

# NEVER SAY NEVER: IMPLEMENTATION OF DECENTRALIZATION REFORM IN MACEDONIA

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## INTRODUCTION

OVER THE LAST DECADE, CONSIDERABLE progress has been 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 of Local Self-Government and the Ohrid Agreement, promising greater rights for the country's Albanian minority population. Although not perfect, the current legal framework as a whole provides a solid basis for building Macedonia's decentralization system. Because this legal framework stems from the Ohrid Agreement—which some consider a “shotgun wedding” imposed by international mediators to end the armed interethnic conflict in 2001—there was a lot of skepticism whether these provisions were ever going to be fully implemented. More to the point, the decentralization of specific functions was delegated to line ministries, which were afraid to use every opportunity to slow down the process, as they had no incentives to give up a significant part of their turf to municipalities.

However, recently, several important milestones have been reached in implementing the legislated system of decentralized government in Macedonia. Notably, the territorial division of municipalities has been significantly rationalized; at the same time, more revenue-raising and fiscal management powers have been given to the municipalities. As a result, local government expenditures as a share of GDP increased by over 60 percent between 2004 and 2007. In this paper we highlight some of this progress, but we dedicate more space and attention to those areas of the decentralized system in Macedonia where important challenges still remain.

The paper is structured along the main pillars of decentralized systems while it analyzes the main challenges and issues the Government of Macedonia faces in each of those areas. In particular, we cover the following main areas: vertical structure and scope of the government sector, expenditure assignments, revenue assignments, intergovernmental transfers, and borrowing. In the final section, we outline the potential contents of an agenda for reform.

## INSTITUTIONAL BACKDROP

Macedonia is a unitary country with a population of just over two million. Its new Constitution, adopted after the secession from the Socialist Federal Republic of Yugoslavia (SFRY) in September 1991, declares the right to local self-government as one of the fundamental values. Unlike other former socialist countries, Yugoslavia had had considerable local autonomy in the form of communes based on the concept of “selfmanagement by the working class.” However, similar to other ex-Yugoslavian countries, in the 1990s Macedonia underwent institutional transformations that created significant challenges for a decentralized system of governance. First, as part of what was thought nation-building and possibly as a reaction to conflicts in the region, the newly created national government concentrated massive powers at the expense of local governments. Second, as in other transition economies pursuing local self-government mostly for political reasons, Macedonia saw the emergence of an excessively fragmented local government structure.

Before 1996 there were 34 municipalities in Macedonia. The 1996 Law on Territorial Organization resulted in a more fragmented structure, including 123 municipalities and the City of Skopje as a special metro-wide government. The 2004 territorial reorganization 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 1,307 persons for Vranestica (which is made up of 15 rural settlements) to 106,481 for Kumanovo (which is made up of 47 settlements in addition to its urban seat). 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 would seem to be well above the “minimum efficient scale” for public services commonly provided by local governments throughout the world.

However, with these large disparities in scale, a strategy of assigning a single scope of functions to all municipalities risks the substandard provision of decentralized functions in some localities while a failure to utilize the capacity existing in some other municipalities. Except for the City of Skopje, which overlaps ten municipalities of its metropolitan area, currently there are no formal structures in place for inter-municipal cooperation to address the issue of lack of efficient scale; however, the necessary legal framework is being discussed and is pending approval.

### EXPENDITURE ASSIGNMENTS

The 2002 Law on Local Self Government 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 list of specific competencies includes the following:

- Urban and rural planning, local economic development, communal activities, and environmental protection;
- Firefighting, emergency management, and civic defense;
- Culture, sports and recreation;
- Social welfare and child protection;
- Education;
- Healthcare.

Although the language of the law is not clear, one can read it as the exclusive assignment to municipalities of the first category of activities (Art. 21), while in the sectors listed in Art. 22, local competences are exclusive only in specific subsectors further defined by subsequent legislation. The development of subsequent legal and regulatory acts took almost three years and produced over 30 laws and 50 by-laws. Therefore, the actual implementation of the fiscal decentralization process did not start until July 2005 and was slated to take place in two phases.

During the first phase, local governments were given responsibilities for the maintenance of facili-

ties such as schools and day-care centers. In four sectors (education, social welfare, culture, and fire-fighting) this was accompanied by allocation of earmarked grants from line ministries to cover recurrent non-wage costs in those institutions. As can be seen from Figure 1, local expenditure as a share of GDP increased from 1.77 percent in 2004 to 2.43 percent in 2006, mostly due to doubling of expenses on goods and services.

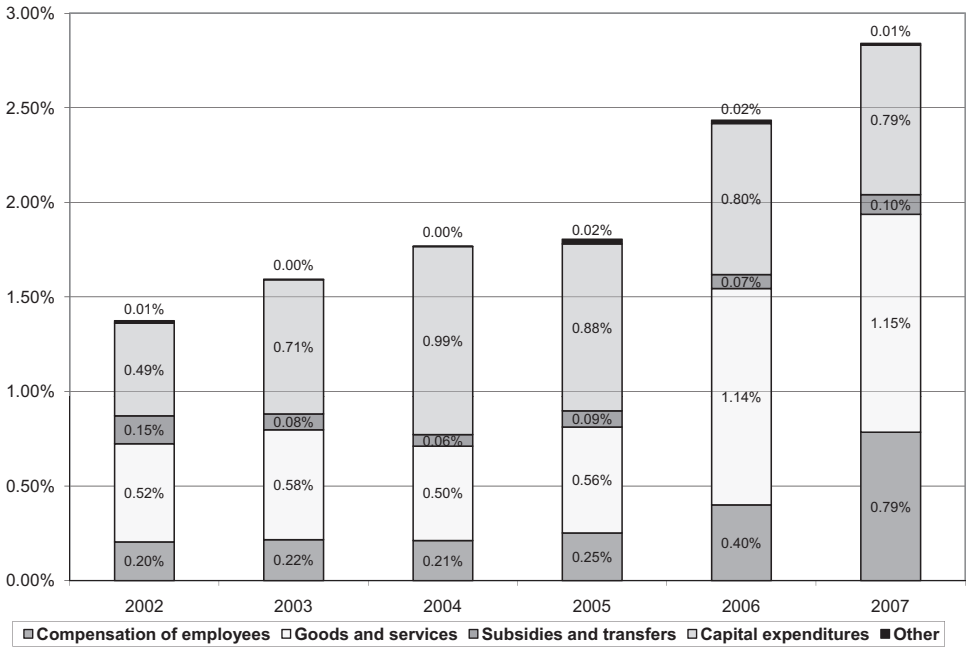
The second phase of fiscal decentralization started in September 2007. The advancement of municipalities to the second phase has been conditional on fulfilling certain criteria which include (1) adequate financial management and tax administration systems and staff, (2) satisfactory financial management and accounting during the previous two years, (3) timely reporting to the Ministry of Finance; and (4) no arrears to suppliers and creditors.

In 2007 only 42 out of total 85 local government units met the criteria and acceded to the second phase. Besides the formal recognition, the only difference that it makes for local governments is that salaries for staff of the transferred facilities are funded from a block grant rather than being paid directly by the line ministry. As a result, local expenditure as a share of GDP increased from 2.43 percent in 2006 to 2.84 percent in 2007, mostly due to doubling of expenses on wages (Figure 1). From January 2009, 66 municipalities in all will be admitted to the second phase.

According to the functional classification of local expenditures, most of local resources are allocated to education services (pre-primary, primary, and secondary), which represent one-third of total expenditures after the decentralization of teachers' wages in 2007 (Figure 2). The second largest functional category of expenditures is general public administration, mostly dominated by the municipal apparatus. The (close) third largest functional category is provision of economic infrastructure, such as roads and bridges, accounting for almost one-quarter of local expenditures.

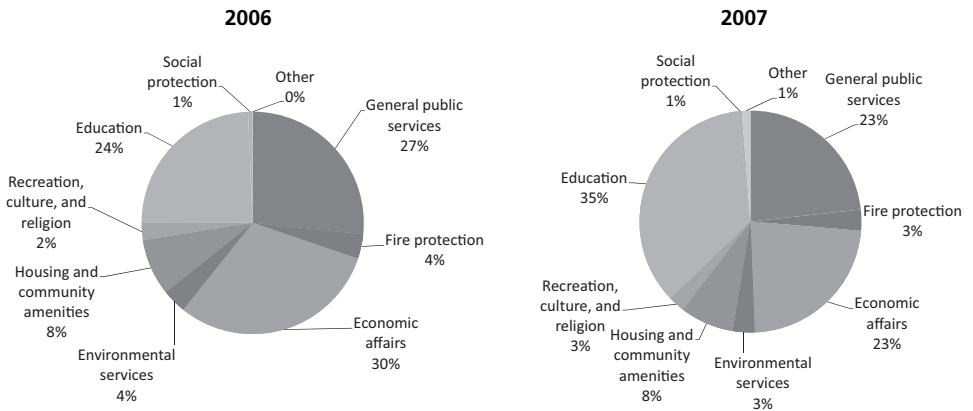
Currently, the wording used in the laws and regulations does not clearly delineate responsibility for the outcome of service provision. A possible reason for the lack of clarity in responsibility assignments is that the current delineation of competencies in the decentralization laws was not preceded nor informed by the development of comprehensive policy frameworks in each of the sectoral areas to be decentralized. Instead the

Figure 1: Local Expenditures by Economic Item in 2002-07 (% Of GDP)



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

Figure 2: Composition of Local Expenditures by Function, 2006 and 2007



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

process of devolving responsibilities has focused on the transfer of facilities, the operation and maintenance of these facilities and personnel.

One 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 or actual enrollment. This is highly problematic because of the unfair results it produces across municipalities; it also 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, which constitute almost one-half of all municipalities and one-third of the national population, 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

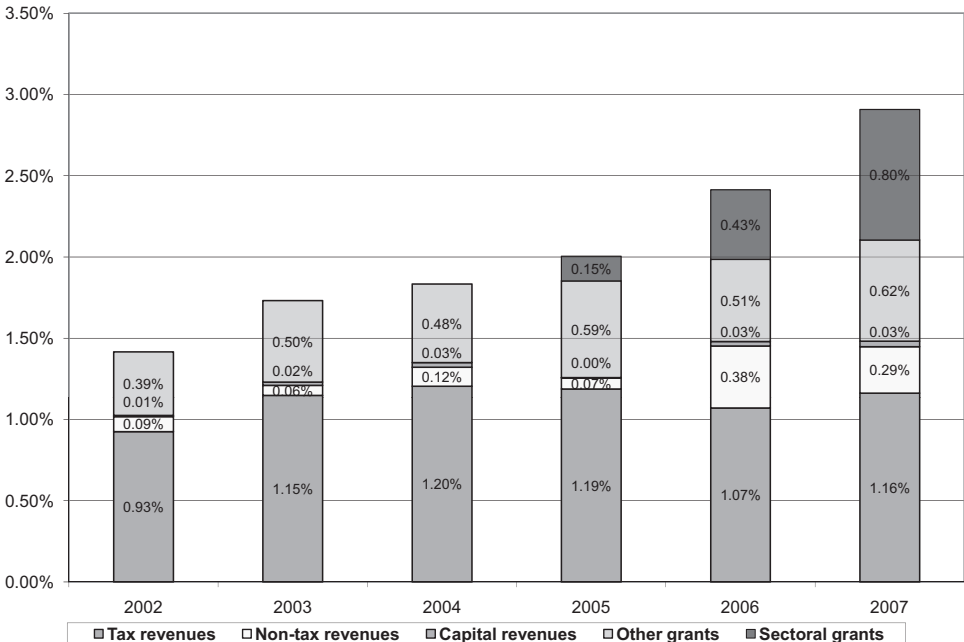
amount is less than in Skopje with the exception of child day care and primary schooling.

**Revenue assignments**

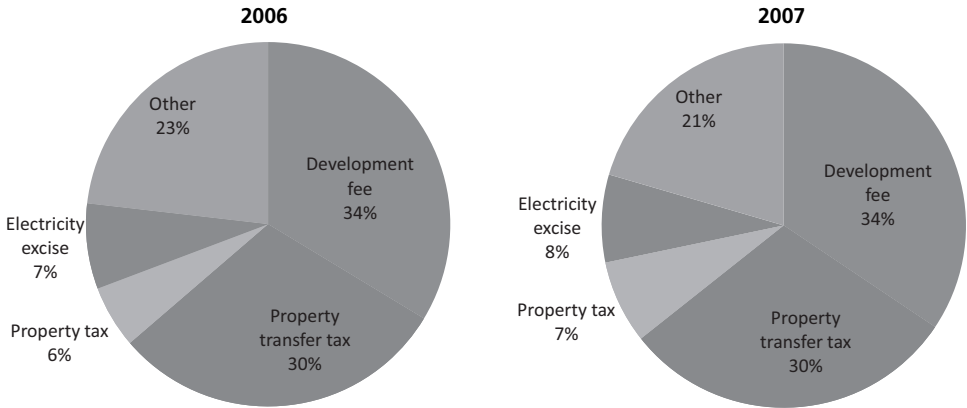
Both before and after the 2005 reforms, locally generated revenues accounted for more than one-half of local budgets (Figure 3). The transfer of public facilities led to a sharp increase in non-tax revenues in 2006 as user-fees and property leasing cover more than two-thirds of non-wage expenses in secondary schools, child day care, and senior homes.

While the law on financing the Units of Local Self Government (Arts. 4-7) and subsequent legislation provides local governments with a long list of tax instruments, most of them have limited revenue yield. In fact, more than three-quarters of locally-raised revenue is accounted for by just four tax instruments: development fee, property transfer tax, property tax, and electricity excise (Figure 4). One should note that the revenue yield for the (annual) property tax is very low at 0.09 percent of GDP; if this were increased to at least the average

Figure 3. Local Revenues as Percent of GDP: 2002-07



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

Figure 4. **Composition of Local Tax Revenue, 2006 and 2007**

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

in other transitional countries, the current yield would be multiplied almost by a factor of 10. At the same time, the taxation of property transactions is heavier than in other countries yielding 0.38 percent of GDP. While taxing property transactions is easier from the administrative perspective, at the same time a transactions tax is more detrimental to the real estate markets as optimal taxation requires lighter taxation of more elastic tax bases.<sup>1</sup> Similarly, the development fee, which technically should cover the costs of public infrastructure extensions to new construction sites, reportedly is not administered properly, placing the burden of all infrastructure upgrades—including those for existing properties—on new development projects.

Prior to the recent reforms of 2005, local revenues were collected by the national tax authorities and then the funds were distributed to the municipalities in accordance to the derivation principle and several equity criteria. Since administration of local taxes was assigned directly to the municipal governments in July 2005, revenue from all municipal own sources have increased with the exception of the development (utility connection) fees. Reportedly, this latter is due to difficulties in obtaining land for development, most of which is owned by the national government. But, unfortunately, the revenue drop from the development fees has outweighed the increases from all other revenue sources, notably property taxes. This has resulted in an overall decline in municipal own revenue between 2005 and 2007.

The design of revenue assignments in Macedonia faces the important constraint of very significant disparities in tax capacities. Thus, while covering only one-quarter of national population, the municipalities of Skopje account for 70 percent of development fee collections and one-half of property tax collections. These disparities impose a limit on how much the system can rely on increases in tax autonomy and tax revenue retention to finance local governments. More importantly, these disparities highlight the important role to be played by an equalization grant system.

#### INTERGOVERNMENTAL TRANSFERS

In addition to the sectoral grants, there are other channels for transferring general-purpose resources. First, local governments are allowed to retain 100 percent of the personal income tax (PIT) collections from individuals engaged in local crafts, and 3 percent from the PIT withheld from salaries of local residents regardless of the location of income source. With revenues from PIT retention accounting for only 2.8 percent of local budgets,<sup>2</sup> this measure has been criticized for being too small or even trivial. Essentially, in its present form, PIT retention is just a counter-equalizing form of intergovernmental transfers with the revenue impact being too small to justify the administrative costs of revenue allocation separate from other transfers.

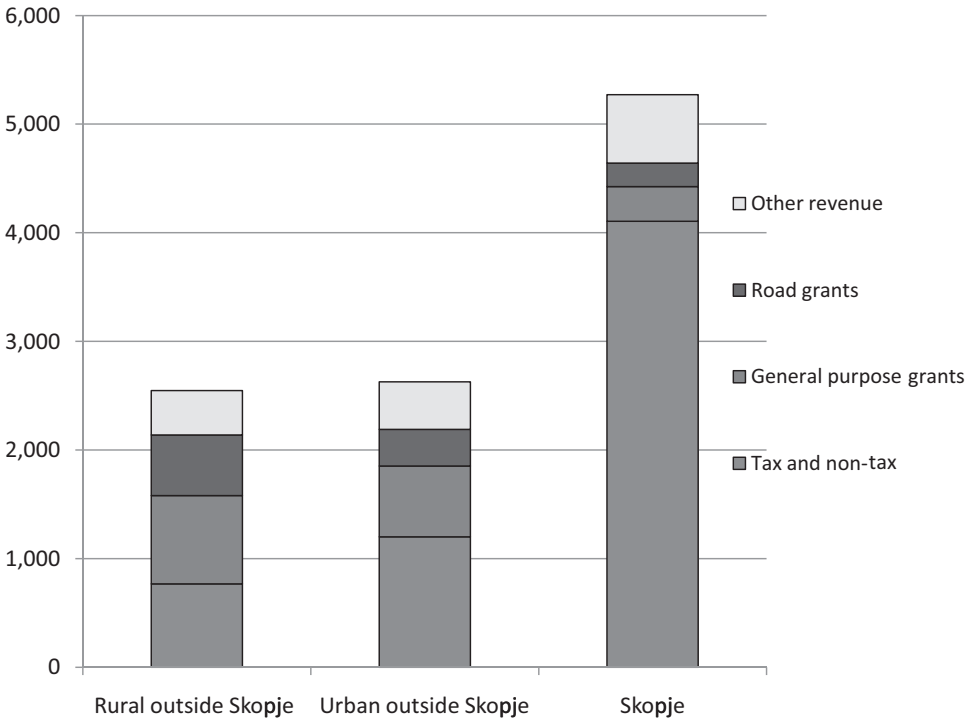
Second, since the start of the fiscal decentralization process in July 2005, a share of the value added

tax (VAT) has been allocated to the municipalities as an unconditional general purpose grant based on a formula. The transfer pool size has been set at 3 percent of the VAT revenues collected in the previous fiscal year. Of this total pool, 10 percent is set aside for Skopje, with 4 percent going to the City government and 6 percent for the municipalities within the City of Skopje.<sup>3</sup> The remaining 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 within the City of Skopje, is not clearly 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 national government in agreement with representatives of local governments. The methodology applied in 2005-2009 established the criteria for distribution of these transfers as 60 per-

cent according to population, 27 percent according to the land area of the municipality, and 13 percent according to the number of settlements within the municipality. Similarly, the distribution of vehicle-related revenue (road grants) is based on population and land area as well as length of municipal roads and the number of registered vehicles.

Although the transfer formulae are not explicitly set to equalize disparities in revenue yields, the transfers effectively achieve some level of equalization, at least among the three groups of municipalities (Figure 5). This is because low-revenue rural municipalities tend to have more land and settlements per resident, the two criteria that actually drive the distribution of 40 percent of the VAT transfer fund. As a result, rural municipalities having 40 percent less pre-transfer revenue per capita than urban municipalities outside Skopje, eventually have almost the same amount of total revenue per capita after the allocation of the two

Figure 5: Disparities in General-Purpose Local Resources (MKD per capita), 2007



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

formula-based transfers. While the formula-based transfers narrow the gap in average expenditures among the three groups of municipalities (rural, urban outside and within Skopje, respectively), at the same time they do little to address disparities within the group of urban municipalities located outside Skopje. To account for different revenue capacities of urban municipalities the formula could include economic indicators, such as average household income, in addition to the proxies for expenditure needs, population size, and land area.

All in all, the allocation of general purpose grants is still in transition and still lacks explicit equalization criteria focusing on disparities in fiscal capacity and expenditure needs. The current VAT revenue transfer presents problems in both the determination of the pool 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. Currently, the criteria used for the allocation of funds from the VAT revenue transfer do not take at all into account disparities in the revenue-raising capacity while disparities in expenditure needs are taken into account only in an approximated fashion. Thus even though the current VAT revenue transfer has equalizing features, but for a variety of reasons it falls short of functioning as a proper equalization grant system.

### BORROWING

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 of municipal enterprises “in accordance with the law.” 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. For long-term borrowing, municipalities have to meet the following pre-conditions: to have submitted positively assessed financial reports to the Ministry of Finance in the previous two years and not to have accumulated arrears towards the creditors in the same period.<sup>4</sup>

Until recently, local borrowing has effectively been on halt due to the presence of outstanding arrears. The bulk of these arrears date to pre-2001

contract payments owed by a dozen of municipalities to the formerly state construction company Granit. In 2004, the total amount of these outstanding debts was estimated at 1.4 percent of GDP, which was roughly equal to the annual amount of local expenditures. However, for some municipalities the debt exceeded their annual revenue by as much as a factor of four. By July 2008, the level of outstanding arrears for the aggregate local sector dropped to 0.3 percent of GDP or 10.5 percent of local budgets. In 2008, 12 out of a total of 85 local government units qualified to borrow but only two have actually taken bank loans.

Municipalities can borrow short-term domestically 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, and (3) the annual debt service outlays need to be within 15 percent of the overall revenues collected in the preceding fiscal year.

### CONCLUSIONS AND THE WAY FORWARD

Despite the considerable progress made to date in many fronts, the decentralization process in Macedonia still faces considerable challenges:

- the assignment of functional responsibilities at the central and local levels remains unclear and the system lacks an objective transparent method for arriving at 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;
- municipal borrowing still remains in its infancy.

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

The likelihood of successful reforms will also be increased with the adoption of a unified and coordinated reform strategy and identification of a clear “reform champion” within the central government. Ideally, the strategy would provide at a minimum a policy vision with respect to the key reform choices; and given the past sensitivities concerning decentralization, these choices need to be agreed on through consultations involving all relevant stakeholders. Once the consensus on the overall system has been reached, the desirable sequencing of the implementation steps could be as follows:

- In the short term, the two most immediate steps for the reform of the intergovernmental systems are, first, to clarify expenditure assignments at all levels of government and develop a methodology 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 medium term, it will be desirable to reform revenue assignments to provide more revenue-raising powers to subnational 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 subnational governments.
- In the medium term, it will also be desirable to restructure 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, especially for capital projects, more often should help leverage additional local resources.

## Notes

- <sup>1</sup> For at least two centuries it has been a common wisdom that property transfer taxes are discouraging to the real estate market since David Ricardo identified them as the ultimate “anti-market” taxes. A thorough discussion and references to the literature can be found in Bird (1967).
- <sup>2</sup> The small importance of these revenues is partially due to the fact that the national PIT only raises 2.6 percent of GDP.
- <sup>3</sup> In the second phase of fiscal decentralization the share of Skopje in the VAT transfer pool will be increased to 12 percent. In addition to VAT revenue, intra-Skopje apportionment of revenues is also performed by applying the same formula to the 80 percent of a pool comprised of 3 percent of PIT revenues, 50 percent of communal fees, 50 percent of vehicle registration fee. The remaining 20 percent of this pool is allocated to the city budget.
- <sup>4</sup> Note that the conditions municipalities must meet to extend loan guarantees to their public enterprises are the same as for long-term borrowing.

## Reference

- Bird, Richard M. Stamp Tax Reform in Colombia. *Bulletin for International Fiscal Documentation* 21 (June 1967): 247-255.