The Fiscal Decentralization Initiative
for Central and Eastern Europe

The Policy Shift in Fiscal Equalization in Macedonia: Yet to Be Implemented

by
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Executive Summary

This paper is an assessment of the fiscal decentralization and equalization system in Macedonia. Macedonia's major breakthrough in the field of fiscal decentralization was the adoption of a new Law on Self-government in January 2002, which substituted for the previous Law on Self-government of 1995 that contained major deficiencies, mainly in the financial functioning of local self-government units.

This fiscal decentralization reform process, besides the adoption of the new Law on Self-government, also consisted of the adoption of other relevant laws, including the Law on Financing Units of Local Self-government, all of which contained revolutionary provisions for the reform of the financial functioning of local self-governments in Macedonia.

The new decentralization reform package was launched on July 1, 2005, and contained three main processes: the transfer of certain competencies from the central to the local level, the transfer of civil servants and other state employees from central to local institutions, and the transfer of funds from central to local budgets. To a certain extent, the adopted reforms, in theory, have overcome the above deficiencies, at least in the legal framework.

A new basis has been established to overcome some of the unfavorable conditions for decentralization and equalization in Macedonia. The challenge now remains to implement and make operational these achievements.

Introduction

Macedonia has had a lengthy experience with fiscal decentralization. During the existence of Socialist Federal Republic of Yugoslavia, there was a high level of fiscal decentralization in the country. Following the break-up of the Yugoslav Federation, Macedonia started building its own fiscal system, where the fiscal relationship between the central authorities and local governments was changed and fiscal competencies of the municipalities were limited. This was confirmed by the Law on Financing the General Social and Common Needs of 1991, later replaced by the Law on Budgeting of 1993, then the Law on Self-government of 1995, and the Law on Caps of Own Revenues,[1] that limited most financial competencies of local self-government units.

This post-communist transitional regime of local self-government was unsustainable due to serious deficiencies: namely, it did not provide for a democratically transparent and effective, economically sound and financially sustainable functioning of the municipalities. The most pronounced financial deficiencies included:

1) The insufficient operationalization of Articles 114–117 of the Constitution of Macedonia that provided for the financial independence of local self-governments. A large discrepancy existed between the assigned sources of financing of local self-government units and their actual revenues;
2) A lack of competencies of the units of local self-government, especially in the spheres of local financing, economic development, and urban planning;
3) No conditions for part of the funding for units of local self-government originated from local taxes and fees and compensations, the rates of which would be determined by units of local self-government;

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* Views expressed in the paper are of the author and do not represent the views of the organizations that he works for. The author would like to thank Liljana Ristovska who read the manuscript in its entirety and contributed helpful criticism and suggestions. The remaining errors and deficiencies must be clearly the author's alone.

[1] Adopted each year prior to the start of the budgeting year.

4) The Law on Caps of Own Revenues limited the already scarce revenues of municipalities, plus other deficiencies;

5) A lack of proper equalization instruments that would correct vertical and horizontal imbalances that existed in the country's intergovernmental finance system.

At the turn of the century, Macedonia entered into a process of serious reform of its political, economic, security, social, and public life that have had revolutionary effects on all levels of governance in the country and that also had implications for the fiscal decentralization and equalization system. A major breakthrough was the adoption of the new Law on Self-government, in January 2002, that substituted the previous Law on Self-government of 1995, which contained major deficiencies, mainly in the financial functioning of local self-government units. This fiscal decentralization reform process, besides the adoption of the new Law on Self-government, also consisted of amendments to the Constitution (Articles 114–117), adoption of a number of laws – among them the Law on the City of Skopje, the Law on Financing Units of Local Self-government, and the Law on Territorial Organization of Local Self-government – for a total 32 new pieces of law and legislation, all of which contained revolutionary provisions for the reform of the financial functioning of local self-governments in Macedonia.

The new reform package contains three main processes: the transfer of certain competencies from the central to the local level, the transfer of civil servants and other state employees from central to local institutions, and the transfer of funds from the central to local budgets.

To a certain extent, the adopted reforms, in theory, have overcome the above-mentioned deficiencies, at least in the legal framework. With the undertaken reforms, a new basis has been established to overcome some unfavorable conditions. The challenge now remains for Macedonia to operationalize the achievements of the legal framework for fiscal decentralization.

In this report evaluating the intergovernmental finance system and the system of financial equalization, due to the recent adoption of thorough reforms, it will be necessary to compare both systems, the one that existed between 1991–2002, or more precisely between 1991–2004, and the one to be implemented from mid-2005 as a result of the reform package adopted in the period 2002–2004.

Basic Competencies of Local Governments

Before the adoption of the new reform agenda, local self-governments in Macedonia had competencies only in limited areas. For example, they did not have competencies in significant areas such as local economic development and financing, or health and education.

With the adoption of the reforms, local self-government units acquired new competencies, including significant economic and social sector responsibilities such as economic development, urban planning, communal activities, management and financing of primary and secondary education, social welfare facilities such as old-age homes and orphanages, and primary healthcare. Until now, local jurisdictions were authorized to adopt the detailed urban plans; the construction permits were awarded by the central government, i.e., the Ministry of Transport and Communication.

With the new reforms, mayors and members of municipal councils are to administer thousands of elementary schools, hundreds of secondary schools, fifty or more kindergartens, and one hundred fifty or more primary healthcare facilities. Local units will be authorized to award construction permits and they will prepare their own economic development plans. Streets, parks, markets, and cemeteries will all be under the competencies of mayors.

In the new system, the general competencies of local governments include, in accordance with the principle of *subsidiarity,* the right to perform activities of local importance on their territory that are not excluded from their competency or are not under the competency of the organs of the state administration.

Municipalities have the right to regulate and perform activities of local importance independently. The competencies are, by law, comprehensive and exclusive and cannot be taken away or limited. Local self-government, in essence, is a constitutional right recognized by the Constitution of Macedonia.

The new competencies of the local jurisdictions are to be transferred to 85 "new" municipalities not more than 90 days after the local elections, held in March 2005.

Table 1.
New Competencies of Local Governments in Macedonia

Competencies	Details
Urban and rural planning	Urban planning, issuing of technical documentation for construction, and issuing of construction permits; regulation and maintenance of construction land.
Environment	Measures for protection and prevention of water, atmosphere, and land pollution, protection of nature, protection against noise and ionizing radiation.
Local economic development	Local economic development planning; determining of development and structural priorities; running of local economic policy; support of the development of small- and medium-size enterprises and entrepreneurship, and in that context, participation in the establishment and development of a local network of institutions and agencies; and promotion of partnerships
Communal activities	Potable water supply; water supply infrastructure; drainage and purification of waste water; public lighting; drainage and treatment of precipitation; maintenance of public hygiene; collection, transport, and treatment of communal solid and technological waste; regulation and organization of local public transport; supply of natural gas and heating energy; maintenance of graves, cemeteries, crematoria, and provision of burial services; construction, maintenance, reconstruction, and protection of local roads, streets, and other infrastructure; regulation of traffic; construction and maintenance of traffic signals; construction and maintenance of public parking spaces; removal of improperly parked vehicles; removal of damaged vehicles from public spaces; construction and maintenance of markets; chimney sweeping; maintenance and use of parks, green belts, and recreational spaces; regulation, maintenance, and use of river beds in urbanized areas, determining names of streets, squares, bridges, and other infrastructure, etc.
Culture	Preserving cultural heritage; celebration of events and persons of importance for the culture and history of the municipality.
Sport and recreation	Development of general sport and recreational activities of citizens; organization of sporting events; maintenance and construction of sport facilities of public interest for the municipality; support sporting associations.
Social welfare and child protection	Kindergartens and homes for the elderly (ownership, financing, investment, and maintenance); social care for disabled persons, orphans, children with educational and social problems, children with special needs, children from single-parent families, persons exposed to social risk, persons with drug and alcohol addiction; raising of citizens' awareness; housing of persons at social risk, sheltering and education of pre-school children.
Education	Establishing, financing, and administering primary and secondary schools, in cooperation with central government, in accordance with law; organizing transportation of students and their accommodation in dormitories.
Healthcare	Governance of the network of public health organizations and primary care buildings to include representation of local government in all the boards of all publicly owned healthcare organizations; health improvement; preventive activities; protection of health of workers at their workplaces; health oversight over the environment; oversight over contagious diseases; assistance to patients with special needs (mental health, child abuse, etc.); and other areas determined by law.
Civil protection	Protection and rescue of citizens and their property against war, natural, and other disasters, as well as against the consequences caused by a state of war.
Firefighting	Firefighting activities performed by territorial firefighting brigades.
Supervision	Supervision over the performance of activities under municipal competency.
Delegated functions	Municipalities can also be tasked by a public administration body for the execution of certain tasks from its competency.

Source: Law on Self-government, January 29, 2002, *Official Gazette*. No. 5/2002. Also Online: http://www.zels.org.mk.

Number and Size of Local Governments

Previously (i.e., between 1991–2004), there were 123 municipalities, plus the City of Skopje as a special unit of local self-government. In total there were 124 units of local self-government. This number was unsustainable.

With the adoption of the new Law on Territorial Organization of the Local Self-government on August 11, 2004, this number was decreased to 85 units of local self-government. In Macedonia, local self-governments are divided into three groups: city-municipalities; village-municipalities; municipalities in the City of Skopje, and the City of Skopje itself as a special unit of local self-government regulated by a special Law on the City of Skopje. In total, there are 85 units of local government (including the City of Skopje).

Merging of some of the old local jurisdictions will not terminate the work of the old offices of those local units. They will continue to function as service centers dealing with the demands and complaints of local residents.

Table 2.
Type and Number of Local Governments

Type of local governments	Number of local governments (2004)	Number of local governments (1991–2002)
City-municipalities	33	116
Village-municipalities	41	
City of Skopje municipalities	10	7
City of Skopje	1	1
Total	85	124

Sources: Law on Territorial Organization of the Local Self-government in the Republic of Macedonia of August 11, 2004. *Official Gazette*. Online: http://www.president.gov.mk; Law on Territorial Organization of the Republic of Macedonia and Determining the Areas of the Units of Local Self-government. *Official Gazette*. No. 49/1996.

Note: A city, according to the country's laws, has more than 3,000 residents (city-municipality). A village-municipality has less than 3,000 residents.

Local Fiscal Autonomy

Legal autonomy of the local governments in finance matters is regulated by the Constitution, the Laws on Local Self-government and on Financing Units of Local Self-government, on the City of Skopje, and other laws that regulate the functioning of local self-government in various fields. The Constitution (Article 115) states that the municipality is "autonomous in exercising its competencies…."

Municipalities are guaranteed judicial protection before the competent courts with regard to the acts and activities of the organs of state administration and government that impede the performance of the municipalities' competencies. In this context, the Law on Financing Units of Local Self-government contains provisions that give the right to the municipal council, as well as mayor, to raise a case before the Constitutional Court for the assessment of the constitutionality of the laws as well as the constitutionality and legality of the general acts of ministries and the other state organs in which the constitutional position and the rights of the municipality may be infringed.

This financial autonomy of the local government mainly covers issues like budgeting, expenditure, revenue raising, property ownership, and borrowing.

Budgeting

Prior to the recent reforms, the preparation of local budgets was closely linked to the preparation of the general budget. Pursuant to the Law on Budgets, the local self-governments' budgets – the administrative budget and municipal funds budget – were prepared and adopted on the basis of the same procedure and by the same dynamics prescribed for the central government budget. For most of this period, local governments did not control a single consolidated budget. Instead, municipal budgets were composed of an administrative budget, and a number of off-budget funds that sometimes were referred to as programs.

With recent reforms, a municipality has greater independence to prepare and execute its municipal budget. If in the course of the fiscal year the revenues and expenditures are not realized as planned by the municipal budget, the mayor may propose that the council change and amend the budget (rebalance) at least twice a year.

Spending Autonomy

Prior to recent reforms, local governments faced several limitations on budget execution. For instance, they did not have the autonomy to decide on spending own source revenues that were capped. The Law on Caps of Own Revenues of Units of Local Self-government limited the already scarce revenues of the municipalities.

With recent reforms, a municipality, within its competencies, independently is able to dispose of its own source revenues. Now, the municipality may decide autonomously about the use of its own revenues, and revenues from shared taxes such as the personal income tax.

Revenue Raising

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, paid to the account of the central budget, and then the funds were distributed to the local government units, according to defined criteria.

With recent reforms, the activities for calculating and collecting of own revenues of the municipalities are set to be performed by the municipal administration. The municipality also is able to define the level of the tax rate and the level of the charges and fees. The municipality will take on employees from the Ministry of Finance – public revenue offices and the department for common and financial affairs, which perform taxation and revenue activities.

Property Ownership

In both systems, the municipality has had a right to ownership over assets, funds, and appertaining rights. The value of ownership of the municipality is evaluated and shown in the annual balance sheet. The ownership of the municipality is disposed of and managed in the best public interest and in good faith. The entire ownership of the public agencies established by the municipality is owned by the municipality.

The municipality may sell assets that are owned by the municipality only through public bidding. The selling price of these assets may not be smaller than their market value. Financial means acquired by the selling of municipal assets may be reinvested only for acquiring new property or reconstruction of existing municipal property.

Municipal property may be given for use to other entities, whereas the authorized beneficiaries as well as the type and scope of the right for usage can be defined in the decision granting the use.

In the new system, as the functions devolve to the local level, so too the ownership of the relevant facilities passes from the state to the local level.

Borrowing

Prior to the reforms, municipalities were entitled to borrow, but borrowing was limited to the funds of the general budget of the country and to the domestic market. With the reforms, the municipality now has the right to borrow from foreign capital markets. But the municipality may borrow from foreign entities only with prior consent from the central government.

The municipality can take out short-term loans, which are to be repaid by the end of the current fiscal year. Short-term borrowing can be used for covering the municipalities' temporary cash deficits but not for payment of fines and penalty interest. The total amount of short-term borrowing in the course of the fiscal year cannot exceed 20 percent of the overall revenues from the current-operational budget of the municipality in the preceding fiscal year.

The municipality is also autonomous in terms of long-term borrowing for the financing of capital assets or investment projects, but only if the repayment is made in equal or decreasing annuities. The municipal council approves the proposed long-term borrowing only after a public hearing has taken place, at which the main features of the project and its terms of financing are explained. The decision for a long-term borrowing reached by the municipal council shall be valid only if the agreement for borrowing is concluded in the same fiscal year of reaching the decision. The total amount of the annual debt-service from long-term borrowing in one fiscal year can amount up to 15 percent of the overall revenues in the current operational budget of the municipality in the preceding fiscal year.

Basic Structure of Intergovernmental Finance System

Before the adoption of the recent reform-oriented laws on local financing, there were numerous problems that hindered the proper functioning of the intergovernmental finance system in Macedonia. For example, there was no possibility for local self-government units to be funded by the revenues from local fees and taxes according to rates that they could define by themselves.

There were limited discretionary rights for local self-government units to establish spending policy within their competency because the funds allocated by the state were for specific use only. Also, local self-government units had trouble accessing the national capital market. Moreover, there was neither consultation nor coordination from state bodies and agencies distributing funds to finance projects in local self-government units at that time.

Furthermore, there was no framework legislation governing municipal finances in the country. Instead, the rules governing the revenues, the formation, and the execution of municipality budgets, and their financial reporting obligations, were embedded in a wide number of laws and ordinances, many of them set annually. In addition, there also was a lack of good data on the current financial situation of local self-government units.

With the adoption of the new laws, a new system of intergovernmental financing has been established. A major feature of this system is that it develops a local public financing system by adopting a special law on financing local self-government units (Law on Financing Units of Local Self-government of 2004) that enables a high level of financial independence.

The new system also amends the laws that previously limited the sources of funding for the local self-government units established by the Law on Local Self-government of 1995. Also, it balances the sources of financing with the actual needs of local self-government units. In addition, it develops legal provisions to support a transparent system of financial balancing of the local self-government units by clearly defined criteria. Moreover, it strengthens discretionary rights of local self-government units to allocate funds in the framework of their competencies and makes local self-government units responsible for the setting and execution of the budget.

The municipalities are to be financed from their own and other sources of financing. Own source revenues of the municipality are: local taxes, charges, and fees determined by law. The municipality, within the framework determined by relevant laws, is to define the level of the tax rate and the level of the charges and fees of its own source revenues. The municipality is also to be financed by grants from the state and other sources of revenues. Moreover, the municipality has the right to borrow from the domestic and foreign capital markets. The municipality, in addition, within its competencies, is independent in disposing of its own source revenues.

Composition of Local Government Revenues

Old System

Before recent reforms, sources of revenue of the local governments were limited to:

1) Taxes: property tax; tax on inheritance and gifts; tax on the transfer of immovable property and rights;
2) Fees, charges, and other revenues: land fee (construction site utilization charge); communal fee (construction site arrangement charge); property revenue, etc.; earnings from public enterprises founded by the local self-government unit (charges for providing local services/local public transportation, water supply, sewerage, waste disposal, etc.);
3) Funds received from various state bodies or agencies;
4) Donations from domestic and foreign sources (in goods and money);
5) Local contributions both in manpower or financial resources.

Local self-government units in Macedonia with these sources of revenues and with no own revenue-raising authority and limited expenditure powers were extremely underfunded. There were huge vertical imbalances between the central government and local governments and horizontal imbalances among the local governments themselves.

Vertical imbalances were characterized by the large amount of debt the municipalities owed to suppliers of goods and services, amounting to around MKD three billion. Also, the local government expenditures made up only around 1.7 percent of GDP (2003) (see Appendix 1.), compared to the central government's GDP expenditures of 21.27 percent. This was the illustration of the centralized fiscal system in the country.

The high fiscal dependency of local governments on central government can also be illustrated by the high dependency of local government units on central government sources of revenues. According to figures from 2001, 67 percent of the municipal revenues derived directly from the national government.

The horizontal imbalance was characterized mostly by the high share of local governments with per capita revenues well below the national average. For example, according to the figures of 2003, 41 local governments, representing 36 percent of the country's population, had per capita incomes of less than 50 percent of the national average. Also, according to figures from 2002, 72 percent (88 municipalities) of the local government units realized less than 40 percent of the average expenditures from the total.

Under the old system the public revenue offices were responsible for administering the local tax revenues (property tax, inheritance and gift tax, and tax on real estate and rights transactions); however, the collections were poor since the highest-quality revenue sources were economic activity related taxes (VAT, personal income tax), which were available only to central authorities – another fact contributing to the financial insufficiency of local self-governments.

Another example illustrating horizontal and vertical imbalances is the poor collection record of the public revenue offices. For example, in 2000, 20 out of 30 local units of public revenue offices collected tax less than the average collection. Also, there were problems in the distribution of local revenues. Local bodies often were not well informed as to the amounts of money collected from the sources of revenues that would serve their needs.

In 2004, a pilot project was launched in four cities (Gostivar, Struga, Sveti Nikole, and Veles) to test the ability of these municipalities to collect the designed revenues. The pilot project was a test for devolving the administration of property taxes to the local government units. The project in practice was very successful. For example, in the period from January to September 2004, the collection rate of property tax increased by 41 percent, and the collection rate of the property transfer tax increased by 195 percent.

New System

In the new system, defined by the adoption of new laws in the period of 2002–2004, sources of financing of the municipality have been extended and they include the following: shared taxes; own sources of revenue; transfers of funds from the budget of the republic and budgets of the state funds; and borrowing.

1. Shared Taxes

As a shared tax, personal income tax is to be a major new source of revenues for local governments. In this case, the municipalities are to realize revenues from the personal income tax, collected in the current year. Revenues from personal income tax are to be distributed to the municipalities according to the following criteria:

- Three percent from the personal income tax from salaries of physical persons, collected in the municipality where they are registered with a permanent domicile and residence;
- 100 percent from the personal income tax from physical persons who are performing craft activity, registered in the territory of the municipality in accordance with the Law on Craft Activity.

Globally, this share from personal income tax amounts to about MKD 180 million, or about four percent of the total revenues of local governments in 2003. The municipalities realize revenues from the personal income tax, collected in the current year.

2. Own Taxes

a) Own sources of revenues are:
   - The property tax;
   - The tax on inheritances and gifts;
   - The tax on the transfer of real estate;
   - Other local taxes established by law.

b) Other revenues include revenues from ownership, including:
   - Revenues from leasing;
   - Revenues from interest;
   - Revenues from the sale of property that does not disturb public functions and competencies of the municipalities.

c) In addition there are other revenues:
   - Revenues from donations: Donations in financial means are revenues to the municipal budget. Donations in assets are registered as property of the municipality. The purpose and the manner of usage of donations are regulated by an agreement between the donor and the mayor, for which the municipal Council gives prior consent.

d) Revenues from fines;

e) Revenues from self-contribution (charge): In order to meet certain needs of the citizens the municipality may introduce self-contribution through a referendum. The decision of the council of the municipality is entitled to regulate the purpose, sector, and duration for which the self-contribution is to be introduced, total amount of revenues that will be collected, payers of self-contribution, exempted persons, amount of the self-contribution (base and rate), manner of calculation, supervision by the citizens over the intended purpose of the funds, as well as other issues;

f) Other revenues.

3. User Fees and Charges

a) User fees include:
   - Utilities fees;
   - Administrative fees; and
   - Other local fees.

b) Local charges include:
   - Charges for urbanization of construction land;
   - Charges for communal activities;
   - Charges for spatial and urban plans; and
   - Other local charges.

The activities for calculating and collecting own revenues of the municipalities, in difference from the previous system, are to be performed by the municipal administration. For the performance of these activities the municipalities may enter into an agreement with another municipality or with the public revenue office.

4. Grants from the Budget

Grants are instruments used by the central government to provide additional revenues for smooth performance of the competencies of the local governments determined by law. Grants from the budget of the government of Macedonia and budgets of the funds, provide additional revenues for the municipalities to finance their competencies, and aim for the equalization of the financial situation of municipalities.

The following grant types are to be allocated from the budget of the government of Macedonia and the budgets of the funds: *earmarked grants; capital grants; block grants;* and *grants for delegated competency*.

a) Earmarked grants: An earmarked grant is used for financing a special activity. The line-ministries and funds propose to the Ministry of Finance the distribution of the earmarked grants per municipality, project, institution, and/or program with a budget calculation for the following budget year. The line-ministries and the funds monitor the execution of the earmarked grant. A line-ministry manages a particular grant under its authority, and this case would include the Ministries of Culture, Labor and Social Policy, Education and Science**.**

b) Capital grants: The capital grant, on the basis of the program determined by the government, is used for financing investment projects. The line-ministries and the funds, in their distribution of the capital grants, give priority to projects that previously have collected the necessary funds and to projects that have started yet not been completed. The line-ministries and the funds control the execution of the capital grant. This includes the Ministries of Transport and Communication, Environment, and particular funds, including the Fund for Economically Underdeveloped Regions and the Fund for Regional Roads.

c) Block grants: Block grants are used for financing through concrete programs the competencies of the local self-governments in the fields of *culture; social welfare and child protection; education;* and *healthcare*.

d) Grants for delegated competency: The grant for delegated competency is used to finance a delegated competency of a mayor's central state management functions. The funds for the delegated competency are provided from the amount set in the budget of the republic for the line-state management body. The minister who manages the state administration body and the mayor of the municipality conclude an agreement for the regulation of mutual relations regarding the grant for delegated competency.

Equalization Measures

Old Equalization Mechanisms

Up to the adoption of the recent Law on Financing Units of Local Self-government of August 2004, and its subsequent implementation in mid-2005, there was no instrument envisaged for the purposes of equalizing the financial situation of local governments set in the legislation on local self-government. However, there were transfers and funds. Although not originally designed for this purpose, in practice they were used for equalization purposes.

The municipalities appeared as users of additional resources that they received, as mentioned earlier, from the central budget and funds as specific grants. These municipal resources were earmarked mainly for investments in infrastructural facilities. However, the municipalities had no discretion in their utilization. Most of these transfers were allocated by the Bureau for Economically Underdeveloped Regions. Several other programs were used as bases for transferring funds to the municipalities, such as transfers from: the "Fund for Roads," the "Water Supply Program," the "Physical and Urban Planning Program," the "Program for Revitalization of Rural Areas," the "Rural Areas Electrification Program," the "Local Media Program," and projects funded from the sale of the Macedonian Telecommunications Company.

Due to the lack of sufficient funds, and the lack of objective criteria in distribution and allocation, the transfers did not provide a proper, functioning equalization system. For example, the Development Fund for Economically Underdeveloped Regions, which could be treated as the most significant equalization fund, suffered from insufficient funds; it amounted to between 0.3–0.1 percent of total national public revenues.

There were no objective criteria set for the priority allocation of funds, while complaints were recorded by mayors and council members that party interests had influenced the decisions. The transfers were not entirely based on quantitatively defined criteria. Rather, there was a high level of central government discretion, mainly political, in the transfer of funds to the municipalities. Only the Road Fund transfers were made according to the defined quantitative formula. The criteria included: number of vehicles, fuel consumption, road network size, population, and local government area.

Mismanagement and lack of objective criteria in the transfer of funds dominated the financial equalization system in the country. Namely, the methodology of transfers included no standards for the minimum acceptable levels of expenditure for municipalities, but was simply a mechanism for donating funds to those units of local self-government that had no fiscal or administrative capacity to generate their planned budget revenues. There was also no clear link between the levels of the municipalities' own revenues per capita and transfers per capita. The methods of fund allocation did not remove horizontal disparities, as allocation was not based on acceptable standards for the provision of public services; nor did it take into account municipal fiscal capacities.

The system of allocating transfers from the central budget to municipalities suffered from a number of deficiencies typical of developing countries that lack financial equalization mechanisms.

Large municipalities were the largest beneficiaries of funds transferred from the central government, while, at the same time, there were frequent cases in which smaller municipalities received resources well beyond their fiscal needs. Also, the system was not sufficiently transparent or based on objective criteria, as the funds were mostly transferred on the basis of the political and personal connections of the mayors.

This created a dependency within municipalities for central government transfers. This has been especially true for rural municipalities, where transfers from the central government were the predominant source of local revenues, although it was also the case in some urban municipalities. However, these transfers did not contribute to the equalization of the financial status of municipalities; even after receiving the transferred funds budgetary differences among municipalities could still be large.

The Capping System

Every year, the government passed a law on the limitation of public expenditures that placed a cap on the amount of shared taxes (mainly the property tax), which could be allocated to the administrative budgets of the municipalities. Municipalities were assigned a 100-percent share of the property tax, the property transfer tax, the hotel tax, and all the communal fees and charges regulated by the law thereof. The rates for all these taxes, fees, and charges were set by the national government, and most, but not all, were collected by government's 30 public revenue offices.

In the cap system, the Ministry of Finance used to allocate the resources obtained from taxes (mainly from property tax) collected among local government units on the basis of the following criteria: 80:10:10 (80: population; 10: number of inhabited settlements; and 10: area km^2). This procedure applied only to revenues of the "administrative budget" of local government units, which covered all items relating to the operation of LGU staff.

What the cap system meant, in practice, was that the regionally collected shared taxes were redistributed back to local governments within the region on the basis of the 80:10:10 formula until they hit their caps, at which point the surplus became the property of the national government. The government then allocated most of this surplus back to local governments once or twice a year, but on an *ad hoc* basis. A special methodology for the allocation of this surplus was adopted only in 2002. According to this methodology, the transfer of funds collected from the surplus revenue against the defined level of local government units' consumption was to be based on two criteria:

- 65 percent of funds were allocated on the basis of local government units' deficit share in the total amount of revenue deficit; and
- 35 percent of funds were allocated on the basis of the share in the total amount of surplus revenues.

However, this methodology was not implemented.

These restrictions did not apply to the budgets of various local government funds, which functioned as separate legal entities, and later, with the reforms, were integrated within the general municipal budget. These funds generated their own revenues called "taxes on specific services," which were not capped by the above-mentioned cap system.

The cap system, despite its disadvantages, in essence, could have been used as an equalization instrument. There were at least two ways in which some equalization could have taken place with the cap system. The first is that the same formula, used to set the caps for the property taxes assigned to local government administrative budgets, could have been designed to affect some equalization. The second is the distribution of the "surplus" (property tax revenue that exceeded the caps) could have been allocated to equalize to a certain percent of the national per capita average.

Equalization Today

With the reforms undertaken recently, and the adoption of the Law on Financing Units of Local Self-government in 2004, the only defined equalization instrument will be revenue that will be transferred from the yield of the value added tax. Also, specifically for the City of Skopje and the other municipalities in the City of Skopje, for the purposes of the equalization, a Joint Fund has been established. The Joint Fund is to be funded by the funds that will come from personal income tax, communal tax for company title, communal street tax for passenger, cargo and auxiliary vehicles, and other means.

Although not explicitly mentioned, one of the four categorical funds, *block grants,* are considered as the instruments to be used by the national government to equalize the financial situation of local governments.

New reforms eliminate the caps system on the revenue that local governments receive from shared property taxes and communal fees, and with it the redistribution of the surplus. The same taxes and fees are becoming the true own source revenues of local governments. In the new system, local governments will be responsible for setting the rates of the property tax, the property transfer tax, and the gifts and inheritance tax, as well as for communal fees and charges like the hotel charge and the sign fee, with maximum and minimum limits specified by the amended laws on property taxes and communal fees. Also, responsibility for maintaining tax rolls, cadastres, and collections are to be transferred from the public revenue offices to local governments.

The new reforms in the system of intergovernmental transfers imply the establishment of an explicit financial equalization system. This, in turn, requires resolving of a basic issue: the transfer allocation mechanism.

Regarding the distribution of transfers, the system should be objective and transparent, i.e., using a formula to determine the amount of funds to be received by each individual municipality. Also, the total transfer amount should be defined in advance, to avoid *ad hoc* decisions that might jeopardize overall fiscal discipline.

VAT as an Equalizing Tool

With the new system, in the case of *the value added tax*, revenues are provided by: three percent of the total amount of collected VAT from the previous fiscal year. The distribution of revenues from taxes are to be executed at least 50 percent, according to the criteria per capita and other criteria to be defined by an ordinance on the methodology of the distribution of revenues from VAT that will be enacted by the national government. The national government is to pass the ordinance, upon proposal by the Minister of Finance, previously accepted by the Committee for Monitoring the Development of the Municipalities' Financing System, no later than June 30 of the current year for the next year.

The other criteria for the distribution of the three percent yield of VAT remains to be seen. But it does leave open the possibility that significant amounts of the equalization fund could flow to the capital, Skopje, despite the fact that Skopje is and will remain far and away the richest jurisdiction in the country. And, as the other criteria are still not known, it is hard at this stage to make an assessment of how the revenues from VAT will affect the horizontal and vertical balances of the system.

For the City of Skopje, there are special criteria determined by the methodology to correct the significant differences between the City of Skopje and the other municipalities. In the case of the Joint Fund of the City of Skopje and the municipalities in the City of Skopje, revenues are to be realized in accordance with the methodology for distribution of the funds from the Joint Fund that is to be adopted by the Minister of Finance.

The global yield of three percent of VAT is about MKD 700 million or about 16 percent of the total revenues of the sector in 2003. With a three percent share of the yield of VAT, local governments are to increase their revenues by 30 percent on an aggregate level.

Block Grants As De Facto Equalization Instruments

Block grants are used for financing through concrete programs the competencies of local self-governments in the fields of *culture; social welfare and child protection; education;* and *healthcare*. The line-ministries and the funds will develop methodology for determining the criteria for the distribution of block grants, which is to be formula-based, using appropriate need indicators for each program. The government will pass an ordinance on the methodology to determine the criteria for distribution of block grants upon the previous approval by the Ministry of Finance with a prior consent from the Committee for Monitoring of Development of Municipalities' Financing System.[2] The total amount of block grants

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[2] The Committee for Monitoring of Development of the Municipalities' Financing System, to be established by the national government, is to monitor the development of the system for financing municipalities. More concretely, it is supposed to monitor the implementation of the criteria for the distribution of grants; to propose measures for the improvement of the grants system; to provide recommendations for overcoming the failures in the distribution of grants; to monitor the transparency of the procedures and their consistent realization when distributing the funds from the grants; to prepare semi-annual and annual reports for the development of the system for financing the municipalities in which it determines proposals for improvement of the system; and to monitor the earmarked use of grants. Article 15, Law on Financing the Units of Local Self-government, August 11, 2004.

cannot be lower than the amount of the funds from the budget of the republic used for the same purpose in that area in the previous year from the year when a certain competence is transferred. Block grants are expressed at certain positions for the budget users in the budget of the republic and budgets of the funds.

The transfer of block grants allows the municipalities to have full responsibility for current expenditures (wages, maintenance, etc.), capital expenditures, management issues, hiring and firing teachers, school management organization and management, as regulated in separate laws for the appropriate areas. In 2003, the amount of expenditures of the central government in the social sector areas, where local self-governments have full responsibility, were around MKD nine billion in education, MKD 30 million in health, MKD one billion in social welfare, and MKD 500 million in the culture sector. With this amount of money to be transferred to the local level, the expenditures of local governments are to increase by more than 200 percent.

A challenge that remains with regard to block grants is how the government is to deal with the potential to reduce the revenues of some local governments and transfer the remainder to other jurisdictions to top their revenues according to their needs.

The new system requires that block grants are allocated in a fiscally neutral way. However, it is unknown how the government will be able to decentralize social sector functions in a revenue neutral way. The reason for this is that the current spending on these functions by the national government is extremely uneven across the country when measured on per user or per capita basis. This means that if block grants are to be allocated fairly across jurisdictions, resources will have to be shifted from areas that are currently overfunded to areas that are underfunded. This can cause political headaches.

The new system also requires a phased-in approach to the decentralization processes. During the first stage, local governments are to receive grants to finance the facility maintenance costs of the social sector functions. The second stage will begin thirty months after the Law on Financing Units of Local Self-governments goes into effect, and with the condition that local governments must be able to demonstrate that they have no payment arrears. During the second phase, local governments will become responsible for bearing the full costs of these functions, including their wage costs.

Conclusion

Fiscal decentralization has been the major part of the reforms undertaken in the framework of overall local government and decentralization reform processes in Macedonia in recent years. The reform package of 2002–2004 is to transform the fiscal intergovernmental system in Macedonia thoroughly. It is to have sweeping changes in the competencies of the units of local self-government, mainly in their budgeting, revenue raising, and expenditure authorities.

The new system established with the reform package of 2002–2004 has led to conditions suitable for the establishment of a new system of financing that would guarantee financial independence and quality performance of the competencies of the units of local self-government in the country. It would provide for the establishment of a new system of local public ownership, in line with the new competencies and responsibilities of units of local self-government, and it will establish the basis for the high-quality, cost-effective performance of public services, through competition and appropriate control.

The new reform laws establish completely new fiscal relations between the central government and local self-government, i.e., the implementation of fiscal decentralization and establishing the balance between local needs and assigned financial sources.

However, there are challenges that might impede successful implementation and operationalization of these new reforms. These challenges are to be faced simultaneously by both national government and local government units. For instance, at the national government level, there will be the need for a thorough overhaul of many sectoral laws. This task requires the coordinated action of a wide range of national government actors who, in practice, tend to be reluctant to cooperate in this field.

The full responsibility of local self-government units for the new functions will not be transferred immediately. There will be a phased-in approach over a number of years, with local governments first assuming the responsibility for the operation and maintenance of the infrastructure, and only later for the personnel. However, a large number of municipalities do not have the sufficient technical and human capacity to cope with the challenges of fiscal decentralization. The successful implementation of fiscal decentralization therefore requires the development of adequate institutional arrangements – fiscal rules, internal and external control, a reporting system, and legal accountability – that will ensure a healthy fiscal position for local self-governments.

Although economic factors are not the only criterion, it is difficult to achieve financial sufficiency if the gross domestic product per capita is as low as Macedonia's. Local self-governments are therefore expected to face financial insufficiency and presumably reduced financial autonomy.

For the successful implementation of the new competencies of local governments there is a need for more money from the state budget and from their own income sources. For example, in the fields of the firefighting and protection of environment there will be a need for more projected financial resources to the local jurisdictions than current levels.

Despite the adoption of fiscal equalization instruments, the differences among municipalities and between central and local governments, reflected in the form of vertical and horizontal imbalances, are to continue. These imbalances suggest that in future there will be "winners" and "losers" in the intergovernmental finance system. Therefore, it is of utmost importance to properly use the re-distributive functions (read *equalization*) through the adoption of clear and transparent criteria that will alleviate doubts and suspicions about political criteria in the equalization system.

Macedonia, despite the undertaken reforms in the fiscal area, is one of the few remaining most fiscally centralized countries in Europe. The addition of the three percent of VAT and shares from three percent to 100 percent of different personal income taxes to the fiscal sources of the municipalities does not to solve the dependency of local jurisdictions on the central government and they do not help local governments cover their debt, amounting to roughly EUR 50 million.

The most painful aspect of decentralization is expected to happen in the health sector, for when this competency would be transferred to local jurisdictions, almost all health services are to be privatized. What will remain in the hands of local jurisdictions will only be ownership of some facilities. Therefore, there is a growing demand among many national and international governments and non-governmental officials for introducing another (regional) level to the local government system.

A higher level of administration than local self-government, which derives its competencies from local level rather than from the state level, is seen as a solution to the fiscal sustainability of many local jurisdictions in order to deal with the newly transferred local competencies. Those jurisdictions that are unable to establish primary healthcare facilities by themselves will be able to join together with nearby jurisdictions in establishing them.

The regional level of local self-government is not unprecedented for Macedonia. The Macedonian local government system already has the unit of the City of Skopje as a regional local unit. The establishment of similar regional units in other places is seen as a way to rescue municipalities from potential bankruptcy.

Many people believe that there will be a change of balance between the central and local government, that there will be more opportunities for economic development, increased competition, and possibilities for cooperation among local jurisdictions in reaching some common objectives in the sphere of economic and social development. But there also are skeptics who argue that the municipalities do not have the sufficient fiscal capacity to deal with the management of all the competencies and financial resources that are to be transferred to the local level and that, in turn, will produce no economic potential for local units. The key here is seen in increasing the own revenues of local municipalities to ensure their success. Thus local units can offset the development implications of transfers from the central level.

There is consensus that fiscal decentralization may not proceed smoothly in the coming period marked by a process of continued upgrading and care in order to facilitate the exercise of citizens' rights in Macedonia. It is the success of decentralization that will prove the administrative capacity of the state to deal with European integrative processes.

National and local debates in Macedonia on local self-government have mainly centered around the territorial reorganization of the municipalities rather than on fiscal decentralization. If fiscal decentralization reforms bring real results, in future the government will have to promote new reform processes in the decentralization field. New reforms are particularly needed in the area of concessions for natural resources, and other areas that require the adoption of the new laws and legislation.

Appendices

Appendix 1.

Local Government Revenues and Expenditures

Table A1.1

Local Government Revenues and Expenditures as a Share of All Public Revenues and of GDP, and Per Capita Averages for Income and Expenditure in MKD (2001, 2002, 2003)

Year	LG revenues as a share of GDP (percent)	LG expenditures as a share of GDP (percent)	LG revenues as a share of all public revenues (percent)	LG expenditures as a share of all public revenues (percent)	Per capita average for income (MKD)	Per capita average for expenditure (MKD)
2003	1.7	1.64	8.2	7.67	2,195.06	2,046.08
2002	1.48	1.37	6.20	5.76	1,786.84	1,660.62
2001	1.09	NA	3.66	NA	1,262.60	NA

Sources: Calculated from data of the State Statistics Council of the Republic of Macedonia. Online: http://www.stat.gov.mk. And from the Final Account of the Budget of the Republic of Macedonia for 2001, 2002, and 2003.

Appendix 2.

Composition of Local Government Revenues and Expenditures

Table A2.1

Composition of Local Government Revenues and Expenditures in Real (MKD) and Percent Terms (2003)

	Revenues	Percent
Tax revenues	2,888,337,268	65
Non-tax revenues	156,189,562	3.5
Capital income	49,662,728	1.1
Transfers and donations	1,294,113,813	29.1
Domestic borrowing	51,312,804	1.1
Total	**4,439,616,175**	**100.0**
	Expenditures	**Percent**
Salaries and allowances	545,234,633	13.1
Goods and services	1,459,990,559	35.2
Transfers	279,305,978	6.7
Interest	8,028,658	1.9
Capital expenditures	1,787,878,845	43.2
Capital transfers	28,147,712	6.8
Loans and stocks	1,289,753	03
Repayment of principal	28,422,077	6.8
Total	**4,138,298,215**	**100.0**

Source: Calculated from data of the Final Accounts of the Budget of the Republic of Macedonia for 2003.

Appendix 3.
Per Capita Revenues of Local Governments

Table A3.1
Average Per Capita Revenues of Local Governments by Quartile
(Poorest 25 Percent, Next Poorest 25 Percent, Next Wealthiest 25 Percent, Richest 25 Percent)
with and without the Operation of the Equalization System, 2003, in MKD

	Poorest 25 percent	Next poorest 25 percent	Next wealthiest 25 percent	Richest 25 percent
With equalization	743.77	1,198.25	1,883.04	5,240.30
Without equalization system	353.98	572.81	872.43	2,170.19

Source: Calculated from data of the State Statistics Council of the Republic of Macedonia. Online: http//:www.stat.gov.mk. And from the Final Account of the Budget of the Republic of Macedonia for 2003.

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