education (dormitories for pupils; primary and secondary schools; transport for secondary school; area units of the Ministry of Education and Science)	Decision-making authority, founding rights of the public institutions; title of immovable goods; employees; working means and documentation	339 primary schools with around 18,505 employees, 81 secondary schools with 6,655 employees and 25 dormitories have been transferred to the municipalities and the City of Skopje. This includes the title of immovable goods, equipment, inventory, archive, teaching equipment, documentation and other means. The transfer of the movable assets and real estate property of the regional units of the Ministry of Education and Science is ongoing.
Protection and rescue of citizens and goods* (Territorial Fire-Fighting Units)	Decision-making authority, founding rights, title of immovable goods; employees; working means and documentation	29 Territorial Fire-Fighting Units have been transferred only one has not been transferred. Title of immovable goods yet to be transferred due to disputed ownership titles. Out of 715 employees 710 have been transferred.
Environmental protection	Decision-making authority	
Communal services ¹²	Decision-making authority	
Social and child protection (child day care centers, elderly homes)	Decision-making authority, founding rights of the public institutions; title of immovable goods;	Founding rights, 51 child day care centers with 3236 employees transferred. Title of immovable goods of 33 child day care centers yet to be transferred due to fully or partially disputed ownership titles. Founding rights, 3 out

¹¹ The transfer of immovable goods, equipment, employees and other working means from the central to the local governments is carried out by Individual Agreements or Contracts between the competent line ministry and the municipality.

¹² Communal activities are deployed by municipal owned enterprises, in most cases a single multipurpose entity.

Sectors	Content of the transfer	Transfer Status
	employees; working means and documentation	of 4 elderly homes as well as the ownership title of movable assets and employees have been transferred ¹³ .
Sport and recreation (sport facilities)	Decision-making authority, founding rights ; title of immovable goods; employees; working means and documentation	Right to use 9 buildings for sport and recreation transferred to the City of Skopje, 3 to the municipalities of the City of Skopje as well as 10 sport facilities to nine other municipalities
Health care (representation on institutions' management boards and health prevention-vaccination)	Decision-making authority	

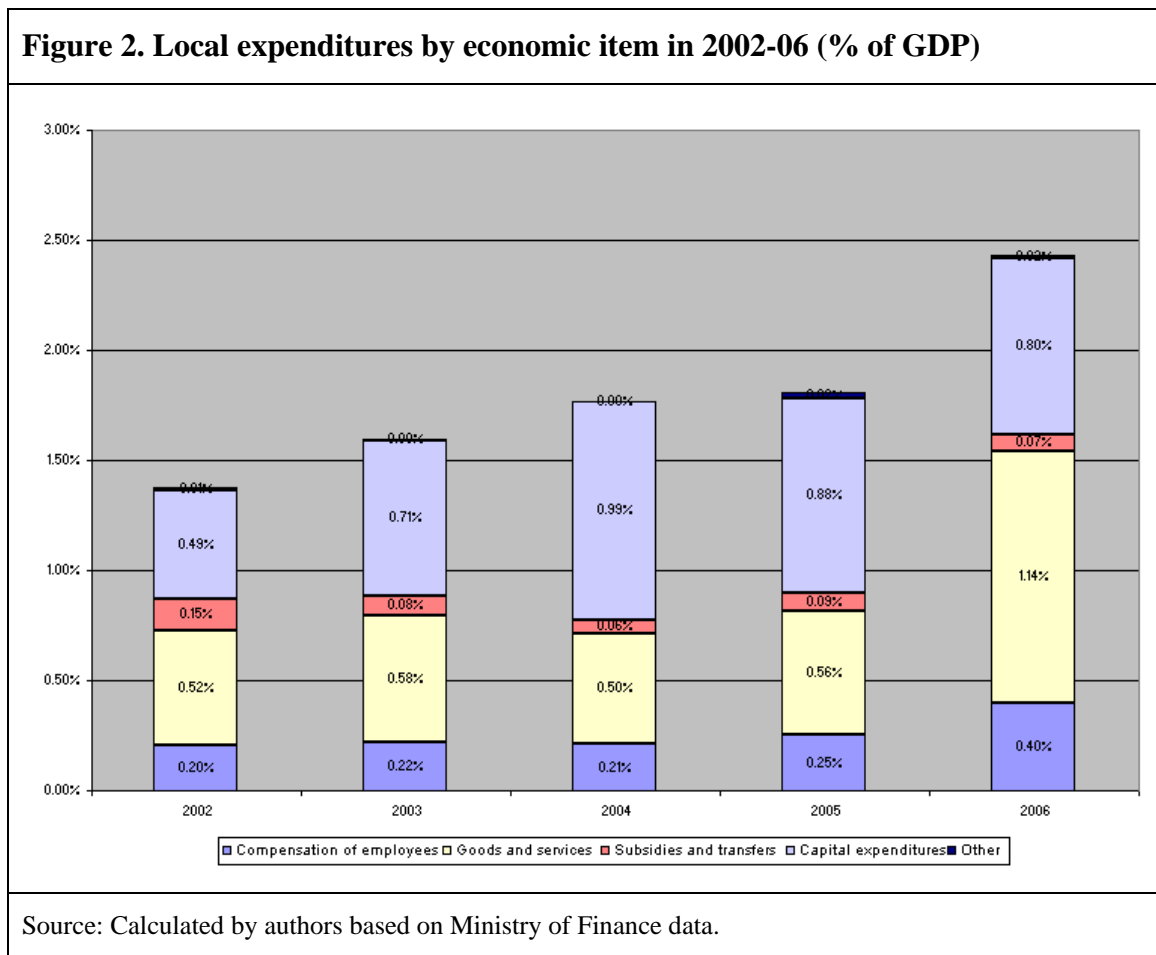
Source: Compiled by the authors from different sources

An important feature of the current process of transferring responsibilities is its focus on the transfer of facilities, the operation and maintenance of these facilities and personnel. The consequence of the approach is that municipalities that did not have any of those facilities in their territories continue to be deprived or unfunded for the full exercise of the transferred functions. This is because for a number of sectors (education, social protection, culture, fire-fighting) transfer of resources is earmarked for specific expenses in the existing facilities rather than local needs for specific services.

II.2.2. Fiscal Significance of Local Competencies

The evolution of local expenditures shows two distinct phases (Figure 2). In 2002-04 we can see a clear trend of decreasing outlays on subsidies and rapidly increasing capital investments, which more than doubled over those three years. However since 2005, capital outlays have been declining while expenditures on goods and services doubled and personnel expenditures increased by sixty percent by year 2006. All in all, as a share of GDP local expenditures almost doubled from 1.37% in 2002 to 2.43% in 2006, most of which occurred in 2006. Nevertheless, local public expenditures remain quite low by international standards. In 2006, as a share of total government expenditures, local expenditures accounted for less than 7 percent compared to the 26 percent average for transitional countries.

¹³ The elderly home transferred to the City of Skopje has not been taken by the City so the process of transfer is still ongoing. The point made by the City of Skopje is that the Ministry of Labor and Social Policy does not transfer as well financial means to take care of the elderly people.



In order to interpret these fiscal data in terms of local powers, we should point out that local authorities have varying degrees of discretion with respect to different parts of these resources. Indeed, local governments operate through a set of separate budgetary accounts: 1) principal budget; 2) budget of donations; 3) the budget of earmarked grants; and 4) the budget of self-financing activities.¹⁴ Essentially local authorities have full discretion for the allocation of funds from the principal budget account only. Resources in the donations account are often bound by the donation agreement; earmarked grants can be used only in line with financial plans of institutions (schools, museums, etc) approved by line ministries; and receipts from self-financing activities (e.g., renting school premises for extra-curriculum activities) are paid directly to the accounts of individual institutions, which can use these moneys at their own discretion (possibly sanctioned by school boards and subject to the general public finance regulations).

¹⁴ In addition, there can be another account for loans if a municipality is authorized to borrow.

Table 3. Composition of local expenditures by economic item in 2006 (% of total)

	Principal budget	Donations	Self-financing	Earmarked grants	Total
Salaries	13.0	0.0	0.1	3.4	16.4
<i>out of which:</i>					
<i>Basic salaries and allowances</i>	9.9	0.0	0.0	2.3	12.2
Reserves	0.3	0.0	0.0	0.0	0.3
Goods and services	22.5	0.1	10.4	14.0	47.0
<i>out of which:</i>					
<i>Utilities, communication and transport</i>	6.7	0.0	1.1	8.8	16.7
<i>Repair and maintenance</i>	8.8	0.1	0.8	0.6	10.3
Interest payments	0.0	0.0	0.0	0.0	0.0
Subventions and transfers	2.8	0.0	0.1	0.1	3.1
Social benefits	0.2	0.0	0.0	0.0	0.2
Capital expenditures	31.8	0.4	0.6	0.0	32.8
<i>out of which:</i>					
<i>Construction of transport and urban infrastructure</i>	26.5	0.3	0.1	0.0	27.0
Repayment of principal	0.2	0.0	0.0	0.0	0.2
Total	70.8	0.6	11.2	17.5	100.0

Source: Calculated by authors based on Ministry of Finance data.

Note: Financing of salaries with earmarked grants is reported in the firefighting sector.

As shown in Table 3, the principal budget represents seventy percent of local expenditures and covers the bulk of expenditures in each economic category except purchasing of goods and services. In other words, local authorities have total discretion over two thirds of their total expenditures. The economic classification of expenditures for 2006 (Table 3) reveals in general a good balance between expenditures on wages and salaries, purchases of goods and services including maintenance, and capital expenditures. Notice that the recorded expenditures on interest payments account for less than 0.1 percent of total local expenditures

Table 4. Composition of local expenditures by program in 2006 (% of total)

	Principal budget	Donations	Self-financing	Earmarked grants	Total
General public services	26.5	0.1	0.0	0.0	26.6
Fire protection	0.2	0.0	0.0	3.4	3.6
Economic affairs	30.5	0.1	0.0	0.0	30.5
<i>out of which:</i>					
<i>Arranging of construction land</i>	7.5	0.0	0.0	0.0	7.5
<i>Maintenance of local roads and streets</i>	5.0	0.0	0.0	0.0	5.0
<i>Construction and rehabilitation of local roads</i>	12.7	0.0	0.0	0.0	12.7
Environmental services	3.4	0.1	0.0	0.0	3.5
Housing and community amenities	7.4	0.0	0.0	0.0	7.4
<i>out of which:</i>					
<i>Street lighting</i>	4.8	0.0	0.0	0.0	4.8
Recreation, culture, and religion	1.1	0.1	0.5	0.7	2.5
Education	0.8	0.1	7.2	11.5	19.6
<i>out of which:</i>					
<i>Primary education</i>	0.4	0.1	2.1	8.9	11.5
<i>Secondary education</i>	0.4	0.0	5.1	2.6	8.1
Social protection	0.0	0.0	3.4	1.9	5.4
<i>out of which:</i>					
<i>Child day care</i>	0.0	0.0	3.1	1.6	4.8
Other	0.8	0.1	0.0	0.0	0.9
Total	70.8	0.6	11.2	17.5	100.0

Source: Calculated by authors based on Ministry of Finance data.

According to the functional classification of local expenditures most of local resources are allocated to provision of economic infrastructure: roads and development-related services account for almost a third of local expenditures and almost a half of the principal budget (Table

4). The (close) second largest functional category of expenditures is general public administration, mostly dominated by the municipal apparatus as opposed to the elected bodies. The relative share of administrative costs is high by international standards. Several explanations may be behind this performance. First, high administrative costs might be explained by the high fixed costs due to rigid personnel requirement mandated by financial and sectoral regulations, which do not take into consideration the size of municipalities. Second, because administration costs are largely fixed costs of operation, the relative share for these operations tends to be higher in countries where local government expenditures represent a smaller share of consolidated public expenditures. Third, it is also possible that municipalities do not fully account costs by different functions and general administration becomes a default category.¹⁵

The third largest functional category is education services (primary and secondary), which represent one fifth of total expenditures in 2006. An interesting aspect of the information provided in Table 4 is that we can see that municipal expenditures on education financed with funds from the principal budget are very low. Most of the 20 percent of total expenditures on education are financed by earmarked grants (12 percent) and by self-financing sources for the schools (7 percent).

II.2.3. Issues in Expenditure Assignments

- The assignment of expenditure responsibilities in Macedonia presents two main problems. First, despite all the progress that has been made to date, the assignment of expenditure responsibilities still lacks clarity; this is a very serious challenge for the further development of the decentralization system in the country. Second, little or no attention has been given in the current legislation and practice on how to arrive at the expenditure needs that are associated with the current expenditure assignments. Admittedly, an assignment of responsibilities that lacks clarity would not allow a precise computation of expenditure needs, but in reality no forward looking methodology has been proposed or put to actual use to link expenditure assignments and expenditure needs. However, as discussed above the historical cost criterion has been used in some cases for earmarked transfers, both for aggregate funding of decentralized functions and for apportionment of these funds across individual municipalities. This void in the decentralization system has channeled the current dialog and discussions between the central and local governments on potential reforms of the system toward financing issues

¹⁵ In many countries it is not uncommon for smaller municipalities to assign all outlays by a multifunction unit to whichever purpose appears to account for the largest part of the tasks performed by that unit or just to general public administration.

(such as in revenue sharing and the determination of central transfers). For the most part, this discussion on financing issues has been and will continue to be sterile until expenditure assignments are finally clarified and a methodology is developed to arrive at the expenditure needs emanating from those assignments. The following paragraphs elaborate further on these and other issues on expenditure assignments.

- One main reason for the lack of clarity in expenditure assignments is that the current delineation of competencies in the decentralization laws was not preceded nor informed by the development of comprehensive policy frameworks in each of the sectoral areas to be decentralized. The decentralization programs while being comprehensive in terms of listing the laws/bylaws to be adopted, at the same time could not provide the strategic visions for how the sectors should operate because they are naturally void of any sectoral policy substance. Lacking direction in policy substance, the drafting of the decentralization laws went beyond the technical implementation of a policy strategy; instead the drafting of decentralization laws actually became the making of sectoral policy choices of strategy but this was internally done within the line ministries without engaging other stakeholders.
- An additional problem associated with not departing from an explicit policy framework is that later year policy changes are less likely to be consistent with the overall goals for the fiscal decentralization program. Absent a policy frame, self-interested groups might make amendments to specific policies that are not consistent with the other pieces of the program that are already in place. The danger is that over time, a system can lose focus. Therefore the proper sequence of expenditure assignments—and the rest of decentralization reforms—is to have consultations first that would result in specific policy choices documented in a policy framework that could guide drafting laws and regulations for decentralization. And it is never too late to go back and produce the policy frameworks especially in those areas where there is or there will be concurrent expenditure responsibilities.
- Some of the current assignments are questionable. Several of the twelve competencies transferred to municipalities have characteristics that make them unsuitable to be assigned exclusively to the local level. Thus, while municipalities might be advantageously positioned to monitor and enforce environmental standards, when going after a big local polluter—who could be the major employer in the locality or in fact a municipal company—they might not properly weigh environmental costs (negative externalities) mostly affecting other municipalities due to particular flows of air or water. Similarly, while municipalities might be advantageously positioned to identify socially

vulnerable individuals, those with the largest number of eligible individuals are also like to be the ones with poor resource base. Therefore, social protection cannot be exclusive responsibility of local governments either. To the extent that some of these competencies have to be concurrent, the central government, somewhere in the law or regulations needs to spell out how exactly the responsibilities will be divided in each of these sectors. And it is important that this division would concern specific outcomes in each sector rather than inputs, such as wages or facilities. This is important for the political accountability as the citizens can gauge the performance of authorities in terms of the quality and levels of services received but not whether the wages and bills are paid in an orderly manner.

- Currently, the wording used in the laws and regulations does not clearly delineate responsibility for the outcome of service provision. This may result from the absence of explicit policy frameworks for the sector but may also be due to less than rigorous drafting. Whatever is the cause, in practice even in the same ministry some stakeholders might hold an opinion that local governments are responsible for the final outcome of those services while other officials in the same ministry would tell you that local governments are only responsible for physical maintenance of facilities but not for finding effective policy measures that would respond to service needs of their citizens. Quite likely there is even less clarity in the mind of ordinary citizens for whom to hold accountable for the level and quality of services that they receive. Reportedly unclear delineation of responsibility has already led to blame shifting and finger-pointing at the other level of government in the case of wild fires getting out of control in Macedonia during the summer of 2007.
- As already introduced in the first paragraph of this section, a key aspect of placing responsibility for a particular function on municipal governments is to clearly define adequacy of resources (or expenditure needs) that “should follow the function.” For the most part, the manner in which adequate level of funding is determined has not been addressed in decentralization legislation. However, for block grants, article 12 (3) of the Law on Financing Local Governments requires that “the total amount of block grants shall not be lower than the amount of the funds from the Budget of the Republic of Macedonia used for the same purpose in that area in the previous year from the year when a certain competence is transferred.” Using aggregate historic spending can only work as a short-term measure as it would not make sense to maintain the same level of funding in the long-term if policy priorities change or, for example, the number of school age-children is reduced to half of what it used to be or prices change radically. But even

in the short term, the historical cost criterion has been a matter of debate and disagreement between local and central government authorities.¹⁶

- There are still unresolved issues with completing the transfer of institutions, employees, movable and immovable property and documents to the municipalities in their respective areas of competence. In particular this concerns titles of immovable properties. Municipalities have been particularly discontented about their lack of land ownership and see this as a main barrier for the implementation of local development policies, by for example offering land concessions to outside investors. To the extent that most of land in the country is state owned or lack clear titles due to past expropriations by the state, municipalities have been able to influence land use in their jurisdictions just by using the construction permit powers granted to them in the decentralization laws. This (central versus local land ownership) is a complex issue beyond the scope of this report. A possible step in resolving this issue is to have a national conference on land (central/local) ownership that would discuss pluses and minuses of reform and provide the basis for a national policy on this matter.
- The pre-qualification of the municipalities' administrative capacity for the second phase of decentralization (discussed in the transfer section of this report) is a positive feature of the process of expenditure assignment reform in Macedonia. Having an asymmetric assignment of responsibilities according to administrative capacity is complex but is a much more preferable situation to a situation where a number of municipalities are incapable of adequate service delivery. However, the second round of qualification that has taken place in recent months reveals two issues that need addressing. First, the set of criteria being used to qualify municipalities has been questioned for alleged unfairness or bluntness. In particular, municipalities get penalized if their budgets have been subject to multiple amendments during the course of past fiscal years. Although, clearly budget amendments can be a sign of budgetary weakness and mismanagement they may also be perfectly justified if there are unanticipated changes and shocks in either revenue sources or expenditure needs. So a finer definition of this criterion would be desirable. Penalizing municipalities for their level of unpaid debt and arrears, a second criterion used, is also understandable; however, some mayors may have inherited indebtedness and despite doing the right thing, such as paying part of the debt, they get penalized. Again a finer definition of the criterion would be desirable. A second issue that needs addressing

¹⁶ The study team has witnessed numerous opinions from local governments that earmarked grants have been underfunded. But, at the same time we have not seen any government document that would authoritatively show what the historic level of funding was and how it is related to the total amount of earmarked/black grants. The study team so far has not been able to obtain data on pre-2005 national expenditures broken down in sufficient detail to determine the historic levels of funding for transferred competencies.

in this exercise is a pro-active plan from the central government, customized for each of the municipalities that have failed to qualify, for how to help those municipalities qualify in the future. For those municipalities, which for issues of size, etc, will probably never qualify the plan should lay out alternative options, such as inter-municipal cooperation arrangements, to provide particular services.

- Communal service enterprises (local utilities), in most cases single multipurpose entities, owned by municipalities are not performing well; services are of poor quality and the future viability and quality of those services are in question. Over the last decade the assets and services of these enterprises have been deteriorating for lack of maintenance, rigid tariff control and poor financial management. Many of these communal enterprises carry arrears and are accumulating short term debts for financing their running costs. This in turn is negatively affecting the debt position of the municipalities as rightful owners. Reportedly in many cases the poor state of communal enterprises is due to past tariff policies, as controlled by the central government. To the extent that the problem is nation-wide and is partly caused by past central government policies, a central government program may be justified to help revitalize and rationalize the sector. Leaving municipalities to deal with this issue on their own threatens to compromise basic service delivery and may be especially unfair to residents of small poorer communities.

II.3 Revenue Assignments

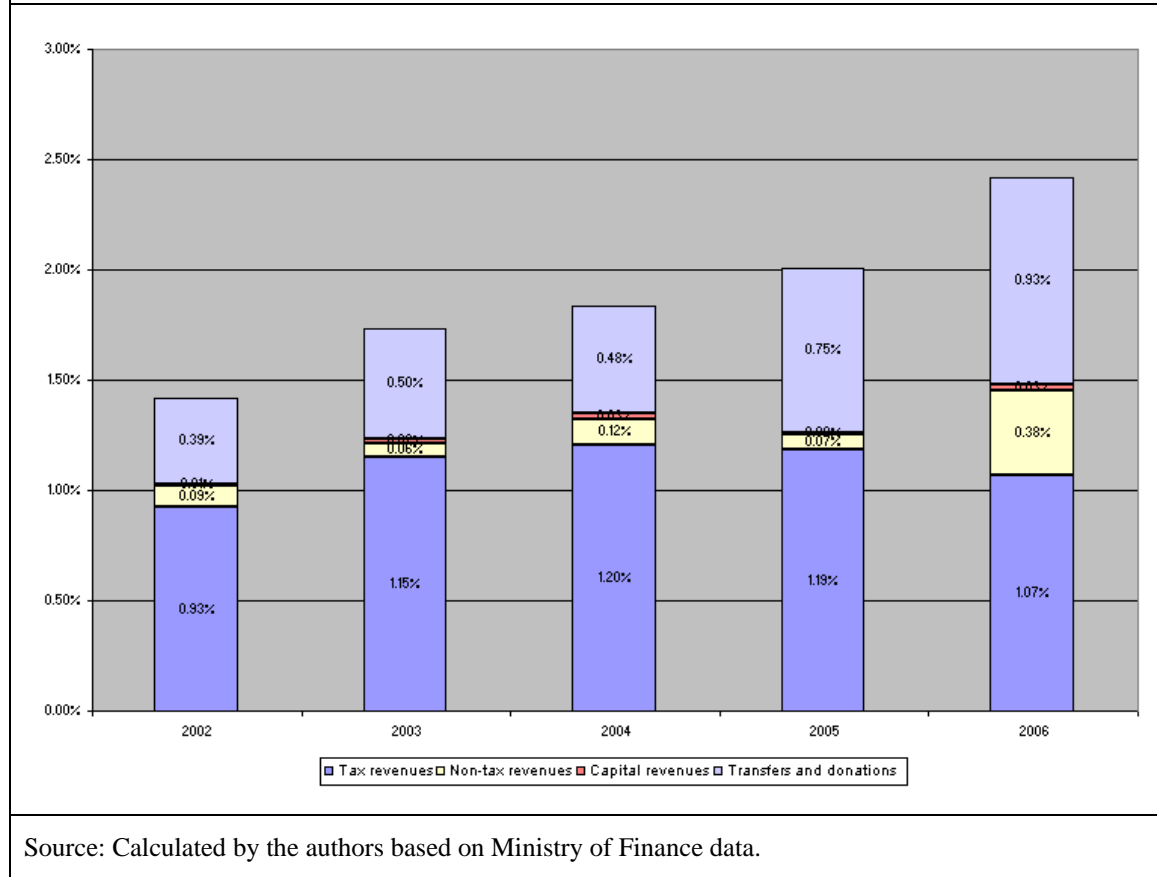
Once expenditure assignments and the adequacy of resources (or expenditure needs) associated with them are determined, it is necessary to look for what tax instruments and other sources can be assigned to local governments so that they can finance their expenditures. In this section we take a look at the recent evolutions of local revenues, what is the current structure and the main taxes assigned to local governments, and what are the main pending issues for reform in this area of the decentralization system.

II.3.1 Importance of Local Revenue Sources

Prior to recent reforms, local government units' independent collection of public revenues was limited. Most revenues were collected by regional branches of the Public Revenue Office of the Ministry of Finance and deposited in the national treasury account and then the funds were distributed to the municipalities in accordance to defined criteria. Starting with the first phase of

the fiscal decentralization in July 2005, the collection of revenue from municipal revenue instruments was assigned directly to the municipal administrations.

Figure 3. Local revenues as percent of GDP: 2002-06



Whatever impact these changes had on collections is not known at this time; importantly, there would be a need to separate the confounding effects on collections coming from other changes in the tax system besides the level of government responsible for collections. But let it as may be, Figure 3 shows a steady growth of own revenues of municipalities until year 2005 and a steady decline thereafter. At its peak in 2004 municipal own revenue from tax and non-tax sources reached 1.32% of GDP. By 2006 this revenue dropped to 1.13% of GDP.¹⁷

The examination of individual sources of municipal revenue shows revenue increase for all sources except communal fee and charges, which are dominated by revenue from construction permit fees (Table 5). A possible explanation for the behavior of communal charges is a reported

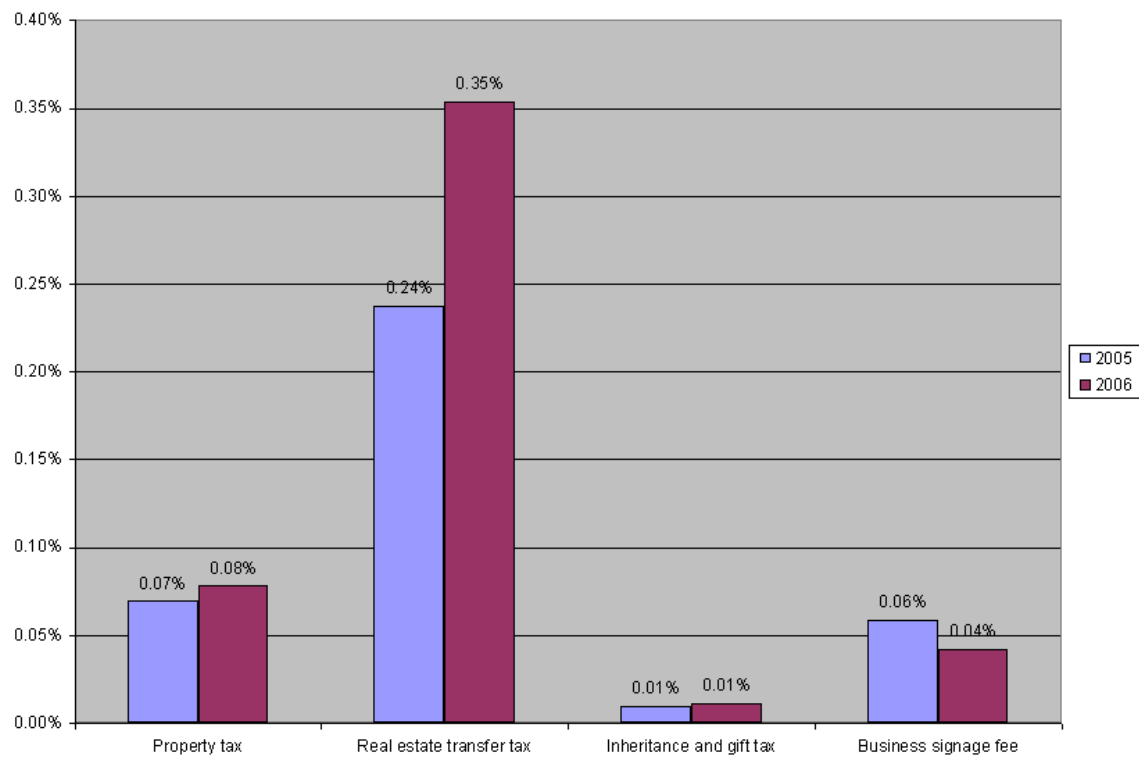
¹⁷ Note that for comparability purposes, the figure for 2006 excludes PIT shared revenues and revenue self-generated by schools.

delay in the approval of local master plans by the Ministry of Transport. The information we gathered in the field visits to the municipalities is that there is a backlog of building permit applications, which the municipalities cannot be issued without an approved master plan by the Ministry of Transport. At the same time it should be pointed out that the revenue from property taxes almost doubled in absolute terms between 2004 and 2006. Figure 4 suggests that between 2005 and 2006 revenue for all the three property related taxes increased but especially for the real estate transfer tax. However, these increases in property taxes were outweighed by the revenue drop from communal charges resulting in an overall decline in municipal own revenue as shown in Figure 3.

Table 5. Yield of local revenue instruments in 2003-2006 (% of GDP)

	2003	2004	2006
Income tax	—	—	0.07%
Property taxes	0.26%	0.26%	0.42%
Communal fees and charges	0.89%	0.94%	0.58%
Administrative fees and fines	0.00%	0.00%	0.02%
Service fees	0.01%	0.05%	0.29%
<i>out of which:</i>			
<i>Collected by schools and child day care centers</i>	—	—	0.26%
Other government services	0.01%	0.01%	0.01%
Other non-tax revenues	0.04%	0.05%	0.06%
Sales of capital assets	0.01%	0.03%	0.03%
Sale of land and non-material assets	0.01%	0.00%	0.00%
Foreign donations	0.02%	0.01%	0.09%
Total	1.24%	1.35%	1.57%

Source: Calculated by authors based on Ministry of Finance data.

Figure 4. Revenue performance of major local taxes as percent of GDP: 2005-2006

Source: Calculated by authors based on data from the Study on Measuring the Level of Collection of Property Tax (ZELS (2007)).

II.3.2 Current Revenue Assignment: What Revenue Instruments are Available to the Municipalities?

In this sub-section we discuss in more detail revenue assignments or what types of revenue instruments are available to the municipalities.

According to the law on financing the Units of Local Self Government (Art. 4-7) and subsequent legislation the municipal revenues are:

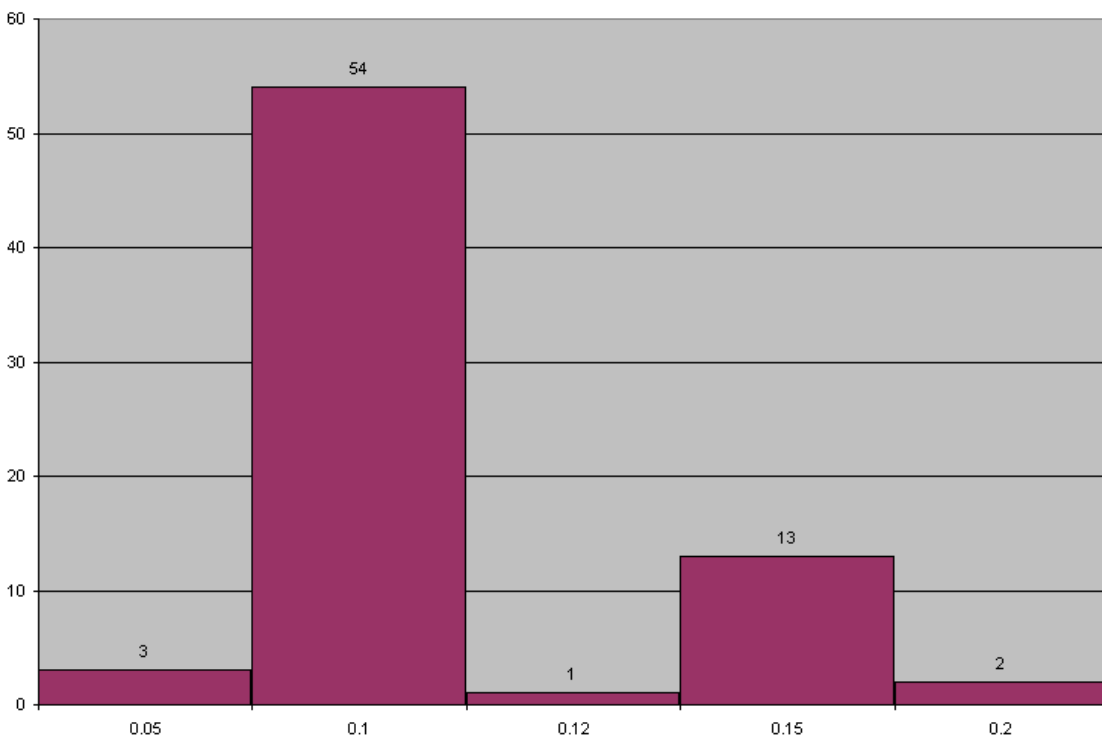
- 1) Property taxes (annual property tax, tax on transfer of real estate, tax on inheritance and gifts)
- 2) Local fees (communal fees, administrative fees)
- 3) Communal charges (development fees, communal activity charges, spatial planning charges)

- 4) Revenues from assets (leasing, interests, property sale)
- 5) Financial donations (a contract between the donator and the mayor after approval from the municipal council)
- 6) Fines
- 7) Self contributions (authorized through a local referendum)
- 8) Revenues from concessions on mineral resources and
- 9) Retained revenues from the national Personal Income Tax (PIT).

Property taxes

There are two types of property taxes, a traditional tax falling on asset ownership and a tax on the transfer of real estate assets.

Figure 5. Distribution of property tax rates in 2006 (number of LGUs)



Source: Study on Measuring the Level of Collection of Property Tax (ZELS 2007).

Property tax. The Law on Property Taxes (June 2004) differentiates among several categories of taxable property: 1. Non agricultural land; 2. Residential property; 3. Business premises; 4. Administrative buildings; 5. Buildings or flats for rest and recreation; and 6. Garages and other structures. Recently, business building and premises and residential facilities in villages located in mountain areas have been removed from the list of exempted properties and thus became taxable. In the Law, the taxpayer is the property owner or its user/beneficiary.

Since July 2005, municipalities have been fully in charge of collecting property taxes. Thus they are responsible for property identification, property valuation, preparation and issuance of tax bills, collection, accounting, enforcement and the initial review of appeals.¹⁸

The Law on Property Taxes gives discretion to the municipalities to set the property tax rate between a minimum of 0.10 percent and a maximum of 0.20 percent of the “market” value.¹⁹ According to a survey of municipalities conducted by ZELS, the most common rate is the minimum 0.10 percent but there is some variation in the application of rates with many municipalities applying a rate of 0.15 percent (Figure 5).

The municipalities are supposed to keep the register of the real estate properties subjected to annual taxation. The property roll including the software to read all the property data have been transferred to the municipalities from the Public Revenue Office (PRO) starting from the second half of 2005. The transfer of data has been encountering significant problems; the property rolls from the PRO date back to the self-declaration by owners exercise in 1994 and have been hardly updated since that time. However, some municipalities are updating their property tax rolls via field surveys and by using secondary information sources on properties. In this regard, it is unfortunate there has been a lack of collaboration and exchange of data and information between the national agencies with real estate information (specifically, the Property Cadastre and the Land Registry) and the municipalities, which in most of the cases, have to pay for any of this information.²⁰

The tax base of the property tax is a market-calibrated value that is assessed by the municipality on the basis of the “Methodology for Establishing the Market Value of Real Estates” developed by the Ministry of Finance.²¹ The application of the methodology is quite complicated and it

¹⁸ The final decision on appeals is issued by the Ministry of Finance.

¹⁹ In the City of Skopje both the city and municipal governments can introduce and receive revenue from their own rate of up to 0.05 percentage points levied on top of the minimum rate of 0.1 percentage point, for which the revenue is shared equally between the two tiers.

²⁰ The Property Cadastre and the Land Registry are being updated through the World Bank-supported Real Estate Cadastre and Registration Project.

²¹ This work was done with technical assistance from USAID.

requires sufficient information at the local level, skilled human resources and adequate financial resources.²²

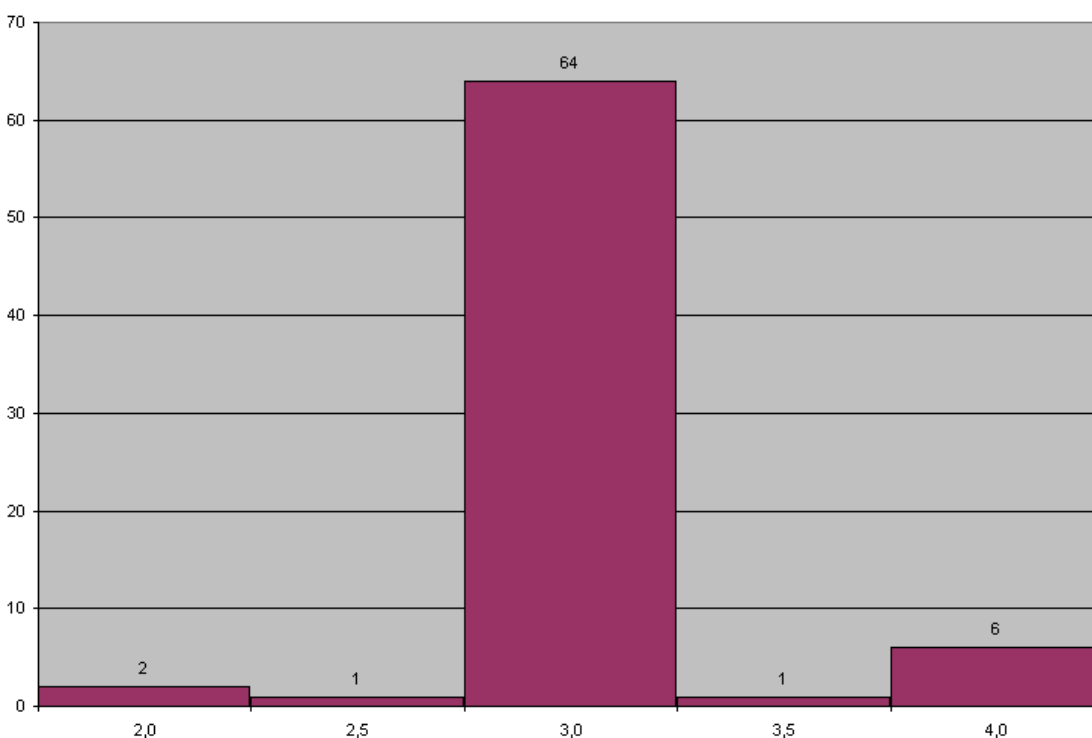
The transfer of responsibility for property tax collection to municipalities has gone less smoothly than desired due to some institutional failures. Reportedly, information in the database of the taxpayers and property objects was transferred after “a tremendous delay and without the software required to read the data.”²³ As a result, municipalities had to hire private companies to transfer the data into usable form. The Law allows municipalities to outsource revenue collection to the PRO, to another municipality or municipalities can collaborate among themselves to perform this task. The delays in transferring the property tax data to municipalities forced at least fifty municipalities to turn back to PRO for issuing property tax bills at a fee of MKD 6 per bill in 2006.

Because, among other things, of administration difficulties and because of its structure, mainly low rates, the annual property tax is still underperforming as a local source of revenue. As of 2006, revenues from the property tax represented only 2.7 percent of the municipalities’ total budget or 0.06% of GDP. The average percent of GDP collected in developing and transitional countries from the property tax is about ten times of what is currently collected in Macedonia.²⁴ Thus, there is a great deal of potential for this tax to become a much more important source of municipal revenues.

²² Some international donors, including UNDP, are supporting a number of pilot municipalities in the application of this methodology.

²³ OSCE/PARD-Survey on the Implementation of the Process of Decentralization, July 2006, p. 32.

²⁴ Forthcoming R. Bahl and J. Martinez-Vazquez, and J. Youngman, (eds.) *Making the Property Tax Work in Developing Countries*. The Lincoln Institute of Land Policy, Cambridge, MA .

Figure 6 Distribution of tax rates or real estate transfer in 2006 (number of LGUs)

Source: Study on Measuring the Level of Collection of Property Tax ZELS (2007).

Tax on the transfer of real estate. This is fundamentally a sales tax on real estate transactions (where there is a transfer of property rights for compensation.) The tax base is the same fiscal valuation of property as for the property tax (i.e., the annual assessment) and the gift and inheritance tax. Within 15 days from signing the transfer agreement for the property, a tax return has to be filed by the seller (or the buyer if stipulated in the sale contract) with the municipality; at this time, the municipality assesses the property value and issues a tax bill. The tax payment has to take place before the notary can “validate” a real estate transaction, which then undergoes cadastral registration. The tight deadlines for the property transfer tax contrast with the annual property tax bills issued by the PRO which apparently did not have a due date. Perhaps partly as a result of that plus higher rates, the property transfer tax has been more productive yielding 0.35% of GDP compared to 0.06% for the annual tax.²⁵ The law allows municipalities to set a rate in the range of 2 percent to 4 percent of “market” value; just a few municipalities use the maximum rate of 4 percent and the vast majority has set a rate of 3 percent (Figure 6).

²⁵ Collections from the inheritance tax only represent 0.01 percent of GDP.

Communal fees

Communal fees are charged for the following objects and services:

- Signs, i.e. the designation of the company displayed at the premises;
- Utilizing space for pitching tents and other similar temporary equipment;
- Utilizing pavements in front of the premises for carrying out business activity;
- Displaying advertisements, messages and announcements at the public places;
- Performance of the music in the public places;
- Placing entertainment objects in the public places;
- Placing showcases for the displaying goods outside the premises;
- Parking motor vehicles and their sidecars, motorcycles, motors and bicycles in a parking lot designated by the municipality;
- Using squares and other parts of the cities, municipalities and other settlements with a purpose of displaying objects, organizing exhibitions and other entertainment performances for a commercial purpose;
- Using the street for passenger, freight, highways, vehicles and sidecars, except for those subject to a property tax and
- Street lighting funded with an excise on billed electricity usage.

Some of the fees and tariffs are set freely by the municipalities; in some other cases, as for communal fees, the tariffs are given by the Central Government within certain ranges. Most of the revenues in this category are generated by the public lighting fee and the business signage fee. The public lighting fee is levied as a fixed monthly amount per electric meter (currently MKD 450, set by the national government) and is collected by the electricity distributor along with the electricity usage bill. Although this form of arrangement has been a very successful collection vehicle in other countries, in Macedonia it has not worked well thus far. Reportedly the collection rate of the fee is not high because the electricity distributors are able to charge the full costs of street lighting to the municipality even if they fail collect the electricity excise due to the municipal budget. The revenue from the public lighting fee accounts for about 3 percent of local budgets, which is below the 5 percent share of local budgets accounted for by public lighting costs.

The business signage fee is charged on businesses according to schedules differentiating among use types and location, and thus it resembles an imputed business income tax. Revenue from the business signage fee accounts for about 2 percent of local budgets.

Communal charges

Among the charges for specific services, the construction permit fee is the most significant municipal own source of revenues. On average it accounts for 20 percent of local budgets. However, in the City of Skopje the fees on construction land account for around 40-50 percent of the total local revenues compared to less than 25 percent in other urban municipalities and less than 15 percent in rural municipalities. Since construction activities are mostly carried out in the cities, smaller municipalities do not have much access to this type of revenue. Another possible reason is that the smaller municipalities do not have urban plans adopted or approved by the central government, without which they cannot issue a construction permit and therefore do not receive these payments.

Revenues from property

The amount of the municipalities' revenues from property leasing or sales is very low (0.01% of local budgets). This situation is in large part a result of the modest property ownership of the municipalities. The municipalities obtained the right to own real estate during 1999 and 2000 but the process of property transfer between the central government and the local government units is still ongoing with the difficulties described above. But clearly, from the point of view of municipalities the potentiality of revenue from property is largely underutilized and it reduces de facto municipal autonomy.

The sharing of PIT revenues

Although revenue sharing is truly another form of intergovernmental transfers rather than a revenue assignment, traditionally derivation-based revenue sharing has been classified as another source of local tax revenue. It is in that spirit that we review the sharing of Personal Income Tax (PIT) revenues here. In Macedonia the revenue from PIT is allocated among the two levels of government as follows:

- 3% from the personal income tax from salaries of physical persons allocated to the municipality where they are registered with permanent domicile and residence:
- 100% from the personal income tax from physical persons who are performing craft activities, registered in the territory of the municipality in accordance with the Law on Craft Activity.

In general, as a way to promote accountability municipal financing through own taxes is more desirable than through revenue sharing. However, if revenue sharing is to be used as a means to close the vertical gap in revenue sources for local governments, the sharing of the PIT on a

“residence basis” is the most preferred form of revenue sharing.²⁶ Therefore, the sharing of PIT revenues in Macedonia rests on sound theoretical basis. However, this revenue sharing has been criticized for being too small or even trivial. Revenues from PIT sharing account for only 2.8 percent of local budgets.²⁷ By international standards, indeed a 3 percent sharing rate would seem to be extremely low. However, the right sharing rate cannot and should not be discussed in and by itself; the appropriate rate of PIT sharing has to come from a careful evaluation of the expenditure needs of local governments and whatever sources of revenues (including transfers) are available to them. Revenue sharing from the PIT should be seen as the means for closing any possible vertical gap being mindful that its application will not be equalizing; this is simply because richer jurisdictions will get more absolute revenues from the homogenous sharing rate.

II.3.3 Issues in Revenue Assignments

- The design of revenue assignments in Macedonia faces the constraint of very significant fiscal disparities. While own revenue on average covers about 70 percent of local expenditures, in some rural municipalities it is as low as 6 percent. There is great disparity in revenue sufficiency among municipalities ranging from 88 percent for the Skopje local governments to 53 percent for other urban municipalities to just 29 percent for rural municipalities. These disparities impose a limit on how much to rely on increases in tax autonomy and revenue retention, and more importantly, these disparities highlight the important role to be played by an equalization grant system.
- Another fundamental problem with revenue assignments in Macedonia is the need for increased revenue autonomy. Even though the property tax has been assigned to the local level with discretion to change tax rates, this and other local taxes still fall short of providing adequate financing to local government. As a general rule own taxes should provide the richest jurisdictions with close to 100 percent of their revenue (expenditure) needs. While local governments within the City of Skopje on average finance almost ninety percent of their principal budgets from own sources, these revenues will be

²⁶ A residence basis (as opposed to a workplace basis) makes individuals pay their income tax contribution in the jurisdiction they live in, which may be different from the jurisdiction where they work. The presumption for the choice of residence basis is that individuals tend to consume more local public services in their place of residence as opposed to their place of work, if these differ.

²⁷ One aspect contributing to the small importance of these revenues is that the national PIT only raises 2.4 percent of GDP.

dwarfed by the level of expenditures required in the newly decentralized sectors, in particular wages of teachers and other formerly national employees.

- One problem that we have identified already is that the revenue yield for the (annual) property tax is very low at 0.06 percent of GDP; this yield should be increased to at least the average in other transitional countries, which means that the yield needs to be multiplied almost by a factor of 10. At the same time the taxation of property transactions is heavier than in other countries yielding 0.35 percent of GDP. While taxing property transactions is easier from the administrative perspective, at the same time it is more detrimental for the real estate markets as optimal taxation requires lighter taxation of more elastic tax bases.²⁸
- Introduction of derivation-based sharing of PIT—that is allocation of a share of tax revenue to the local budget where the taxpayer resides—has certain promises but also dangers. Generally establishing a link between the jurisdiction receiving revenue and the place where taxpayers receive local services is beneficial because it gives local governments the right incentives to fund an optimal amount of locally provided goods (where marginal costs equal marginal benefits). It also promotes accountability by enabling local residents to evaluate the efficiency of local government services as to how much value they get for the money they pay. However, unlike local taxes, tax revenue sharing does not constitute the kind of cost-benefit link that would lead to efficient level of service provision and accountability of local officials to their constituencies. The reason is that, even if local residents face the tax price of the local services funded with retention of the yield from the shared tax, efficient allocation does not occur because residents cannot respond to this tax price by choosing more or less of the local service. Because localities cannot adjust the rate of the shared tax, there is likely to be a mismatch between the distribution of the local yield from the local tax and the distribution of need for local services. Thus, in its present form PIT retention is just a counter-equalizing form of intergovernmental transfers with the revenue impact too small to justify the administrative costs of revenue allocation separate from other transfers.
- Besides increasing the revenue yield of annual property taxes, by a more efficient administration and by raising the range of rates applicable by the municipalities, the most promising avenue for raising revenue autonomy is the introduction of local surtax (or

²⁸ It has been a common wisdom that property transfer taxes are discouraging market for at least two centuries since David Ricardo identified them as the ultimate 'anti-market' taxes.' A thorough discussion and references to the literature can be found in Richard M. Bird, "Stamp Tax Reform in Colombia," *Bulletin for International Fiscal Documentation*, 21 (June 1967), 247-55.

piggyback) on the PIT.²⁹ This tax would be a flat rate, with minimum and maximum rates nationally legislated, and would have the same tax base as the national PIT. If national policy objectives are to reduce tax burdens, this proposal can be accommodated easily by the central government creating “fiscal space” for the local piggyback PIT by reducing the national flat PIT rate by several percentage points. The heavier reliance on autonomous taxes, including the piggyback PIT, is far preferable to the expansion of PIT revenue sharing.

II.4. Intergovernmental Fiscal Transfers

It is practically impossible to design revenue assignment in such a way that all local jurisdictions will have their revenue needs satisfied. Because there are disparities in the economic base and fiscal capacity of local jurisdictions producing horizontal fiscal disparities, there will always be a need for a system of equalization transfers. In addition, because central governments may have an advantage in centralizing the collection of many productive taxes, there is likely to be vertical imbalances which need to be closed by central government transfers. Other transfers may be needed because central governments want to stimulate local expenditures in areas of national priority, need to address externalities across jurisdictions, or because of some other centrally determined sectoral objectives. In this section we first review the current status of the transfer system in Macedonia and later we analyze the main issues and options for reform.

II.4.1 The current system of intergovernmental fiscal transfers

The fiscal decentralization process started in July 2005 was slated to take place in two phases. The evolution of Macedonia’s intergovernmental fiscal transfer system is closely connected with that phased approach to fiscal decentralization reform.

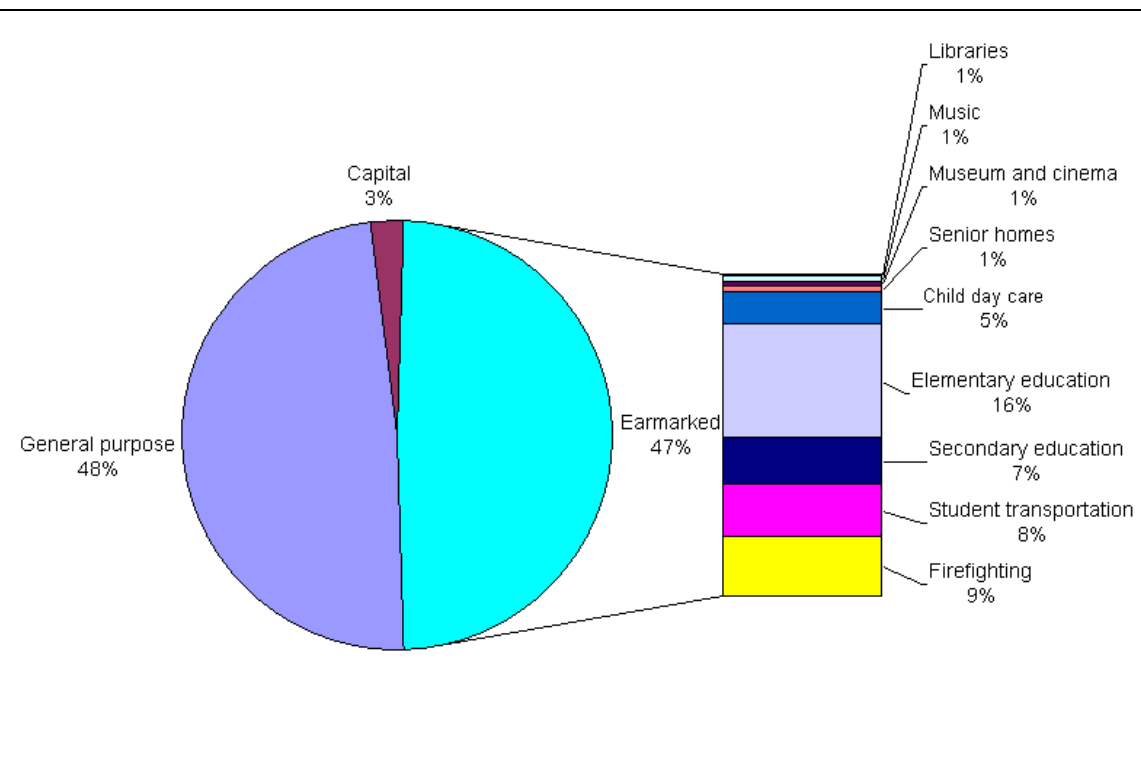
The first phase of fiscal decentralization

The Law on Financing the Units of Local Self-Government (Art. 8-13) foresees the following type of transfers from the central government to the municipalities: 1) three earmarked grants for assisting municipalities respectively in the areas of education, culture, social policy and child protection; 2) a general purpose transfer from VAT (shared) revenues; 3) retention (sharing) of Personal Income Taxes (PIT); 4) capital grants; and 5) funds received for delegated competencies. As shown in Figure 7, the general purpose transfers accounts for 48 percent of all

²⁹ See the Methodology Appendix for more details on piggyback taxes.

intergovernmental grants;³⁰ in the second place, earmarked grants account for another 47 percent, while capital grants account for only 3 percent of the total transfer amount.³¹ In the following paragraphs we look into each of the transfers in more detail.

Figure 7. Composition of grants to municipalities, 2006



Source: Calculated by authors based on Ministry of Finance data.

VAT transfer

Since the start of the fiscal decentralization process in July 2005, a share of the Value Added Tax (VAT) has been allocated to the municipalities as an unconditional general purpose grant. The amount shared with municipalities has been set at 3 percent of the VAT revenues collected in the

³⁰ On this figure, the category of general purpose transfers also includes grants from the Public Roads Fund, which although require local governments to produce a work plan for maintenance and construction of local roads, are not earmarked for specific projects and are allocated to the principal budget of municipalities on a formula basis similar to that for VAT revenue.

³¹ Recall from Figure 3 that the total amount of grants accounted for 38 percent of municipal expenditures in 2006.

previous fiscal year. Of this total pool, 10 percent is set aside for Skopje, with 4 percent going to the City of Skopje itself and 6 percent for the municipalities of within the City of Skopje.³² The leftover 90 percent of the total pool is distributed across the other municipalities according to a formula. The formula, which also applies for the distribution of the 6 percent for the municipalities of the City of Skopje, is not well defined in the law. The law only requires that the formula should put at least a 50 percent weight on population. The applied criteria and weights are stipulated in a methodology defined by the government in agreement with the Commission for Monitoring the Development of the Financing System. The methodology applied in 2005-2007 established the criteria for distribution of these transfers as 60 according to population, 27 percent according to the surface area of the municipality, and 13 percent according to the number of settlements within the municipality.

Existing disparities and impact of the VAT transfer

Given the relative importance of the VAT revenue transfer, an important question is its impact, especially on fiscal disparities across municipalities. Table 6 presents an overall picture of how much disparity already exist across municipalities in terms of population, land area and also fiscal resources from own taxes and PIT shared revenues.

As shown in Table 6, there are three distinct groups of municipalities in Macedonia: a) rural municipalities excluding Skopje; b) urban municipalities excluding Skopje; and c) the municipal and city governments in Skopje.³³ The rural municipalities group accounts for just under half of all municipalities but only 20 percent of national population; these are typically municipalities with smaller population and land area and also with a smaller number of settlements. They also have on average significantly smaller revenues per capita from own taxes and fees. By contrast urban municipalities outside Skopje account for less than a third of all municipalities but for more than half of the national population; they also have twice as much land and include more rural settlements in addition to the urban seat. More significant from a fiscal perspective, compared to rural municipalities, in per capita terms, urban municipalities generate twice as much revenue in personal income tax and fifty percent more in property taxes and communal taxes (construction permits). However, compared to Skopje, urban municipalities generate less

³² In the second phase of fiscal decentralization the share of Skopje in the VAT transfer pool will be increased to 12%. In addition to VAT revenue, intra-Skopje apportionment of revenues is also performed by applying the same formula to the 80 of a pool comprised of 3 percent of PIT revenues, 50 percent of communal fees, 50 percent of vehicle registration fee. The remaining 20 of this pool is allocated to the city budget

³³ We refer as rural to those municipalities with a seat in a village according to Article 10 of the Law on the territorial organization.

than half revenue from personal income tax and less than a quarter of revenue from property taxes and communal taxes in per capita terms.

Table 6. Disparities in municipal geography and per capita revenue yield, 2006

Municipality Group	Population	Area in km ²	Density	Settlements	PIT*	Property taxes*	Communal charges and fees*
Rural outside Skopje (41 units)							
Average	9,694	232	65	18	41	262	315
Minimum	1,322	23	5	1	11	25	36
Maximum	28,997	819	371	42	125	1,821	2,325
Coef. Of Variation	0.76	0.76	1.06	0.57	0.74	1.35	1.38
Urban outside Skopje (33 units)							
Average	33,884	449	96	29	81	368	460
Minimum	4,545	49	8	4	34	33	43
Maximum	105,484	1,194	613	66	160	1,241	1,252
Coef. Of Variation	0.85	0.54	1.20	0.53	0.33	0.63	0.66
Skopje average (composite)	50,693	57	887	5	187	1,310	2,005
National average	24,078	296	81	21	100	625	846

* (MKD per capita)

So, what is the impact of the VAT transfer on municipal fiscal disparities? Although the VAT transfer formula does not explicitly equalize disparities in revenue yield, that is what it effectively achieves, at least among the three groups of municipalities (Table 7). This is because low-revenue rural municipalities also have more land and settlements per a thousand of population and that is what actually drives the distribution of 40 percent of the transfer fund. As a result, rural municipalities having 40 percent less pre-transfer revenue per capita than urban municipalities outside Skopje, eventually enjoy ten percent more of total revenue per capita after

the allocation of the VAT transfer, thus reversing the actual standing of the average municipality in the two groups. There is also substantial effective equalization vis-à-vis the comparatively richer local governments in Skopje but by much less than among the two groups outside Skopje. The Skopje municipalities while having three times more pre-transfer revenue per capita than urban municipalities elsewhere, at the end have at their disposal only twice as much as other urban municipalities.

Table 7. Disparities in the principal municipal budget revenue (MKD per capita), 2006

Municipality Group	Tax and non-tax	VAT transfer	Total revenue
Rural outside Skopje (41 unit)			
Average	681	1,395	2,193
Minimum	136	467	695
Maximum	3,112	4,169	5,235
Coef. of Variation	1.09	0.59	0.53
Urban outside Skopje (33 units)			
Average	1,014	839	2,005
Minimum	124	358	784
Maximum	2,149	2,978	7,400
Coef. Of Variation	0.46	0.61	0.55
Skopje average (composite)	3,776	481	4,275
National average	1,737	647	2,461

While the VAT transfer narrows the gap in average expenditures among the three groups of rural municipalities, urban local governments outside and within Skopje respectively, at the same time it aggravates disparities within the group of urban municipalities located outside Skopje. This is evident from a higher coefficient of variation in total expenditures compared to the variation in own-source revenue in that group of municipalities. Thus, to distinguish revenue capacities of urban municipalities the formula needs to include economic indicators, such as average household income, rather than crude measures of population size and land area.

Capital development grants

According to the Law on Financing of the Units of Local Self-Government (Art 11), capital grants from the competent line ministries and from the Public Roads Fund are to be used to finance municipal investments.

The Public Roads Fund provides financing for construction, reconstruction, and maintenance of local roads. The criteria for the allocation of the Fund are prescribed in the Rulebook on Allocation of Funds for Construction, Reconstruction and Maintenance of Local Street and Roads adopted annually by the Ministry of Transport and Communication. The amounts allocated each year to different municipalities do not appear to be published. The total amount of the funds distributed in 2005—including those for road maintenance—was 506,700,000 MKD (or 21 percent of local capital expenditures); while in 2006 it was 500,000,000 MKD (or 20 percent of local capital expenditures).

The Ministry of Transport and Communication disposes of another fund for financing capital investments in local infrastructure (water supply and sewerage). The size of this fund depends on the annual central budget allocation. This fund is dedicated to potable water pipelines and sewer collector systems and it gets distributed on a project basis. Municipalities submit projects to the Ministry of Transport and Communication for consideration and funding. Normally, the money allocated to the municipalities in the framework of this fund covers just a portion of the total cost of the project submitted. Thus, the actual distribution of the capital grants tends to give priority to projects that have secured necessary matching funds and to projects that have been started but not yet completed. The list of the municipalities receiving the fund's money is published annually. The amount of the money disbursed to the municipalities through this fund was 150,000,000 MKD (or 6% of local capital expenditures) in 2005 and 171,500,000 (or 7% of local capital expenditures) in 2006.

Another form of capital development grants come from the Bureau for Development of Underdeveloped Regions under the Ministry of Local Self Government, which allocates funds to the “underdeveloped” regions in the country. These regions are identified on the basis of several criteria, which can be revised annually and include variables such as the level of economic development and demographic characteristics. Underdeveloped regions are classified into four categories: hill/mountainous areas, extremely underdeveloped regions, rural areas, and border areas. By law the level of funding for the Bureau is set at 1% of the GDP on an annual basis plus external donations. However, the actual allocations have averaged 0.2%-0.3% of GDP. The Bureau finances three types of projects: infrastructure projects (e.g., air pollution prevention, local water supply system, electrification); economic support projects, such as loans to small enterprises; and vocational training or contributions to the health and security insurance for the

employees in these regions. In the case of economic support projects, vocational training and health and security contributions, the applicants can be legal or physical persons located in the defined areas, while only the municipalities are eligible for infrastructure projects. In the course of the year, the Bureau opens tenders in the above-mentioned areas of interventions. The applicants submit their projects to the Bureau and a commission composed of, among others, the representatives of the Ministry of Local Self Government and other line ministries, selects the project and the respective funding allocations. The financing covers just a portion of the project proposals up to 3,000,000 MKD. Formally the selection of the projects is done on specific criteria; however municipalities claim that these criteria have not been consistently applied and the selection of projects has been politically driven.

The legal framework for the Bureau was revised with the adoption of the Law on Balanced Regional Development in May 2007. According to the new law, the Regional Development Bureau, as a body within the Ministry of Local Self-Government, will be responsible for analytical support, drafting government documents, and technical assistance to planning regions in the area of regional development. While the focus of these activities will be on planning regions, areas with specific developmental needs, and villages, it also concerns municipalities in two ways. First, as a founding principal the new law proclaims cooperation between the central and local authorities in preparation, implementation, monitoring and evaluation of planning documents and programs and measures in the area of regional development. This partnership also entails equal sharing of operating costs of Planning Region Development Centers. Second, local self-government units that encompass areas designated as having “specific developmental needs” will have the authority to submit project proposals and, if approved, receive funds from the Bureau. The total amounts of funds allocated for such projects will account for twenty percent of the funds appropriated annually for the purpose of encouraging balanced regional development. In addition, local self-government units will have the authority to submit project proposal for development of their constituent villages. The total amounts of funds allocated for the latter type of projects will account for ten percent of funds appropriated annually for the purpose of encouraging balanced regional development but would also have to be matched by an equal amount from urban municipalities proposing projects for their constituent villages.

In addition to the aforementioned channels of capital grants, other line ministries (e.g. Ministry of Education through the Department of Investments) disburse capital grants for financing municipal investment programs. The investments are provided on the basis of programs identified by the competent line ministry and determined annually for selected municipalities.³⁴

³⁴ A more thorough analysis of these capital grants is not possible because of the lack of information and data on the programs.

In 2006 only 13 municipalities (8 rural and 5 urban – all outside Skopje) reported that they had received capital grants totaling MKD 67,452,795. Possibly some funds were paid directly to contractors from the central agency budgets or were miss-classified as recurrent revenue in the municipal budgets. However, the information on the total amount of capital funds appropriated for local projects by the Ministry of Transport and Communication and the Road Fund suggests that less than half of local capital investments are financed with national budget resources.

Earmarked grants

The earmarked grants have been established for fire-fighting, education, social policy, and culture. During Phase I, these earmarked grants excluded the funds for the salaries of public employees in these areas, which are still being directly paid by the Central Government (except for firefighting brigades).

The amount of earmarked grants for 2005 was set up considering the historic costs borne by the responsible line ministries in the previous years, although there never was clear explanation on how these amounts exactly derived.³⁵ In 2006, having observed the effects of the previous year, the central government increased the pool of funds for these transfers and the Ministry of Labour and Social Policy, Ministry of Education and Ministry of Culture used formulas to distribute the grants.

Currently, the criteria for the distribution of the earmarked grants are established annually by the respective line ministries through an ordinance adopted by the Government of Macedonia at least two months prior issuance of the budget circular. However, the actual application of these criteria is not quite clear because the adopted decrees do not specify the calculation procedures for weights applied to different criteria and sources of data

Earmarked grants are disbursed to the municipalities on a monthly base and the grants flow to the recipient institutions passing exclusively through a special account in the municipal budget. Municipalities have limited discretion in allocating the earmarked grants; within the category of "Goods and Services" the implementing institutions can make requests but once these requests have been approved by the respective line ministries, municipalities cannot alter the allocation. They can revise (rebalance) their own budget during the fiscal year but not the financial plans of the institutions; any alteration of the institutions' budgets has to be approved by the line ministries

³⁵ The municipalities have been consistently complaining that only a portion of the historical costs were included in the earmarked transfers.

The Ministry of Education has set up three earmarked grants for the education area respectively for: 1) the maintenance³⁶ of primary education, 2) the maintenance of secondary education, and 3) transport costs for primary education. On the basis of the pilot municipal surveys conducted by the Decentralisation Working Group, around 40 percent of the municipalities responding to this question felt that the earmarked grant for primary education covered only between 41 and 60 percent of the actual needs in 2005-2006. Similarly, on the adequacy of the earmarked grant for secondary education almost half of the municipalities felt that the earmarked grants covered between 41 and 60 percent of actual needs for 2005-06. However, on average municipalities only supplemented those activities (with funds from their general budgets) by four percent on top of the amount received in earmarked education grants and service fees collected by schools in 2006.

The formula for the distribution of the earmarked grants to primary schools takes into account the number of pupils in primary schools adjusted for population density, while the earmarked grant for transportation takes into account the number of students and the routes' length. The earmarked grants for secondary schools are distributed on the basis of the number of students in secondary education adjusted for density and the share of student attending gymnasiums.

The Ministry of Labour and Social Policy has set up two earmarked grants for the maintenance of child day care centers and elderly homes respectively located in the municipalities. On the basis of the pilot municipal surveys conducted by the Decentralisation Working Groups, the majority of municipalities that answered the question in 2005 (only a few municipalities actually have child day care centers in their territory) felt that the earmarked provisions met between 20-60 percent of actual cost needs. For 2006, on the question of the adequacy of earmarked grant for child protection, the majority of the municipalities felt that the grant covered costs in the range of 21-40 percent. However, on average the general budgets of the municipalities covered only ten percent of the actual expenses of those institutions with the rest made up by user fees (60 percent) and earmarked grants (35 percent).

The allocation formula of the earmarked grants for child day care centers took into account the number of children in each institution, the expenses per child, the heating period, and the useful space per child in the institution. The earmarked grants' distribution for elderly homes was based on the number of persons accommodated, the number of tenants placed and financed by the ministry, the length of the heating period in the institution, and the expenses for maintenance of the institution premises.

³⁶ This includes utilities, heating, electricity, communication and transport, office supplies, tool and petty inventory, hygiene maintenance supplies, newspapers and magazines, ongoing maintenance, other agreed services and other operational expenses.

The Ministry of Culture is charged with implementing earmarked grants for the operational costs of the local institutions of culture. During the pilot municipal surveys, the municipalities (those who have cultural institutions), responded to the question of the sufficiency of the earmarked grants allocated in the area of local cultural institutions, by stating that earmarked grants only met between 21-40 percent of needs in 2005 and between 0-20 percent in 2006. In actuality, only 40 percent of the aggregate local expenditures in this sector were covered by earmarked grants; the rest was made up by user fees, donations, and more importantly by general budget funds which covered on average about 20 percent of the operating costs. The earmarked grant for the local institutions of culture are distributed on the basis of the historical expenses, variable expenses (resources for financing library, museum and musical/show activities of local interest), material expenses, and the resources for insurance of real estate and property rights.

In addition to the above-mentioned earmarked grants, the Ministry of Interior distributes funds to the municipalities with fire-fighting units in their territories. The earmarked grants cover the salaries and allowances for the local employees and the personnel seconded from the ministry. The transfer of the earmarked grants for the fire-fighting units became effective in 2006.

The incidence of earmarked grants

The incidence of earmarked grants across municipalities is very uneven. As shown Table 8, rural municipalities, which constitute almost half of all municipalities and a third of the national population, do not receive any resources earmarked for libraries, music, culture, museums, cinema, child day care, high schools, or fire-fighting. While urban municipalities outside Skopje receive earmarked grants for each of the functions, the per capita amount is less than in Skopje with the exception of child day care and transport for primary school students. Thus there is a clear anti-rural bias in the allocation of earmarked grants. This bias would be somewhat offset to the extent that the facilities in urban municipalities also serve residents of adjacent rural municipalities. However, no information is available on those potential cross-jurisdictional services; but even if they are common, rural residents could not hold urban governments accountable, and thus there is no guarantee that these facilities would be responsive to the needs of rural residents or that they give them equal access to the services as for their own urban residents.

Table 8. Incidence of earmarked grants to the municipalities (MKD per capita), 2006

	Rural outside Skopje	Urban outside Skopje	Skopje	National average
Libraries	0	8	12	7
Music	2	5	23	9
Museum and cinema	0	7	28	11
Senior homes	0	63	125	66
Child day care centers	0	14	11	10
Primary education	223	215	261	228
Secondary education	0	111	133	95
Student transportation	191	103	47	106
Firefighting	0	143	164	120

A higher allocation to the Skopje local governments is particular questionable given that per capita revenue in their principal budget is double of that for other municipalities. Again it is possible that some of the Skopje facilities serve the entire nation; but that raises the question of suitability of assigning services with national benefits or national catchment areas to the local level; it is also unreasonable to believe that local governments in Skopje would feel or behave in an accountable manner to the rest of the nation for these services.

The fundamental source of the discrimination or anti-rural bias is that the formula or criteria used in the allocation of the earmarked grants are not always based on the potential number of clients but instead they use partly or exclusively criteria based on the existing physical capacity. This means that those municipalities that did not have a facility built in the past (and so were discriminated against) continue to receive no funds in the present and therefore continued to be discriminated against. A possible way to ensure accountability of service providers is to allocate resources to municipalities regardless of availabilities of facilities and then let some municipalities use these resources to contract some services for their residents from other municipalities and thus place certain contractual obligations for serving out-of-jurisdiction clients, or to use these and other funds to start building the necessary physical infrastructure. The historical deficit in some forms of infrastructure should also be addressed by the capital development grants from the central government.

Transfer of Financial Resources in the Second Phase of Decentralization

The second phase of fiscal decentralization was supposed to start in July 2007 but its implementation has been postponed to September 2007. The second phase is conditional in the sense that to access to this phase municipalities have to comply with certain criteria defined in the law on Financing of the Units of Local Self-Government (Article 46):

1. The conditions for phase I are fulfilled.³⁷
2. There is an adequate capacity in terms of financial management staff;
3. Good financial results are shown in the past 24 months;
4. Timely and regularly reporting to the Ministry of Finance on fiscal performance; and
5. No outstanding liabilities towards suppliers or any other creditor that exceed the usual payment term.

A Commission for monitoring and assessment of the fulfillment of the conditions for acceding to the second stage of the fiscal decentralization process was established in January 2007 to evaluate compliance with these conditions. The Commission consists of a president, nine members and a secretary appointed by the Government of Macedonia. Notably among the members are the President and Vice President of ZELS, mayors of municipalities, representative of the line ministries, academia, and international experts.

In July 2007 the Commission issued assessment of the 72 municipalities that had applied for access to the second phase. Of those that applied, around 40 to 44 met the criteria. The Commission is supposed to reconvene by mid-October 2007 to review again the other applications.

Because, the specified legal conditions were somewhat vague (e.g., “good financial results”), the commission came up with some operational criteria that could be used to score municipal performance. However, some of these operational criteria are rather questionable. For example, “good financial results” are gauged as revising the budget no more than once a year. But many budgeting experts would argue that good financial management requires prompt budget revisions in response to diversion of actual developments from the assumptions underlying budget

³⁷ These conditions for phase I were: a. the municipal administration should have at least two employees who are qualified to work on financial management, budget preparation, budget execution, accounting and financial reporting; and b. the municipal administration should have at least three employees, who are qualified to work on determination and collection of taxes.

projections. Even the law on Financing of the Units of Local Self-Government (Art. 29) requires the mayor to propose budget amendments to the council at least twice a year. At the same time the rationale for attempting to instill responsible budgeting is quite understandable. And there does seem to be a problem. For example, the actual revenues of local governments diverged from their budget estimates by more than a third for all categories of local revenue in 2006. Probably a better measure to gauge responsible budgeting is not the frequency of budget revisions but the extent of forecasting errors in the initial budget estimates.

Besides frequent budget revisions, other main reasons for low assessment scores included low staff capacity, timely quarterly reports and the outstanding debts, which in most cases had been inherited from previous municipal administrations.

In the second phase of fiscal decentralization, the earmarked grants will be substituted with the block grants. The law on Financing of the Units of Local Self Governments foresees the block grants for financing the municipal activities in four sectors: education, social policy and child protection, culture and health. While many municipal officials attach high political significance to being accepted for the second phase of decentralization, not many of them can tell what difference it would make for their fiscal powers. According to the legal definitions, the difference appears quite subtle. Current earmarked grants are “intended for financing a concrete activity,” while the future block grants are “intended for financing the competencies in certain area determined by law.” Thus one interpretation could be that the block grants will cover the wages and salaries of the employees in these sectors in addition to the maintenance cost currently covered by earmarked grants. The block grants will be distributed according to a formula defined by the competent line minister, approved by the Ministry of Finance and adopted through a legislative disposition by the Government of the Republic of Macedonia.

The block grants became effective in October 2007 for the first group of municipalities that met the conditions to access the second phase of the fiscal decentralization. It should be noticed that while the Ministries of Education and Labour and Social Policy are working on the definition of the allocation formula for the block grants, the Ministry of Culture already put forward a formula for the distribution of the earmarked grants for 2008.

II.4.2 Issues in intergovernmental fiscal transfers

- The intergovernmental transfer system in Macedonia is still in transition and has not attained yet a mature desirable structure. In particular, the system lacks an explicit

formula-driven equalization grant that equalizes fiscal disparities in fiscal capacity and expenditure needs. The current VAT revenue transfer has equalizing features but for a variety of reason falls short (as discussed below) of functioning as an equalization grant system. In addition the current system of conditional or earmarked grants is quite fragmented, is not fully transparent, and often uses unfair criteria for the distribution of the funds. Thus an overhaul of the transfer system is needed. The paragraphs below expand further some of the issues and concerns with the current system of transfers.

- The current VAT revenue transfer presents problems in both the determination of the pull of funds and the formula or criteria used for the distribution of the funds. Identifying the pool of funds for distribution as 3 percent of VAT revenues is problematic in two counts. First, it would be less polemic to identify the source of funds as general central government revenues (of course, including the VAT, but other central taxes as well). Using the VAT as the source leads to claims from particular jurisdictions where the VAT is raised. This must be the logic of setting aside a share of the revenue pool for the City of Skopje and its municipalities (further increased from 10 percent to 12 percent of the transfer pool in 2008). Within the context of a conventional equalization grant system it would be very unlikely that the richest municipalities in the country would receive an equalization grant. The City of Skopje may receive a special grant for its role (and extra associated costs) of serving as the capital of the country, but certainly it is less likely that it deserves an equalization grant because it is relatively poor. The second problematic issue with the 3 percent VAT rule is whether it yields enough funds to carry out the level of equalization Macedonia desires. By hearing from some of the municipalities or by looking at the disparities that still exist in expenditures per capita across municipalities after the transfer, the answer may be that the funds are insufficient. However, how much equalization is performed in any decentralized system is eminently a political issue, which reflects the level of solidarity in the country and other factors, and one to which we have very little to add as observers of the system.
- The criteria for the allocation of funds from the VAT revenue transfer do not take into account disparities in the revenue-raising capacity while they take into account disparities in expenditure needs only in an approximated fashion. None of the criteria currently used (population size, land area, number of settlements) contains information on the fiscal capacity (tax bases) of the jurisdiction. In the case of expenditure needs, it is quite possible that those needs will be correlated with population and land area. The first question is whether there may be a more direct and exact way to measure expenditure needs, for example using budgetary norms for each service. The second question is whether population, land area and number of settlements are the only or even the best variables to approximate expenditure needs. We must recognize that nevertheless the current allocation of VAT transfers manages to effectively mitigate disparities between the two groups of rural and urban jurisdictions respectively but not so effectively within

these two groups of municipalities. The question is whether that equalization can be improved.

- The reliance on historic expenditures for the allocation of some earmarked transfers is problematic both with respect to aggregate funding of decentralized functions and apportionment of these funds across individual municipalities. The aggregate levels of historic funding are of little guidance in the environment of shifting policy priorities due to demographic and economic changes. At the same time the historic pattern of territorial allocation might entrench past biases and also be out of touch with new policy priorities as the aforementioned underlying changes might affect different parts of the country differently. Therefore a more flexible updatable system of estimating the need for transfers should be explored.
- The allocation formula for the earmarked grants in many cases just takes into consideration the existence of a physical facility and other physical features such as useful space. This is highly problematic because of the unfair results it produces across municipalities and because it sends the wrong message to the local authorities that what counts is less the number of potential clients for the service and more the existence of a facility. The formula for the distribution of the earmarked grants should be fine tuned to base them on need as reflected by potential number of clients and differences in the costs of provision of standardized services. Those should be the basis for block grants in the second phase of decentralization.
- There is a huge need at the municipal level to provide certain types of local infrastructure that cannot be fulfilled by the existent capital grants system. The historical deficit in some forms of infrastructure across municipalities needs to be recognized and addressed by the capital development grants. It is patently unfair that just those communities that in the past were fortunate enough to receive infrastructure of different kinds now are also the only ones receiving assistance for those services.
- In general, capital grants are allocated in a very fragmented manner due to the nature of local government project proposals, which are submitted through different line ministries. The selection of projects for funding continues to take place without clear guidelines and in an environment lacking transparency. Thus, while the Road Fund has an adopted rulebook for the allocation of capital grants, it does not publicize the results of project selection. At the same time the Ministry of Transport publicizes the results of project selection but not the criteria based on which the decision is made. If municipalities become responsible for capital investments in the newly decentralized sectors, channeling capital grants through line ministries will only aggravate the fragmentation of policy instruments leading to ineffectiveness and significant administration costs. Therefore there is a need to think about the possibility of

introducing some form of capital block grant that recognizes historical deficiencies and that allows municipalities to direct the resources to where infrastructure is most needed.

II.5 Municipal Borrowing

Sub-national borrowing is the fourth pillar of a decentralized system of finance and comes to close the financing system of local outlays in infrastructure and other items that will provide useful services over a period of time exceeding the normal fiscal year.

II.5.1 Current Status

The law on Financing of the Units of Local Self Government allows the municipalities to borrow from domestic and foreign entities for their own purpose and to issue guarantees on the borrowing by municipal enterprises “in accordance with law.” In particular Article 50 (1) requires the following pre-conditions for long-term borrowing by a municipality:³⁸

- it has regularly submitted positively assessed financial reports for the period of at least 24 months from the day this law enters into force; and
- It does not have any arrears towards the creditors in the last 2 years from the day this law enters into force.

The latter clause has put local borrowing effectively on halt due to outstanding arrears. The bulk of these arrears date to pre-2001 contract payments owed by a dozen of municipalities, mostly to the formerly state construction company *Granit*. In 2004, the total amount of these outstanding debts was estimated at 1.4% of GDP, which was roughly equal to the annual amount of local expenditures. The fourteen municipalities that in 2007 did not qualify for the second phase due to having their accounts frozen collectively held an outstanding debt equal to 0.02% of GDP in July 2007. For these municipalities as a group, this debt accounts for about 170 percent of the annual revenue in their principal budgets. However, for some of these municipalities the debt exceeds their annual revenue by as much as a factor of four.

³⁸ Note that the conditions municipalities must meet to extend loan guarantees to their public enterprises are the same as for long-term borrowing: to have submitted positive assessed financial reports to the Ministry of Finance in the latest 24 months and not to have contracted arrears towards the creditors in the same period.

Municipalities can access credits from foreign entities only with prior consent of the Government of Macedonia on the basis of a positive opinion issued by the Ministry of Finance.

The municipalities can take domestic short-term borrowing to cover temporary cash shortfalls with the obligation to repay them by the end of the fiscal year. Short term borrowing is limited to 20 percent of the overall revenues collected in the preceding fiscal year.

Long term borrowing by municipalities is subject to the “golden rule”: they can borrow on a long-term basis only to finance capital assets or investment projects.

In addition long term borrowing is subject to other rules and limits: (1) repayment of the principal needs to be made in equal or decreasing annuities; (2) the total outstanding liabilities including guarantees cannot exceed the total amount of revenues collected in the preceding fiscal year; (3) the annual debt service outlays need to be within 15 percent of the overall revenues collected in the preceding fiscal year.

Finally, the Law enables the Government of the Republic of Macedonia to offer guarantees and take liabilities that may derive from the long terms debts contracted by the municipalities.

II.5.2 Issues in Municipal Borrowing

- The current regulatory framework for municipalities in Macedonia is quite adequate in what concerns rules and limits. In what concerns actual monitoring and implementation all indications are that there is adequate reporting from the municipalities to the Ministry of Finance, at least so far. Therefore, there are no major problems in the system from the demand side of the market. It is less clear that current system of municipal finance and the degree of development of credit markets will allow any time soon a significant development of supply of loanable funds to the municipalities. Given the huge capital infrastructure needs in the country and the important role municipalities are to play in many areas of public infrastructure; there will be a need to consider options to stimulate local credit markets such as a financial

intermediary at arm's length from the government and strictly operating with banking criteria.

- There are two other more secondary issues that deserve the governments' attention. First, the strict requirement of no arrears in the last two years should be re-examined; for example, it could be modified to allow municipalities refinance existing debt on better terms. Second, the historic debts of transferred institutions needs to be re-examined also; but of course, the danger here is that these issues, in combination with other unsettled questions with respect to the adequacy of funding for transferred responsibilities and so on, might create soft-budget constraint pressures from the municipalities.

III. THE WAY FORWARD

In this report we have highlighted some of the progress that has been made in the reform of the system of intergovernmental fiscal relations in Macedonia, but we have dedicated more space and attention to those areas of the system where challenges still remain. In this section we outline a possible agenda for reform. For space reasons the outline of the agenda is brief with the perspective that a fuller more complete agenda will be the subject of future work. While the detailed reform agenda should emerge locally through a collaborative process involving all relevant stakeholders in Macedonia in order to ensure broad buy-in and ownership, it is our hope that this report contributes to this process by providing an informed framework and a range of policy options to choose from.

The most important step in the way forward is to come up with a unified and coordinated reform strategy and a clear "reform champion" within the central government. The strategy should provide a policy vision with respect to key reform choices that need to be agreed on through consultations involving all relevant stakeholders. Until there a clear vision of the policy choices with respect to different dimensions of the decentralized system, efforts to focus on tactical benchmarks (e.g., number of laws adopted) are likely to be counterproductive. The reforms outlined below will take time to discuss and ultimately implement and there is also a question on the right sequencing of these reforms.

An agenda for reform of the system of intergovernmental fiscal relations in Macedonia should consider the following items:

On intergovernmental relations and the vertical structure of government:

- The central government job is not done with just issuing decentralization laws and implementing regulation. The central government should actively seek the implementation of legal provision at the municipal level by providing more information and guidance to municipalities.
- There is a need for an explicit and fair strategy to deal with municipalities lacking administrative capacity:
 - Individualized diagnostic should be performed for every municipality;
 - Individualized capacity building and training plans should be developed for those municipalities currently lacking capacities but capable to “graduate;”
 - For the remaining municipalities, voluntary cooperative arrangements should be promoted through adopting/amending relevant laws and regulations;
 - An alternative to cooperative arrangements is private contracting as a potential solution for some forms of service delivery;
 - In the meantime, central provision might be the only way to assure the minimum level and quality of the key social services where mere capacity building is not likely to succeed.
- Accountability of local government to their constituency can be improved by promoting “benchmark competition” among local governments with publicizing all local budgets and performance indicators.
- Central government must honor its commitments and follow the rules it makes. As with any reform it might difficult to get everything right the first time; however fine-tuning should be done in an orderly way. Not following its own rules by the central government is particularly problematic given the level mistrust and division along the partisan and ethnic lines in Macedonia.
- The disputes between the central authorities and the municipalities should be mediated when necessary by the courts.

On expenditure assignments:

Expenditure assignments can be improved by undertaking the following measures:

- Clearly defining the role of municipalities in concurrent expenditure responsibilities by identifying attributes/obligations for different levels of government for: i) regulation; ii) financing; iii) implementation of each function.
- For the twelve decentralized sectors, decentralization should be a key part of the sectoral strategies rather than just a project pursued independently from strategic programming in respective line ministries.
- To bring clarity to the question of adequacy of funding for the transferred functions, it is necessary to perform the critical step of quantifying expenditure needs associated with expenditure responsibilities. The Government of Macedonia should consider using explicit per-client budget financial norms adjusted for different costs of service delivery.

On revenue assignments:

Local revenue autonomy, which is critical for accountability, can be increased by:

- modernizing tax policy and administration with respect to property taxes in particular on commercial premises;
- introducing a piggyback flat rate for the personal income tax with minimum and maximum rate approved by law as a replacement to the current sharing of PIT revenue;
- considering other tax sources such as a local vehicle tax or a presumptive simplified levy on small businesses;
- complementing revenue needs with PIT sharing on a residence basis (as is done currently) but it is preferable to create “fiscal space” for local governments;
- sharing of other taxes (VAT or corporate income tax) on the derivation basis should be avoided.

Overall, revenue assignments should finance the expenditure needs of the “richest” sub-national governments.

On intergovernmental transfers:

Unconditional equalization transfers should be redefined to make the allocation more equitable, objective and predictable by:

- Introducing a funding rule for the overall pool of funds available for equalization (for example as a percent of central government revenues). It is not advisable to attach it to VAT or any other specific source because it creates political issues stemming from the confusion with derivation-based revenue retention. There should be no confusion that, unlike local taxes, these transfers are the central government money used to achieve national goals, such as national cohesion, ensuring minimum standards of service provision, and so on.
- The distribution formula should address differences in both “expenditure needs” and “fiscal capacity.” Expenditure need indicators should capture differences among local governments in the amount of money they must spend to achieve a given quality of public services due to differences in input prices and socio-economic environment (e.g., population size, number of students, elderly, etc). Fiscal capacity indicators should capture the ability of the municipality to raise revenue for public spending given the level of economic activity within its boundaries (e.g., local economic product, average wage, etc).
- Expenditure needs should be defined on the basis of the per-client expenditure norms and for fiscal capacity should be defined on the basis of estimated own revenue potential (plus shared revenues and other transfers).

Sectoral grants also need to be reconfigured:

- Compared to the present system of earmarked grants, the system of block grants should be simplified and rationalized as supporting major thrusts in central government policies including support for infrastructure and by using matching fund arrangements and objective criteria for allocation.
- The formula for the distribution of the sectoral grants should be based on potential number of clients (rather than actual enrolment) and differences in the costs of provision of standardized services (and not on physical capacity criteria or outdated historical costs). Using matching fund arrangements more often should help leverage additional local resources.
- Capital transfers need to be rationalized into a smaller number of block grants and to connect their disbursement to a concrete and comprehensive exercise of a sound investment planning (eventually within the context of the Medium Term Expenditure Framework). Taking into account the status of Macedonia for EU accession, investment planning is crucial to bring the municipalities into the position to use the Regional Development Fund and later on the EU structural funds, when they will become available. The investment plan could also be used as an incentive to establish a powerful synergy with the “project financing” contractual mechanisms that different donors are implementing at the level of the municipalities in Macedonia.

On borrowing:

- The central government should continue developing its capacity to implement the regulatory framework for sub-national borrowing and facilitate the development of credit markets for sub-national governments (bank loans and bond issues). There are many good reasons to have sub-national borrowing but also many reasons to be cautious and strictly regulate a framework for the future
- Care should be taken to express a clear vision for the funding of local capital infrastructure, as capital grants have the potential to undermine private credit markets by retarding the development of a credit market culture. The arrangements for local capital funding should attract rather than suppress or just supplement private capital in the country. Whenever possible, government co-financing should leverage private sector funds by providing comfort to private participants or taking positions with greater risk or lower liquidity.
- Besides providing capital grants as a short-term assistance strategy, donor agencies and international financial institutions can play a role in making market borrowing a viable option in the long run. Donors can sponsor technical assistance and training for local governments in local financial management, identifying and analyzing capital needs, operating and managing facilities, capital planning, cash flow projections, and project management. Likewise, Macedonia could benefit from donor assistance in the structural development of the financial sector and securities markets.

On the proper sequencing of the reforms:

- The likelihood of successful reform will increase with the proper sequencing of the reforms. There is, for example, no point in reforming revenue assignments until there is much more definition on what are the actual responsibilities and expenditure needs of sub-national governments. In addition, allowing sub-national governments to borrow should be preceded by enhanced revenue autonomy, more transparent budgeting procedures and increased accountability by sub-national officials.
- In the short term, the two most immediate steps for the reform of the intergovernmental systems are, first, to reform and clarify expenditure assignments at all levels of government and develop per client expenditure norms to quantify expenditure needs flowing from the new expenditure assignments, and second, to reform the system of equalization grants.

- The reform of the system of equalization grants should encompass the introduction of a funding rule based on general central government revenues to determine with more predictability the funds available for equalization and a distribution formula based on the difference between expenditure needs and fiscal capacity. These reforms of the grant system can be carried out in parallel with the reform of expenditure assignments.
- In the shorter term it should also be feasible to increase horizontal accountability, through “yardstick competition” among all sub-national governments, by publishing more recently updated and more extensive sub-national government data for budgets and basic performance indicators (benchmarks).
- In the medium term, it will be desirable to reform revenue assignments to provide more revenue autonomy to sub-national governments. The new revenue instruments should provide sufficient own-revenues to the richest sub-national governments.
- In the medium term, it will be also desirable to re-structure the system of conditional or earmarked grants.