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**MACEDONIA LOCAL
GOVERNMENT ACTIVITY**

Local Government Finances in Macedonia Today: Possible Reforms for Tomorrow

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Introduction

Over the last six months, the USAID sponsored Macedonian Local Government Activity, in cooperation with the Macedonian Municipal Association ZELs and the Ministry of Finance, has developed a relational data base on local government revenues and expenditures for the years 2006-2008. The information contained in the data base is drawn from the national Treasury System and covers all local government revenues and expenditures to the sixth digit of the Chart of Accounts.

This report has two basic objectives. The first is simply to use the unprecedented detail and comprehensiveness of the data base to present a picture of how local government finances have evolved over the last three years. In particular, we are concerned with how the 2005 Law on Local Government Finance is working, and with the movement of local governments from the so-called first phase of decentralization to the second.

This movement is still incomplete. But its magnitude can already be seen as social sector functions –particularly responsibility for managing and financing primary and secondary schools—get progressively transferred to local governments. Indeed, this process makes answering certain questions that once seemed distant and abstract, immediate and pressing.

The second objective of the report is to provide some suggestions about what can be done to improve the efficiency, effectiveness, and equity of intergovernmental financial relations in Macedonia. Our suggestions are not meant to be complete or comprehensive. Indeed, we have consciously chosen to concentrate on what we think are the most serious challenges facing policy makers, both to make the report more “digestible” and to focus attention on the issues that we think are of greatest systemic significance¹.

The most fundamental question is simply whether local governments have sufficient funds to provide the service responsibilities they have been assigned, and whether these funds are being allocated efficiently, and equitably. This question is difficult to answer because it manifests itself in a variety of different ways when one looks across different types of local governments, the different institutions and functions they have to maintain and develop, and the different ways they receive funds to finance them.

¹ Many of these problems are fairly well known. See for example, Nicoleta Fegulio, Jorge Martinez-Vasquez and Andrey Timofeev, “Fiscal Decentralization in Macedonia: An Assessment,” UNDP, September 2007, pp. 1-85, and Tony Levitas, Gabor Peteri, “Second phase of fiscal decentralization in FYROM: Strategy paper on issues for 2008-2010,” Council of Europe, Directorate of Political Institutions, October 2007, pp. 1-21.

But our answer to this question is basically: “No, local governments do not have sufficient funds to pay for the services they have been assigned. Equally importantly, the funds that are available are not being allocated efficiently or equitably.” Unfortunately, while this conclusion is easy enough to arrive at, fixing the problems associated with it are more difficult.

This is true in most countries, but more so in Macedonia because it is both poor and ethnically divided: On the one hand, there is simply not enough public money around to satisfy peoples’ legitimate desire for better public services. On the other hand, moving money from one level of government to another, or across beneficiaries, inevitably raises very painful political questions. It is like trying to make a blanket that is too small cover the feet of a half dozen people sharing the same bed.

Obviously, and over the long term, what is needed is a bigger a blanket. In the immediate, however, yanking it from side to side, or from top to the bottom, does nobody much good. In fact, it distracts attention from what should be the common goal of knitting together a larger quilt. Again, and unfortunately, there are no obvious or magic solutions to how this should be done, especially when people are tired and cranky after a long winter of fitful nights. Indeed, even well rested and warmer people can and will disagree strongly about what reasonable solutions might look like.

Nonetheless, after observing the Macedonian political scene from more than half a decade, my feeling is that instead of concentrating on the inevitably painful issues that result from the country’s poverty and its ethnic divisions, people are still spending most of their time and energy trying to pull the blanket from here to there. Thus, at the risk of being too frank, the first part of this report attempts to name and frame the most divisive of these political questions, questions that I think must be addressed head-on if there is any chance of reaching some consensus about how to make the blanket fit better now, and even more importantly, how over the longer term, all who lie under it, can focus more on making it bigger.

Here, there are three central points. The first is that too little of Macedonia’s too small fiscal pie is going to local governments. The second is that too much of that too small piece of the fiscal pie is going to Skopje. And the third is that too little of that too small fiscal pie is going to poorer jurisdictions. As such, the main beneficiaries of any immediate increase in local government revenues should go to poor jurisdictions outside of Skopje².

² There are also serious problems with the equity of the distribution of funds within Skopje that should in principle be dealt with through the Joint Fund created by Article 23 of the Law on the City of Skopje. It is beyond the scope of this paper to address this question.

The second part of the report outlines a strategy that might make it possible for people to share a blanket that is admittedly too small now, in the name of working together to grow a bigger one in the future. This strategy has four essential components. The first is simply that the national government has to commit to making the blanket a little bigger now.

The second is that the new money put into the system comes from a significant increase in the local government share of the Personal Income Tax. This increased share will benefit urban jurisdictions in general and Skopje in particular, while making both less dependent on grants. It will also “free-up” money currently coming out of the General Grant (VAT) for more explicit equalization purposes. Finally, it should also create an incentive for all local governments to work with the national government to reduce personal income tax evasion.

The third component of the strategy is to change the way the current equalization system works so that more money flows to jurisdictions whose tax bases are weak. Here we propose a mix of three basic instruments or measures. The first and most important is equalizing the revenues of poorer local governments to a percentage of the average per capita yield of the (new) PIT share and the average per capita yield of a (three-year average) of the Transfer Tax.

Throughout transitional Europe, equalization systems are largely, if not exclusively based, on the per capita yield of the personal income tax as the basic measure of the relative wealth of different jurisdictions³. In Macedonia, we think supplementing this standard measure with a three year average of the per capita yield of the Transfer Tax makes sense because the Tax accurately reflects activity on the real estate market. Using a three-year average of the yield is necessary to avoid distortions that might result from single larger transactions that took place in the previous year.

Alongside of these measures, some funds would continue to be allocated on the basis of the physical size of local governments to help local governments that have large land masses and low population densities; and some funds would be allocated on straight per capita basis. Finally we propose introducing a lump sum payment for all local governments, but will help those local governments that have both small populations and small land areas.

³ The second phase of the UNDP’s recent work in Macedonia comes to a similar conclusion. “In line with the fiscal data currently produced for the local level, the computation of the fiscal capacities should be undertaken on the basis of a proxy variable that is highly correlated with localities fiscal capacity. Local PIT revenues as shown in this study can perform that role.” Musharraf Cyan, Jorge Martinez-Vasquez, Andrey Timofeev, “Financing Equitable Service Delivery for All Citizens” UNDP, May 2009 pg v. In Macedonia however, policy makers have resisted using PIT as a measure of relative wealth. However, PIT yields still constitute the single most reliable proxy measure of relative wealth, and a coefficient based on them should be introduced into Macedonia’s equalization formula, particularly if the PIT share is increased.

In the Simulator⁴ that accompanies this report each of the potential variables mentioned above, including the size of the new PIT share can be adjusted and the resulting distribution of revenues analyzed. But conceptually, what is being done is that a new PIT share is being introduced and the existing General Grant (VAT) is being used to fund the equalization measures described above. These measures, however, have been designed so that the General Grant (VAT) pool can remain fixed to protect the national budget.

Finally, the fourth part of the strategy is for Macedonian policy makers to recognize that the success of the entire decentralization process is now in large measure dependent of what happens in primary and secondary education, and to a lesser degree the other social sector functions that are currently being devolved to local governments in the second phase of fiscal decentralization. On the one hand, the financial significance of these social sector functions simply cannot be underestimated. On the other hand, and equally importantly, the ability of local governments to successfully manage their schools, kindergartens, and old age homes – where they have these institutions— or to provide these services when they don't already have them, will require an intensification of strategic planning, inter-ministerial coordination, and intergovernmental dialogue.

⁴ By simulator we mean a series of linked excel spread sheets that allow policy makers to adjust variables and see and measure outcomes against the existing allocation of funds in the sector, and against different reform scenarios.

Part I

Local Government Finances in Macedonia Today

I. The Law on Local Government Finance

To understand local government finances in Macedonia today it is necessary to briefly review the major changes that the 2005 Law on Local Government Finances introduced into Macedonia's intergovernmental finance system. The changes can be summarized as follows.

- a. The Law transferred responsibility for administering and collecting the Property Tax, the Property Transfer Tax, and the Gift and Inheritance Tax from the national government to local governments. It also gave local governments rate setting powers over these taxes, within limits set by the national government, clearly making them local government *own revenues*.

In 2006, these revenues constituted about 21 percent of total local government revenues, with the lion's share --17%-- coming from the property transfer tax. The immediate financial impact of assigning these taxes to local governments as own revenues was, however, modest because prior to the law revenues from these taxes were 100% shared with local governments. Since 2006, and as we shall see, local governments have significantly improved the collection of the property tax. It is also worth adding that in 2008, the national government amended the Law on Property Taxes and significantly expanded the base for the taxation of property owned by legal persons⁵.

- b. The Law gave local governments a 3 percent share of the personal income tax paid by people living in their jurisdictions, and a 100 percent share of the tax on independent artisans. The total yield of these shares was about 140 mln denars in 2006, or about 3 percent of total local government revenues. Since 2006, however, the yield of these shares has actually declined by about 10 percent because the National government has moved to a 10 percent flat rate on the income tax.
- c. The Law earmarked 3 percent of the national yield of the Value Added Tax (VAT) for a General Grant to local governments. In 2006, this grant increased local government

⁵ Similarly, the national government doubled the allowable rate local governments are allowed to charge for the so-called public lighting fee, a fee which is used not just to pay for the electricity bills associated with public lighting but is used for the other purposes as well. See "Letter of Intent and Technical Memorandum of Understanding between the Former Yugoslav Republic of Macedonia and the IMF," February 2008.

revenues by about 810 mln denars and immediately came to constitute about 13 percent of total local government revenue. As such, this grant was the source of the most palpable improvement in the financial position of local governments created by the Law.

The Law states that at least 50 percent of the VAT fund will be allocated to local governments on a per capita basis, though it allows for exceptions for the City of Skopje and the municipalities within it. The allocation formula is determined by the Ministry of Finance after consultation with the Committee for Monitoring the Development of the Local Government Finance System, a body that includes both representatives of the national government, and through ZELs, local governments.

We will examine the formula that is currently being used at greater length later on in the report. For the moment, it is simply worth noting that the allocation of the VAT fund has, not surprisingly, been a source of great contention, with Skopje arguing that it has been unfairly discriminated against, and poorer jurisdictions arguing that more of the fund should flow to them.

- d. The Law created a two-phased process for the decentralization of social sector functions. In the first phase, local governments were made the owners of primary and secondary schools, cultural institutions, sports facilities, old age homes, and fire protection units. They were also given earmarked grants to pay for the costs of maintaining these facilities. For education, by far the most significant of these functions, this earmarked grant amounted to 13 percent of total local government revenues in 2006.

Under the second phase of decentralization, local governments who had met specific conditions would become responsible not just for maintaining these facilities, but for paying the wages of the people who worked in them. At this point, earmarked grants would be transformed into sectoral block grants, meaning that local governments would be free to spend, for example, their block grant on education on any mix of education spending they thought was most effective, but could not spend this money on, say, roads.

By 2008, 51 of Macedonia's 85 local governments had entered the second phase. This has had profound consequences on the total amount of money flowing to local governments. As we shall see in greater detail in a moment, local government revenues as a percentage of GDP have almost doubled in the last two years, primarily because teachers' wages constitute such a significant share of all public expenditures.

The progressive and still incomplete movement of local governments into the second phase of decentralization however, presents serious problems for the analysis of

the sector because it means that the revenue and expenditure data that we have is not fully comparable across all local governments from year to year.

More importantly, the transfer of social sector functions to local governments raises many critical policy questions that have yet to be fully addressed. Perhaps the most significant of these is whether under the second phase of decentralization, the national government is transferring social sector *functions* to local governments, or just responsibility for running particular social sector *institutions*? For example, and to put the matter more concretely, some cultural institutions in some jurisdictions have been transferred to local governments. And these local governments are now receiving block grants for culture. But in many other local governments there were no cultural institutions to be transferred. As a result, these local governments receive no additional money from the national government and thus unlike other jurisdictions have to support whatever cultural activities they do provide from other funds.

In general, this problem is caused by fact that most social sector institutions – indeed much of the country’s urban infrastructure-- was concentrated in the 34 municipalities of the old Yugoslav order and simply does not exist in many of Macedonia’s newer jurisdictions. Unfortunately, there is no easy way to resolve the problems generated by the historically uneven distribution of what should now be municipal institutions. Moreover, possible solutions to this dilemma will differ depending on whether we are talking about culture, fire protection, or secondary education.

What is clear however, is that as the second phase of decentralization goes forward much greater attention has to be paid to developing these solutions, and that this will require an intensification of the dialogue both between the national government and local governments, and across line ministries. We will return at greater length to this is issue in the second part of the report.

II. Local Government Revenues as a Share of GDP and Total Public Revenues

There are no simple metrics for measuring either how much decentralization a country should have, or for judging whether local governments in any given country have adequate funds to meet their expenditure responsibilities. The main reason for this is that local governments perform different functions in different countries, and do so against different socio-economic and institutional background conditions. Further complicating matters, is the fact that the budget classification systems and financial reporting practices of countries also vary substantially. As result, it is hard to compare revenue and expenditure patterns across countries without getting into fairly detailed analyses of what function local governments

provide, and in what way their budget classification systems categorize revenues and expenditures.

For example, in one country, local governments may pay teachers' wages while in another country they are only responsible for maintaining school buildings, and in a third all education functions may be paid for by the national government. Similarly, in some countries the maintenance and development of water and sewage systems may be a national government responsibility, a local government responsibility, or indeed, entirely privatized.

Nonetheless, some basic judgments can be made by looking at the share of local government revenues (and or expenditures) in relation to a country's GDP and comparing these shares to other countries where we have reason to believe that the division of responsibilities between levels of government are similar. Table 1 below, presents the share of local government revenues in Macedonia as percentage of GDP and of Central Government Revenue in 2004 –the year before the Local Government Finance Law went into effect-- and then from 2006 through 2008. The year 2005 has been left out of the series because the new law actually went into effect in July, meaning half the year was under the old system, and half under the new system.

Table 1

Local Government Revenues in Macedonia as a share of GDP and Central Government Revenues*				
	2004	2006	2007	2008
GDP	265,257,000,000	310,932,000,000	353,786,000,000	398,640,000,000
Public Revenues	88,176,000,000	104,044,000,000	119,609,000,000	136,412,000,000
LG Revenues	4,439,616,175	6,235,763,929	9,430,093,107	18,266,061,329
LG Revenues as % of Public Revenues	5.0%	6.0%	7.9%	13.4%
LG Revenues as % of GDP	1.7%	2.0%	2.7%	4.6%

Source: Ministry of Finance. *Transfers to local governments from the Central government have not been netted out of the calculation.

Between the 2004 and 2006, local government revenues as a share of GDP increased from 1.7 to 2.0 percent, and as share of Central Government revenues from 5.0 to 6.0 percent. About 1 bln denars of this growth came from the new "VAT fund" and the new PIT shares (810 mln VAT, 200 mln PIT) with the remainder coming from the new earmarked grants for social sector functions. In September 2007, 42 local governments entered the second phase of decentralization and began receiving block grants, most importantly for teachers pay.

The importance of the shift of teachers pay to the local government level cannot be underestimated: The fact that half of the country's local governments became responsible for teachers' pay in the last quarter of 2007 was enough to increase the share of local government revenues in the GDP from 2.0 to 2.7 percent. More importantly, by the end of 2008, when 66

local governments had moved into the second phase, teachers pay had boosted the share of total local government revenue in the GDP to 4.6 percent and in total central government revenues to over 13 percent. Indeed, it is likely that once all local governments have entered the second phase of decentralization local government revenues as a share of GDP and as a share of total public expenditures will have almost tripled, standing at near 5 percent of GDP and about 15 percent of total public revenues.

This is truly impressive growth. But what does it tell us about how adequately funded Macedonia’s local governments really are?

Here, the first thing to bear in mind is that in most European and OECD countries, teachers’ wages typically account for about 3 percent of GDP. This is also true in Macedonia, and means that by the end of the decentralization process local governments will receive about 2% of GDP to finance all functions other than teachers’ wages. As such, it is fair to say that the overall financial position of local governments has not improved very significantly since the first year of the reform when the new General Grant (VAT Fund) and PIT share increased local government revenues by a billion denars and raised local government revenues as a share of GDP from 1.7 percent to 2.0 percent.

Table 2

Local Government Revenues as a Share of GDP in Select European Countries		
Country	% of GDP	year
Countries in which Local Government DO pay teachers wages		
Macedonia	4.60%	2008
Albania	5.80%	2006
Bulgaria	7.43%	2007
Hungry	12.34%	2007
Poland	15.30%	2006
Countries in which Local Government do NOT pay teachers wages		
Serbia	6.60%	2006
Croatia	5.80%	2006
BiH - FBiH	4.30%	2007
BiH - RS	7.00%	2007
Estonia	8.52%	2007
Czech	12.00%	2007

Unfortunately, it also means that local government revenues in Macedonia remain extremely low. This can be seen from Table 2 above. The Table presents local government revenues as share of GDP from select countries in the region and beyond. The first group in the Table contains countries in which local governments are responsible for teachers pay. As can be seen from the Table the only country in which local governments are responsible for teachers pay, and total local government revenue is less than 6% of GDP are Albania and Macedonia.

Moreover, even if we assume that when all Macedonian local governments enter the second phase of decentralization the share of local government revenues in the GDP will rise to close 5 percent; this will still be 20 percent lower than in Albania. Meanwhile, if we look at countries in which local governments are not responsible for teachers pay, all of them –with the exception of the Federation of Bosnia Herzegovina (within BiH),-- already provide their local governments with significantly more funding than Macedonia does now. Indeed, if we were to assume that in FBiH responsibility for teachers pay were to be devolved to local governments then it is safe to say that local government revenues as percentage of GDP would exceed 7 percent, considerable exceeding the current share in Macedonia.

For us, these measures --as inexact as they may be-- strongly suggest that despite the progress that has been made since 2004, Macedonia is still significantly underfunding its local governments⁶. Indeed our guess is that even if local government revenues were to rise to 7 percent of the GDP over the next 2-5 years, they would still be low in comparison to the other countries in the region, given the fact that unlike most of them, Macedonian local governments pay teachers' wages. Doing even this, however, will be extremely difficult under current economic circumstances. Nonetheless, we are convinced that efforts in this direction must be made. We return to the question of how this might be done in the second part of the report.

⁶ Cyan, Martinez-Vasquez, Timofeev, "Financing Equitable Service Delivery for All Citizens" note that only three countries in Europe and Eurasia provide their local governments with less funding than Macedonia does as a percentage of GDP: Greece, Armenia and Malta.

Interestingly, they then do a regression analysis to estimate what percentage of GDP Macedonian local governments might be expected to have at some point in the future (pg. 64-67). The regression model is based on country size, GDP per capita, and local government expenditures as a percentage of central government expenditures. The model suggests that it would not be unreasonable for local government revenues in Macedonia to double to 5.0% of GDP sometime in the foreseeable future.

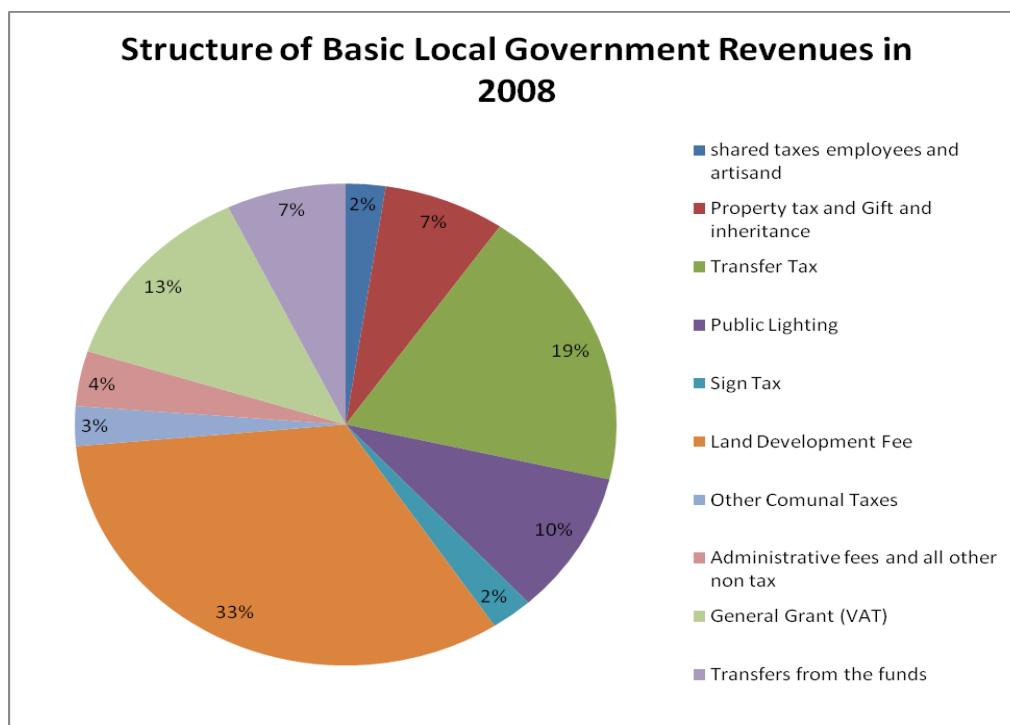
The problem is that, that Macedonia had already achieved this level by the time the report was published. The authors did not anticipate this, in part because they were working with 2007 data and in part because they failed to understand the significance of Macedonia's block grant system for education. The result is instructive about the dangers of this sort of regression analysis. In short, it produced a lower "normative value" for decentralization in Macedonia than would have been the case, if the regression analysis had only included countries that had decentralized teachers' wages. At the risk of over extrapolating, if we accept the UNDP's figure for Macedonia as being really for a Macedonia in which teachers wages have not been decentralized, then we should add at least 3 percentage points to it. This would give us a "decentralization target value" of between 7 and 8% of f GDP.

III. Analysis of the Basic Revenue of Local Governments

In this section of the report we analyze the composition of the “basic revenues” of local governments over the last 3 years, and how this composition differs among different groups of local governments. By “basic revenues” we mean local government own revenues, shared taxes, and revenues from the General Grant (VAT Fund) and the Road fund. We call these revenues “basic revenues” because all local governments receive them on a regular basis; because their yields are fairly predictable; and because unlike earmarked or block grants, they are not designated for the delivery of particular social sector functions.

Moreover, this group of revenues has been stable for all local governments for the past 3 years, meaning that unlike with earmarked or block grants, the amount of money local governments have received through them is not dependent on whether they have entered the second phase of decentralization. Chart 1 below presents the composition of local government revenues by each of the major revenue types within this group of basic revenues in 2008.

Chart 1



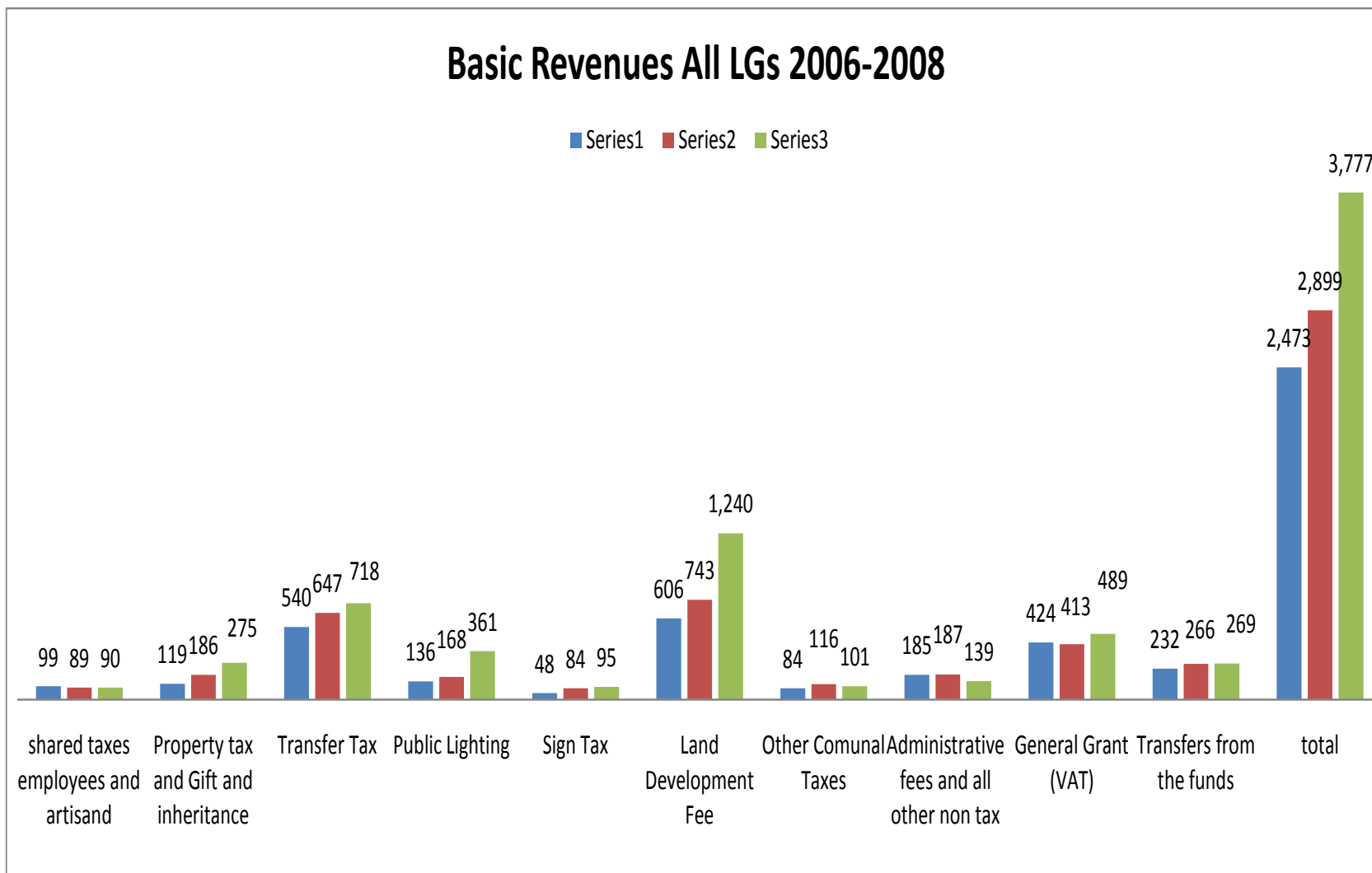
As can be seen by the Chart, the single most important local government revenue is the Land Development Fee⁷ (33%), followed by the Transfer Tax (19%), the General Grant (VAT)(13%),

⁷ The Land Development Fee that investors pay local governments for new construction. The fee is set by local governments and set on a square meter basis.

the Public Lighting Fee (10%), Property Taxes (7%) and transfers from the Road Fund (7%). Together these revenues account for almost 90% of all local government revenues.

Chart 2, shows the growth of each of these revenues in per capita terms, inflation adjusted terms for all local government between 2006 and 2008.

Chart 2



As can be seen from Chart 2, the basic revenues of local governments have increased by more than 30% over the last 3 years, rising from about 2500 dnrs per capita (c. 40 Euros) to close to 3,800 dnrs per capita (c. 60 Euros) in 2008 dnrs. Most of this growth has come from the Land Development Fee and the Transfer Tax. This indicates that at least in certain places the real estate market has been active and that new, private sector investment is being made.

It is also worth noting, that revenues from the Property Tax have more than doubled since local governments have assumed responsibility for the tax. As can be seen from Table III below, the Property Tax (without the Gift and Inheritance tax or the Transfer Tax) now accounts for almost 500 mln dnrs in local government revenue. Despite this impressive growth, however, the average property tax burden is low at about 4 euro per capita. Clearly there is significant space for improvement here, especially since revenues from legal entities should increase with the 2008 decision to expand the base of the property tax for firms.

Table 3

Yield of the Property Tax 2006-2008 in 2008 dnrs					
	2006	2007	2008	% growth	total
property tax	205,353,956	327,622,403	496,439,979	242%	8,072,195
per capita	102	162	245	242%	4.0 Euros

Revenues from the Public Lighting Fee have also tripled. Much of this growth is the result of the national governments decision to double the maximum allowable rate. But at least some of it is coming from better collection, suggesting that here too local governments are taking their own revenue responsibilities more seriously.

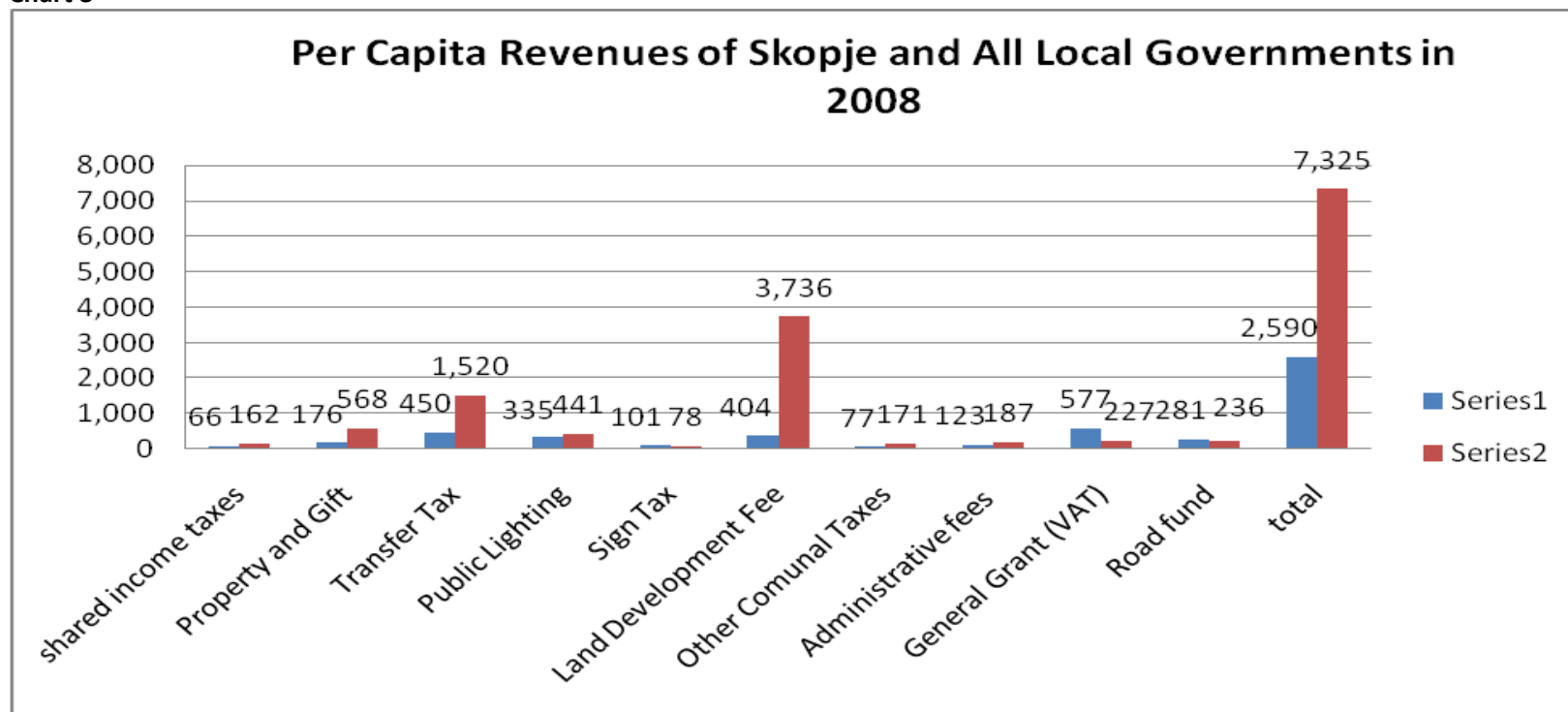
Despite economic growth over the last three years, revenues from the very modest PIT share have not increased. This is because the government has lowered the general personal income tax rate to a flat 10 percent over the last few years. Meanwhile revenues from the General Grant (VAT) and the Road Fund have grown, but relatively modestly.

This generally positive picture of the growth of local government basic revenues however begins to unravel a bit when we look at it from the point of view of what is happening in Skopje versus the rest of the country. Table 4 below, presents the growth of basic revenues for the consolidated municipalities of Skopje versus all other local government between 2006 and 2008 in inflation adjusted denars. Chart 3 below, shows the per capita basic revenues for the consolidated municipalities of Skopje versus all other municipalities in 2008.

Table 4

Growth in Basic Revenues from 2006 to 2008 for Skopje versus all Other Local Governments											
	Shared PIT and Artisanal Tax	Property. Gift and inheritance Taxes	Transfer Tax	Public Lighting	Sign Tax	Land Development Fee	Other Communal Taxes	Admin. Fees Other non- tax revenue	General Grant (VAT)	Transfers from the funds	total
Other LGs	-12%	81%	41%	193%	119%	58%	6%	-16%	13%	20%	38%
Skopje	-5%	209%	27%	118%	46%	126%	46%	-38%	37%	5%	72%
All	-9%	130%	33%	166%	99%	105%	20%	-25%	15%	16%	53%

Chart 3



As can be seen from Table 4 the basic revenues of all local governments increased by an average of 53 percent between 2006 and 2008. But Skopje's revenues grew by 72 percent, while the revenues of all other local governments grew by only 38%. Most of the difference in the overall growth rates comes from the difference in the growth rate of the Land Development fee which grew by 126 percent in Skopje, but only 56 percent elsewhere. Indeed, the land development fee (as can be seen from Chart 3) generates over half of Skopje's per capita revenues (3,736 out of 7,325 dnrs per capita) and is almost 9 times more than the average elsewhere (404 per capita)⁸. Not surprisingly the rate of growth of the property tax in Skopje was much higher than elsewhere (209% vs 89%).

More curiously, revenues from the General Grant grew in Skopje faster than elsewhere (13% vs 37%). This is attributable to the fact that lobbying by Skopje succeeded in increasing the City's share of the pool of funding from 10 to 12 percent in 2007. Conversely, however, other local governments did better with Road Fund, where their revenues from this source increased by 20 percent while Skopje's increased by only 5%.

It is important to note that the growth rates of the sign tax and the public lighting fee in non-Skopje local governments outpaced those of the capital. This and the high rate of growth for the Property Tax even outside of Skopje suggest that it is not only Skopje that is intensifying its effort to collect own revenues.

Nonetheless, the overall picture that emerges from Chart 3 is disturbing. The total per capita revenues of Skopje are almost three times more than the average elsewhere. Indeed, Skopje accounts for almost 50 percent of all the revenues in the system despite that fact that only 25 percent of the population resides in the capital.

To be sure, the cost of providing services in the City is higher than elsewhere, if for no other reason than the fact that the City probably pays significantly higher wages for many types of services. Moreover, there is no question that the Capital provides services to citizens

⁸ In the past, some municipal officials –particularly from Skopje-- have objected to including the Land Development fee in any calculation of the general revenues of local governments on the grounds that proceeds from the fee are earmarked for capital investments, and more particularly for providing the utility hook-ups and other public amenities needed to service the investors who are actually paying the fee. Here, three things should be noted.

First it is simply not true that municipalities use most of the fees to provide new public services to the *particular investors* who pay the fees. On the contrary, the fee is used as a general source of capital revenues.

Second, as a general source of capital revenues, the disparities in the proceeds of the fee clearly have implications for the overall developmental possibilities of local governments, and thus should be taken into consideration when thinking about the relative wealth of jurisdictions and any equalization policy.

Third, and perhaps most disturbingly, total capital revenues (land development fee + road fund + capital grants) in the consolidated jurisdictions of Skopje in 2008 exceeded total capital expenditures by 457 mln dnrs, or 20% of all capital revenues. (This was not true in non-Skopje jurisdictions where capital expenditures exceeded capital revenues by 341 mln dnrs.)

throughout the country. And finally, there is no doubt that the City must expand its infrastructure, particularly as people migrate to the capital.

But it remains an open question whether the developmental needs of the entire country are best served by these kinds of disparities in public spending. Indeed, it seems to us that Macedonia is at the risk of falling into something of a vicious circle: As public services deteriorate or fail to improve outside of the capital, more and more people will immigrate to Skopje, putting ever greater financial pressure on the City. Thus, despite the Capitals' undoubted need for new money, we think that the existing disparities suggest that any immediate increase in the overall revenues in the system should be directed to jurisdictions outside of Skopje⁹.

IV. Further Analysis of Disparities in the Basic Revenues of Local Governments

Unfortunately, the problem of radical disparities in the basic revenue of local governments is not confined to the question of Skopje versus all other jurisdictions. Indeed, if we drill down a little farther into the data we see that these problems get worse. To do this, we have organized local government revenues by quartile. What this means is that we have ranked, by total per capita income, all non-Skopje jurisdictions from poorest to richest into four equally sized groups, and then looked at the average per capita revenues for each group by revenue type. Table 5 below presents the results.

Table 5

Basic Revenues of Local Governments by Quartile and with Skopje Municipalities and the City of Skopje Consolidated in 2008											
	shared wage taxes per capita	property tax per capita	transfer tax per capita	public lighting per capita	sign tax per capita	land dev per capita*	other communal fee per capita	admin fees and non fiscal per capita	VAT per capita	Transfers from the Funds per capita	Total Basic Revenue per capita
1st Quartile	30	68	222	182	36	68	22	50	499	205	1,382
2nd	66	163	429	373	114	225	60	111	517	242	2,300

⁹ There are also significant differences in the per capita revenues of the jurisdictions within Skopje. Unfortunately it is beyond the scope of this paper to address these. It should be added that the data base assembled by MLGA, ZELS, and the Ministry of Finance allow for the analyses of these problems.

Quartile											
3rd Quartile	78	142	355	356	90	373	79	211	741	345	2,770
4th Quartile	89	319	753	404	147	992	152	149	622	362	3,988
Skopje	162	568	1,520	441	78	3,736	171	187	227	236	7,325

*It should be noted that six local governments failed to record income from the land development as budget revenue. As a result, we do not know how much revenue they earned from the fee. This failure is a violation of the Budget Law and should be monitored by the national government and corrected by the concerned local governments. The absence of this revenue from these six jurisdictions however would not significantly change the picture presented in this Table.

As can be seen from Table 5, the poorest 25% of Macedonian local governments have per capita revenues 6 times lower than those of Skopje, and 3 times lower than the richest 25% of jurisdictions without counting Skopje. Indeed, the poorest jurisdiction –Lipkovo, population 27,000—had per capita revenues (768) equal to about half the average of the poorest quartile (1,382), and only 10.5 percent of those of Skopje (7,325).

What is particularly striking about the Table, however, is that the poorest jurisdictions are getting the least amount of money from both the General Grant and the Road Fund. Indeed, the next poorest group of local governments (those contained in the Second Quartile) also gets significantly less from the General Grant and the Road Fund, than the richer Third and Fourth Quartiles.

Table 6 below, sheds more light on what is going here. The Table presents local governments in quartiles by both population and per capita wealth for the 74 non-Skopje jurisdictions. The first quartile for population contains the smallest local governments and the fourth the largest; while the first quartile of per capita revenue contains the local governments with the lowest per capita basic revenues and fourth the ones with the highest.

Table 6

Number of Jurisdictions by Population and Per Capita Basic Revenues					
	1st Quartile Population	2nd Quartile Population	3rd Quartile Population	4th Quartile Population	Total
1st Quartile per cap revenue	3	7	8	1	19
2nd Quartile per cap revenue	2	8	5	4	19
3rd Quartile per cap revenue	6	4	3	5	18
4th Quartile per cap revenue	10	2	4	2	18
Total	21	21	20	12	74

As can be seen from the Table, 10 of the 18 jurisdictions with the highest per capita revenues, and 6 of the 18 with the next highest belong to the smallest group of local governments by population size. Almost all of them owe their relative wealth entirely to the distribution of the General Grant (VAT) and the Road Fund. For example the small, Fourth Quartile local governments of Novaci, Vraneshtica, and Drugovo all receive more than 2000 dnrs per capita from the General Grant (VAT) and 1000 dnrs per capita from the Road Fund.

At the same time, the quartile of local governments with the lowest per capita basic revenues is dominated by larger local governments. Particularly, striking is the fact that almost half of the Third Quartile by population size in the First Quartile by per capita revenues. This group is dominated by local governments which, like the small jurisdictions in the richest group, get very little money from own revenues or shared taxes. They also, however, get very little from the General Grant or the Road Fund. For example Lipkovo, Zhelino, and Bogovinje all have populations of over 25,000 and are in the Third Quartile by population. But they get less than 500 dnrs per capita from the General Grant and less than 200 dnrs per capita from the Road Fund.

It is unclear exactly why the distribution of the Road Fund works in the same way as that of the General Grant¹⁰. But with respect to General Grant, the reasons for this are clear: Once 12 percent of the total pool is subtracted for Skopje, the rest is divided according to a formula in which 60 percent is allocated per capita, 27 percent on the basis of a local government's share in the total territory of Macedonia, and 13 percent on the basis of a local governments share in the total number of settlements in Macedonia.

The theoretical justification of the use of territory in the formula is that the physical size of local government is a proxy for it "rurality" and by extension a measure of wealth or rather poverty. The theoretical justification for the use of settlements in the formula is that it costs more to deliver services to citizens living in small villages scattered across a single jurisdiction.

Both of these theoretical justifications are defensible and in fact both measures have been used in other countries. What is less defensible however, is the amount of money being allocated according to these criteria; the absence of the use of any other measure of relative wealth; and the fact that in Macedonia the use of settlements not only double counts the same factor as jurisdictional size, but in practice works against municipalities with more concentrated settlement patterns.

V. Local Government Expenditures between 2006 and 2008

¹⁰ Unfortunately, we did not have the opportunity to examine the formula in detail.

In this section, we briefly examine the expenditures of local governments between 2006 and 2008. Our main purpose here is to show the magnitude of the shifts taking place with the second phase of decentralization. Unfortunately, however, it remains difficult to seriously analyze the expenditure patterns of local governments since 2006 for two reasons. The first reason is that not all local governments have entered the second phase of decentralization, and those that have, have entered in different waves --including waves that started in the middle of the year. As a result, data is not comparable across or even within years.

The second reason is less visible, but over the longer term more important. It is a product of a problem we have alluded to earlier, meaning that the second phase of decentralization has—at least in certain sectors—been primarily about devolving to local governments control over particular *institutions*, or particular types of institutions, and not really about decentralizing the *functions*. As a result, there are second phase municipalities who receive no money for culture or for preschools simply because they don't have these institutions, while other second phase municipalities of comparable size receive substantial block grants simply because they have always had them¹¹.

We will return to this problem in the second part of the report. For the moment, what is important is that this problem makes it difficult to compare social sector spending across local governments because this spending is primarily being driven by block grants whose size is being determined by the historical costs of existing institutions, and not by local government decisions.

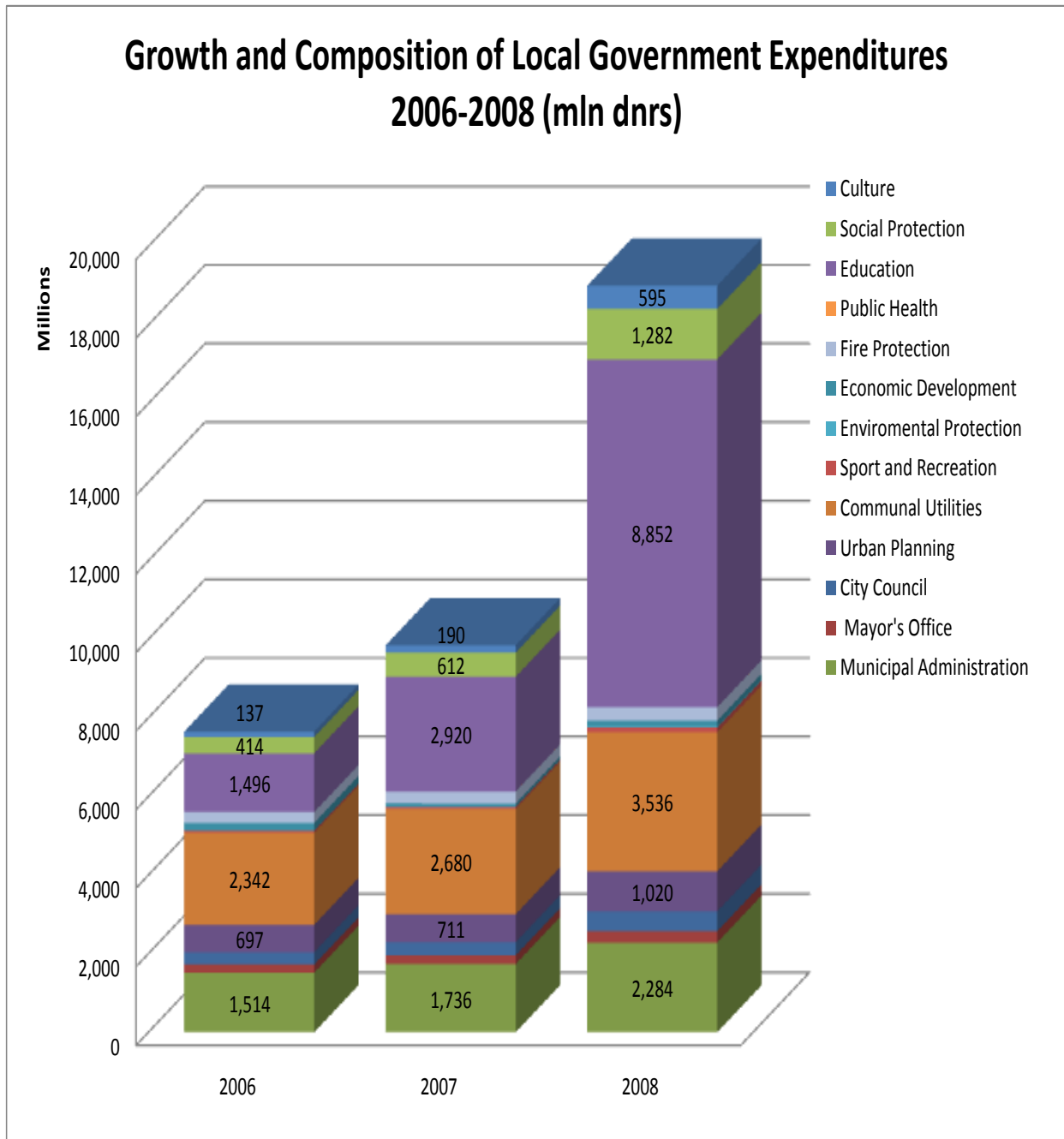
Chart 4 below, presents the growth and composition of local government expenditures from 2006 to 2008. The Chart shows the magnitude of the financial effects of the second phase of decentralization. The top four segments of the columns show the shift that is occurring as block grants are given to local governments for culture, social protection (mainly kindergartens), education and fire protection. Expenditures on these functions now constitute well over half of all local government expenditures. Of obvious particular importance are education (primary and secondary schools) and social protection (primarily kindergartens). Together, these two functions now account for 53 percent of all local government expenditures.

¹¹ In the area of culture at least, the situation is further complicated by the fact that the national government seems to be making almost individual decisions about which particular institutions should be transferred to which local governments. Consider for a moment, two local governments that are of identical sizes, each of which has a library a youth center and a museum. In one, the national government decides to transfer all three institutions to the local government, while in the other only the youth center is transferred. As a result, not only do the amounts of the block grants for the two jurisdictions differ both in absolute and per capita terms, but it is no longer obvious what “decentralizing culture” really means.

In 2007, the national government allocated block grants for education simply on the basis of the historical costs of schools.¹² In 2008, however, the Ministry of Education moved to formula system of funding. The formula includes three factors; a “lump sum per municipality,” an amount based on the number of pupils attending schools in the municipality (including

¹² See the Ordinance on the Methodology for Establishing the Criteria for allocation of Block Grants for Primary and Secondary Education, Official Gazette of Republic of Macedonia, August 2007.

Chart 4



coefficients that “weight” students with special needs; who attend vocational classes, and who have subject teaching); and a coefficient for population density designed to ensure that in rural

areas –where class sizes are necessarily smaller than in urban ones—local governments have enough funds run their schools.¹³

The importance of this formula for the future of both Macedonia’s education system and for the finances of its local governments cannot be underestimated. And it is to Macedonia’s great credit that it has made a commitment to moving to a weighted per pupil system of financing because over the longer term this is the only way to ensure that education funds flow to where they are needed, meaning to where pupils actually attend school¹⁴.

But at least two things should be noted. The first is that at the moment, money is flowing to local governments not on the basis of the number of pupils attending schools in their jurisdictions but primarily on the basis of the number teachers teaching in them. This is problematic because Macedonia has many schools with overcrowded classes and many schools in which class sizes are unstainably low. Moving towards a more equitable allocation of resources in the sector –and with it a more equitable allocation of financial resources for education to local governments—will by a long and difficult process, not least because schools in some areas will have to be closed, while in other areas they will have to be built. At a minimum, this means that the national and local governments will have to cooperate in solving these problems, and that over time, the weights for different types of pupils and for population density will have to be adjusted in order to meet the goals of both increased equity and efficiency in sector.

The second thing to be noted is that while the ordinance for the allocation of education block grants have been published and the formula it contains express the Ministry of Education’s commitment to a transparent and equitable allocation of education resources, the formulas are not presented in a way that would allow any local government to calculate the size of its education grant. Indeed, key elements of the formula’s are missing (e.g. the amount of the lump sum per municipality, the basic weight per pupil) . Moreover, and unlike in the past, the ordinance does not inform local governments of the amount of money each of them will receive for through the block grant in the coming year.

As such, the formulas only begin to fulfill the national government’s promise of moving to a more equitable and efficient allocation of resources in the sector. Equally importantly, the

¹³ See the Ordinance on the Methodology for Establishing the Criteria for allocation of Block Grants for Primary and Secondary Education, Official Gazette of Republic of Macedonia, October 2007.

¹⁴ This movement is in line with Article 12, point 2 of the Law on Local Government Finance which obligates the line ministries responsible for developing the formulas used to allocate block grants to use “appropriate measures of need.” In education, the most appropriate measure of need is obviously the number of pupil attending schools in its jurisdiction.

absence of the full formulas, the sums for the next year, and perhaps most importantly, a clear statement of the policy that the Government intends to pursue over the coming years, it will be very hard for local governments to rationally manage the sector, and to sensibly think about reorganizing their school networks or reallocating teachers between schools.

It is also extremely important to recognize that while the Ministry of Education has taken concrete steps to meet its obligation under Article 12, point 2 of the Law on Local Government Finance with respect to the allocation of block grants “in line with appropriate measures of need”, this is not true for either the Ministry of Culture or the Ministry of Labor and Social Welfare. Instead, these Ministries are allocating funds on the basis of the historical costs of cultural institutions, preschools and old age homes. As a result, and as we have already noted, local governments that already have preschools and cultural institutions receive block grants for maintaining them, while local governments who don’t have these institutions, receive little or nothing.

Correcting this problem is very difficult without putting new money into the system. If the historical amount of money that is currently being spent on a limited number of institutions in a limited number of jurisdictions is allocated more fairly –meaning, for example in the case of kindergartens on the number of pre-school age children in the jurisdiction, or in the case of culture on the basis of the total population—than those jurisdictions that have the institutions already may not have enough funding to keep them running. At the same time, local governments that don’t already have the institutions may not receive enough funding to provide the services in a meaningful way.

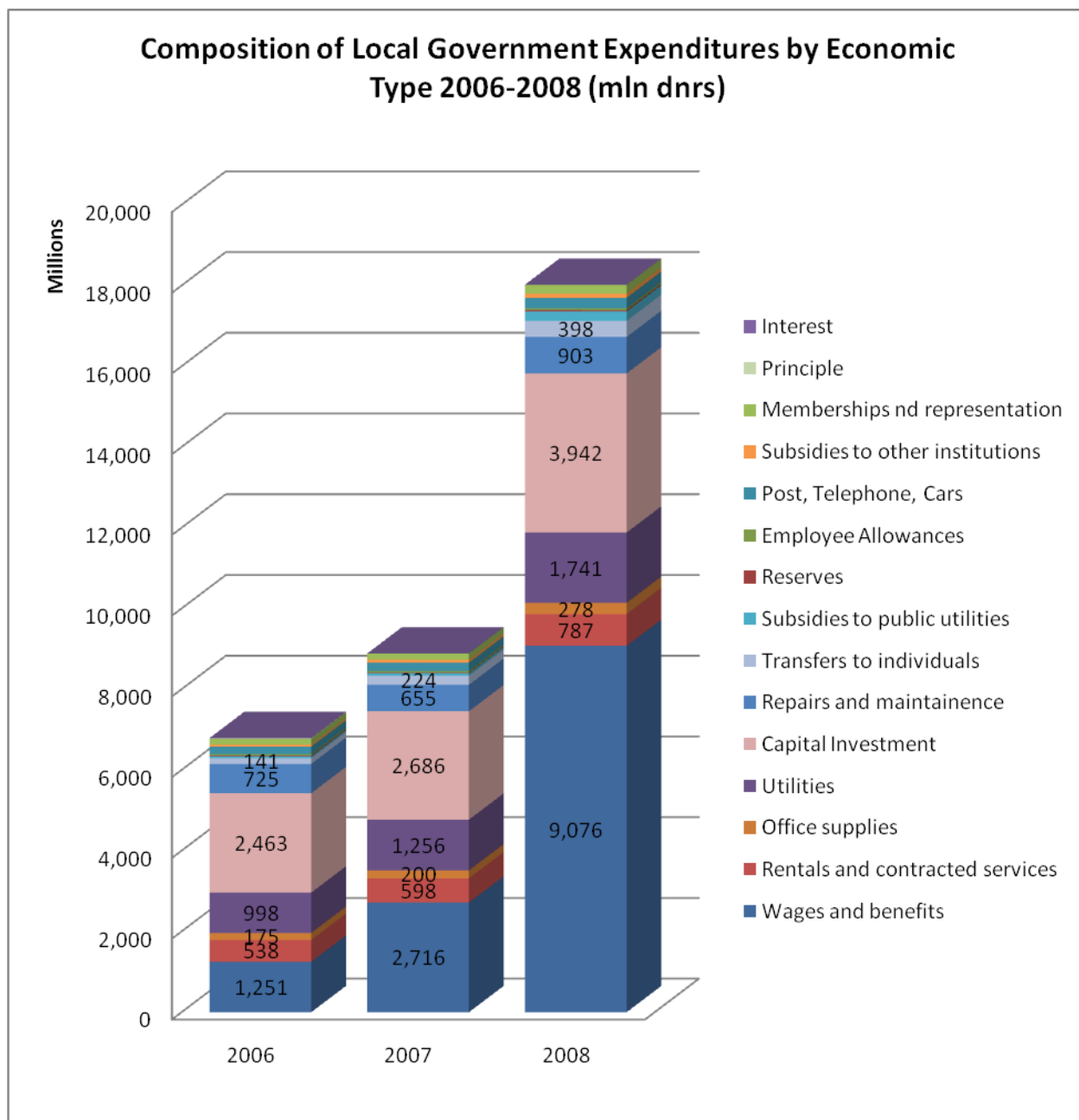
Indeed, the current allocation of funding for preschool education and cultural activities clearly expresses at least one dimension of the larger problem of the underfunding of municipalities in Macedonia today. How to fix this problem however, is a more difficult question, if for no other reason than because there is –again—too little public money available for the national government to provide all municipalities with the funds they would need to provide services equal to those provided by the municipalities who are already have with the relevant institutions.

Chart 5 below is similar to Chart 4 except that instead of presenting the growth and composition of expenditures by their functional purpose, it presents them by their economic type¹⁵. As can be seen from the Chart, expenditures on wages have increased more than 7

¹⁵ The difference in the total amount of expenditures in the two charts comes from the fact that Chart 4 contains the expenditures of budget users finance from own revenues (self-financing) while Chart 5 contain only spending from the City budget. In 2008, there was about 1bln denars of spending financed by the own revenues of municipal budget users (e.g. money earned by schools and spent on education by them)

times since 2006, again primarily because local governments who have entered the second phase are now paying teachers wages.

Chart 5



After wages, the second largest type of local government expenditure in 2008 was on capital investment, and then on repairs and maintenance. In 2006 and 2007, however, capital investments constituted a larger share of spending than did in wages. Nonetheless the absolute amount of local government capital spending has increased every year despite its declining share in total expenditures. This is good news because it means that local governments have continued their capital spending even in the face of assuming massive new social sector

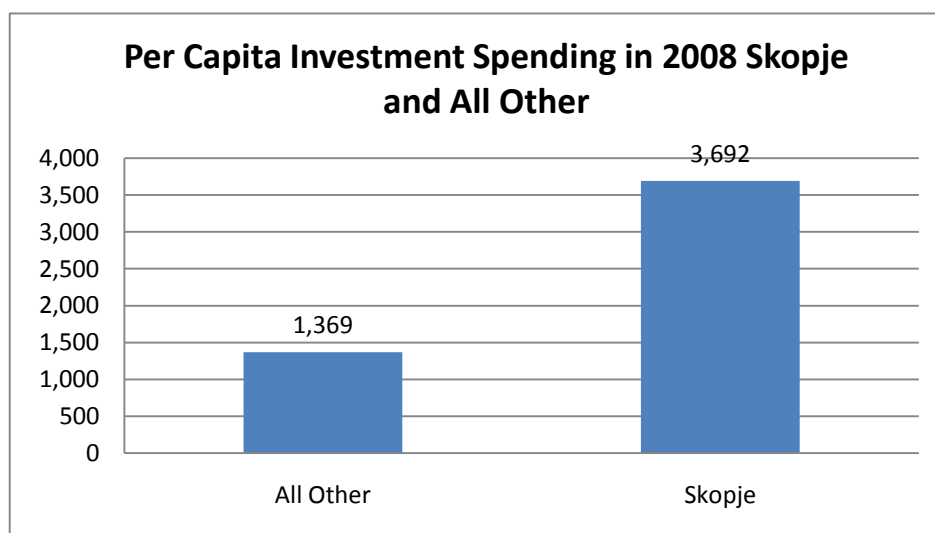
responsibilities. Table 7 below shows the changes in the composition of the most important expenditure categories.

Table 7

Changes in the Composition of Local Government Expenditures 2006-2008						
	wages	utilities	capital	repairs and maintenance	other	total
2006	18%	15%	36%	11%	20%	100%
2007	31%	14%	30%	7%	18%	100%
2008	50%	10%	22%	5%	13%	100%

Not surprisingly however, Skopje is responsible for 48 percent of the 4.8 bln dnrs of local government spending on capital investment and repairs in 2008, despite serving only 25% of the country's population. As can be seen from Chart 6 below, per capita investment spending in Skopje is almost three times higher than elsewhere in the country.

Chart 6



Part II

Possible Directions for Reform

Introduction

In the first part of this report we have identified a number of major and inter-related problems with Macedonia's current system of intergovernmental finance. To summarize, these can be briefly stated as follows.

- Macedonia's local governments are underfunded and their revenues constitute a significantly smaller share of GDP than almost all of the countries in the region and all but two in Europe.
- The current allocation of the General Grant (VAT) and the Road Fund are skewed and do not provide a reasonable share of the available funds to poorer jurisdictions.
- Skopje, understood as both the City of Skopje, and the municipalities within it, is relatively overfunded, receiving close to 50 percent of all local government revenues despite serving only 25 percent of the population¹⁶.
- The current funding and allocation of block grants remains problematic, particularly for culture and social welfare (pre-schools and old age homes) where the national government has yet to begin to honor Article 12 of the Law on the Financing of Local Governments with respect to allocating these monies on the basis of "appropriate measures of need." At the same time, it is of critical importance that the efforts that have begun in the education sector are both continued, and made more transparent.

Solving these sorts of problems is extremely difficult in any country because it means shifting public money not only between levels of government, but across local governments, creating winners and losers at both levels. Worse, all these problems are particularly hard to address during a serious economic crisis when public revenues are shrinking and there is less money to be moved around.

¹⁶ As we have indicated there are also very serious problems with disparities in the financing of the jurisdictions within Skopje. It is however beyond the scope of this paper to address these.

As such nobody should have any illusions about there being easy solutions. Moreover, given the current economic downturn, it is likely that any reasonable solution really must consist of a set of steps, or at least a clear policy direction, that will only be implementable over a number of years. In short, not only are there no easy solutions but there are no quick ones. Nonetheless, in the following, I try to lay out what I think is a reasonable set of possible reform initiatives and to describe both what I think the major choices are, and what I think might be the next best steps.

I. Putting New Money into the System

There are a number of ways that new money can be put into Macedonia's local government system. Most of them are not mutually exclusive. But all of them have different advantages and disadvantages. Below we briefly describe the main possibilities, and the issues associated with each.

Own Revenues: Increasing the own revenues of local governments by expanding their existing tax powers or giving them new ones is desirable because it increases the political accountability of local officials who become responsible to their electorates not just for how they spend public money, but for how they raise it. Increasing the own revenue raising powers of local governments can also be attractive for national governments because the increase does not cost the central budget money, and because the national government does not have to bear political responsibility for raising taxes.

Unfortunately, however, there are a very limited number of high yield taxes or fees that can easily be assigned to local governments. Moreover, Macedonia has already assigned what is generally considered the best local government tax—the property tax—to municipalities. Thus, while the national government might give local governments some new own revenue powers these are unlikely to radically improve their financial situation over the short term¹⁷. Here, it should also be noted that increasing the own revenue powers of local governments almost always benefits jurisdictions with strong tax bases much more than jurisdictions with weak ones, usually putting new burdens on a country's equalization system¹⁸.

¹⁷ The most important thing the national government could do on this front is to improve the ability of local governments to effectively administer their still new property tax powers by, for instance, improving their access to cadastre data, and providing training. The UNDP reports referred to earlier also suggest the introduction of a motor vehicle tax, and so-called betterment fees. Finally, the UNDP raises the possibility of eventually converting local government shares of the personal income tax into a local government income tax, in which the municipalities would actually be able to set—within limits allowed by law—a local income tax rate.

¹⁸ It is worth adding, that it can be very hard to equalize across local governments for certain types of non-fiscal revenues because finding a uniform measure for the base of the fee is virtually impossible. This is true today in Macedonia for the most important local government own revenue—the land development fee—which as we seen yields almost ten times more per capita in Skopje than elsewhere in the country.

Shared Taxes: Central governments can increase local government revenues by raising the shares local governments receive of national government taxes, such as the Personal Income Tax. Theorists of fiscal federalism generally dislike giving local governments shares in national government taxes because tax sharing comes with all the disadvantages of own revenues – greater inequality between richer and poor jurisdictions— with none of its benefits, meaning no increase in the political accountability of local governments vis-à-vis their electorates.

Nonetheless, tax sharing is used throughout the world and has been particularly prominent in post-Communist Europe where large shares of Personal Income Tax have often been assigned to local governments. There are many reasons for this. First, the administration of shared tax systems is easy and does not require new skills or personnel at the local level. Second, national governments can assign local governments tax shares, and give up central government revenue, without “losing control” of tax policy.

Third, and conversely, tax shares often feel like own revenues to local government officials because the shares are typically stated in law and their yields are clearly related to the performance of the local economy. Here, however, it must be stressed that this feeling can be profoundly misleading, precisely because the national government still controls the base and the rate of the shared tax. Indeed, many local governments have seen the value of “their” shares erode dramatically, as national governments change tax rates and bases in order to lower overall tax burden¹⁹.

Fourth, national and local government officials in post-communist countries typically dislike the very idea of grants, in part because the idea smacks of the socialism everybody is trying to leave behind, and in part because in practice, grants have often served as instruments of political favoritism. Finally, and perhaps most importantly, tax sharing –particularly the sharing of PIT— at once creates a mechanism for giving significant amounts of tax revenue to local governments, while almost automatically creating a way to equalize for some of the disparities in wealth that tax shares –like own revenues—inevitably produce.

In other words, many post communist countries have assigned local governments significant shares of PIT, while simultaneously introducing rules that require the national government to equalize the revenues of local governments whose per capita yield of PIT is significantly below the national average. Here, in other words, PIT is being used to give local governments something that feels –a little illusorily-- like on an own revenue, while at the same time creating an automatic mechanism for equalization that doesn’t feel like a grant, and which like good grants can be made independent of political manipulation.

¹⁹ By going to a 10% flat rate personal income tax Macedonia has one of the lowest PIT rates in Europe. So it is hard to imagine that either the tax rate or base will be reduced in the coming period.

Grants: National governments can provide local governments with new revenues through a variety of different sorts of grants. These can be earmarked or special purpose grants, meaning grants to administer very particular programs or projects, or to build specific types of infrastructure. They can be sectoral or block grants, meaning grants designed to give local governments the monies they need to provide a type of service, but which leave them free to spend that money for *that service* anyway the like. And they can be general grants which by definition come with no strings attached.

Many countries make use of all three types of grants, and almost all make use of some mix of general grants and special purpose ones. Nonetheless, the literature on local government finance typically argues for limiting the number of special purpose or block grants in a system, and for consolidating as many of these as possible into a general grant so as to increase the real space for meaningful expenditure decisions at the local level. This makes good sense. And there is little question that the Macedonian grant system is overly fragmented.

At the same time, it is important to recognize that unlike most countries at a similar stage of development, Macedonia has assigned responsibility for financing and managing primary and secondary schools to local governments. And given both the importance of education and the relative inexperience of local governments, there are extremely good reasons for why the national government should want to be able to ensure that monies earmarked for education are indeed spent on improving the quality of primary and secondary school. Similar arguments can be made about kindergartens, especially if one sees them not as social welfare institutions, but as an integral part of a country's education system.

Conversely, however, there are probably good reasons for giving local governments greater latitude over spending decisions in the area of culture, and indeed for eventually folding the money currently provided to local governments through the block grant for culture into some more general instrument²⁰.

Be that as it may, there are two critical questions that must be answered for any type of grant. The first is: "What rules define the size and the stability of the pool of money being used to fund the grant? And the second is, "What are the rules for allocating this pool across local governments?"

²⁰ Similar arguments could probably be made about the Road Fund, which might be thought about less as capital grant for roads, but as a part of the general grant, though perhaps earmarked for capital purposes. It may also make sense for Macedonia to fold the block grant for social welfare into the block grant for education while transferring responsibility for kindergartens –early childhood education—from the Ministry of Social Welfare to the Ministry of Education.

In Macedonia today, the rules defining the size of both the general grant and block grants are fairly clear. The size of the general grant is specified as 3 percent of the national yield of VAT. And the size of block grants are defined as being at least the amount of money spent on the function by the national government prior to its devolution to local governments, and adjusted upward for inflation²¹.

With respect to the allocation of these grants, however, the situation is less clear. As we have already indicated, Article 12 of the Law on Local Government Finance obligates the line ministries responsible for particular block grants to develop formulas based on “appropriate measures of need”. This means that the allocation of funding for culture, social welfare, and education should slowly be put on a per-user or per-client basis, and moved away from the current system of allocating funds on the basis of operating costs of existing institutions. Indeed, the formula for allocating education funds to local governments, despite its lack of transparency, does seem to be moving in this direction.

But this does not yet seem to be happening with funds for culture and social welfare. Moreover, as we have discussed earlier (pg 22-23), doing this at current levels of expenditure -- the current levels of the block grants for culture and social welfare-- will be difficult because of the unequal endowment of the institutions associated with delivery of these public services across local governments. One way of ameliorating the problem is to increase the role of the private sector in the provision of these services.

For example, local governments need not build and run preschools. Instead, they can be allowed and indeed encouraged to purchase preschool services from private providers. Another way of improving the situation is to create mechanisms which allow local governments that don't have the necessary institutions to provide a service, to purchase the service from one that does. For example, local governments might all receive funds for elderly care, with those that don't actually have old age homes, buying such services for their citizens from those who do.

²¹ In most countries, the size of grant pools for capital purposes are set on an annual basis. In part, this is because they are by definition designed to support particular, relatively limited purposes. In part this is because the money set aside for any given program of investment support is usually the result of various inter-ministerial battles for extra funding. And in part it is because the overall level of capital spending that a national government can support is usually treated as the residual of its operating revenues over its operating expenses.

Unfortunately, the allocation of capital grants is even more problematic. On the one hand, line ministries are often not particularly good at, or committed to, creating clear criteria or application procedures for the allocation of capital grants. On the other hand, allocating capital grants on a formula basis means that all potential beneficiaries get some money, but nobody gets enough money to build anything of significance, defeating the purpose of the whole exercise. Typically, the improvement of the allocation of capital grants requires that the national government to get serious about forcing line ministries to create clear and transparent application procedures; selection criteria; co-financing requirements; and reporting and monitoring standards.

Here the solutions are likely to differ from sector to sector. Nonetheless, it is likely that all workable solutions will ultimately require at least some additional funding from the national government. As such, there are good reasons for considering putting more money into block grants, and at least in the area of culture thinking about folding the existing block grant into a more general funding mechanism.

How much additional funding should be put into each block grant, and what policy reforms must be put in place to make sure that this additional funding is used effectively and efficiently (e.g. rules for private sector provision) will require sector by sector analysis. Such analysis is beyond the scope of this report. But, one thing is clear, it will be necessary to look at the adequacy of the block grants in the near future, particularly when all local governments have entered the second phase of decentralization.

The question of what should be done with the General Grant, however, is more immediate because local governments have recently intensified their efforts to get the national government to substantially increase its size. Moreover, there are good reasons both to put more money into the local government finance system, and to reform the way the General Grant is allocated.

At the same time, however, we are a little wary of simply expanding the size of the general grant without first clarifying its role in Macedonia's overall intergovernmental finance system. Unfortunately this role has never been entirely clear, starting with the name of the Grant itself. Indeed, the section in the Law on Local Government Finances that deals with the grant is entitled "Revenues from VAT", something that has encouraged people to talk about the grant, as the VAT Fund, and to lead some to believe that the intention of the Law was to give local governments a share of the VAT generated in their jurisdictions.

More importantly, the rules governing the allocation of the general grant have always been both contentious, and poorly justified. In practice, the fund has clearly been used to direct additional funding to some types of jurisdictions. Moreover, Skopje has always gotten less per capit than the rest of the country. At the same time, however national policy makers have been extremely reluctant to talk about the general grant specifically in terms of equalization and have resisted developing a proxy measure of relative wealth based on actual financial data.

As a result, not only has the allocation of the grant to poor jurisdictions been questionable, but there has been no clear way to define why Skopje is being treated differently from other richer jurisdictions. Not surprisingly, Skopje has considered this unfair, and repeatedly fought and sometime succeeded in getting more of the grant allocated to the Capital City. In short, the practice of the last few years suggests that the grant hangs uneasily between being an

instrument for fiscal equalization, and an instrument for providing all local governments with equal amounts of additional revenue. Worse, the uncertainty here has proved extremely politically divisive for ZELS.

Technically and legally it is possible for a single grant pool to serve both general revenue and equalization purposes. Our feeling at the moment, however, is that in Macedonia today it is probably better to more clearly distinguish between these two functions. We therefore propose that new general purpose funds be put in the system by substantially increasing the PIT share that local governments receive from the national government.

At the same time however, we propose that the first call on the general grant be used to equalize the revenues of poor jurisdictions to a statutorily binding percent of the average per capita yield of all shared taxes. This two sided movement would at once serve to increase the revenues of virtually all local governments, while clearly establishing equalization as the central purpose of the general grant.

II. The Basic Outlines of the Proposal

In the Simulator that accompanies this report, I have proposed that the local government share of PIT be increased from its current level of 3 percent to 15 percent. A 15 percent share in 2008 would have amounted to an additional 660 mln dnrs in local government revenue, or a 7.5 percent increase in their basic revenues.

There is no strong justification for why this share shouldn't be 13 percent, 17 percent or 20 percent or perhaps even more. On the contrary, it is explicitly an effort to find a politically acceptable, but economically reasonable compromise between what the national government might be able to afford in the current economic circumstances, and what local governments need to feel a palpable improvement in their financial situation.

With this said, however, it should be understood that a significant increase in the PIT share is not without its risks and problems. As we have indicated, shared taxes benefit local governments with stronger tax bases. This means that the revenue from a larger PIT share will flow primarily to richer jurisdictions and in particular to Skopje, which accounted for 46 percent of the entire yield of the tax in 2008. As a result, just increasing the local government share of PIT without reforming Macedonia's equalization system will lead to a further increase in the disparities in local government revenues across jurisdictions.

Moreover, if the national government increases the PIT share by too much, it will assign too much revenue to Skopje, while simultaneously depriving itself of revenues that it may need to

fix other aspects of Macedonia's public finance system. For example, it may lack the revenues necessary to improve the adequacy and fairness of the allocation of block grants for education and social welfare.

As a result, increasing the PIT share should be treated with some caution. Equally importantly, the increase must be accompanied by very significant changes in the way the General Grant is thought about, and how it is allocated. We therefore propose that the increased PIT share be accompanied by a new set of rules for the allocation of the General Grant. The most important rule is that the first call on the General Grant will be to equalize the revenues of all local governments to somewhere between 80 and 90 percent of the average per capita yield of the Personal Income Tax, and the Transfer Tax.

This means accepting that the yield of these two taxes constitute the best measures available for measuring the relative wealth of local governments. On the one hand, the Personal Income Tax –even discounting for tax avoidance—is the best measure of the overall level of economic activity in a given jurisdiction. On the other hand, the Transfer Tax constitutes the best measure of the vitality of the local real estate market and its yield is very strongly correlated with the yield of the PIT, and with other measure of relative wealth²².

The value of the Transfer Tax however can differ significantly from year to year –particularly in smaller jurisdictions—because of large, single investments. As a result, a three year average of the tax should be used for equalization purposes. It should also be noted that local governments have been given the right to set the rate of the Transfer Tax within boundaries determined by the national government. As such, it is important in computing the average yield of the Transfer Tax to compute it at a standardized rate for all jurisdictions. This is necessary to prevent local governments who choose to impose a lower rate for the tax from receiving additional equalization monies.

In the Simulator, I have simulated how much money from the general grant would have to be allocated to poorer local governments if the rule governing the grant stated that local governments will receive equalization funds equal to the difference between the per capita yield of the PIT share and the three-year average yield of the Transfer Tax in their jurisdictions, and 90 percent of the national per capita average of these same two taxes. In 2008, this would have consumed about 470 mln of the 990 mln dnrs earmarked for the General Grant.

²² Avoidance of the Transfer Tax is relatively limited because it must be paid in order to get official title to the property being purchased. Research elsewhere on in the region suggests that transaction prices are typically understated by 10-20%.

This equalization rule will benefit all local governments with weak tax bases. But it will particularly benefit those jurisdictions which are currently receiving relatively little from the General Grant for the reasons discussed earlier (see pages 17-19). At the same time, the rule will leave approximately 520 mln dnrs of the General Fund to be allocated according to different criteria.

In the Simulator we have included three possible criteria, and have assigned notional percentages for how much of the residual fund should be allocated for each. The first criterion is the share of a local government’s territory in the total territory of Macedonia. This, in other words is the same criteria that is currently being used to allocate 27 percent of the General Grant, and is designed to provide additional support jurisdictions with large land areas and low population densities.

In the baseline proposals contained in the Simulator we suggest that 40 percent of the residual of the general grant --after the equalization for PIT and Transfer tax revenues-- be allocated according to this criterion. If these rules had been applied in 2008, this means that the c. 200 mln dnrs of the General Grant would have been allocated on the basis of area and instead of the 300 mln dnrs that actually were.

We also propose that the next 40 percent of the residual be allocated to all local governments on a lump sum basis. The logic of this lump sum is to help local governments that have both small populations and small land areas. If 40 percent of the residual of the general grant were allocated in this way, each and every local government, including the local governments of Skopje, would receive about 2.5 million dnrs in general support.

Finally we propose that 20% of the residual of the general grant be allocated to all local governments on straight per capita basis. In the scenario contained in the Simulator this means that all local governments would receive c. 50 dnrs per capita from this criterion.

These new rules substantially improve the equity of the existing system. Table 8 below summarizes the effects of the base line scenario contained in the Simulator with the current system.

Table 8

Comparison of Simulated System with Current System on the Per Capita Basic Revenues of Local Governments		
Quartile by per capita income	Current System	Simulated System

Ist Rev. Quartile	1,451	1,956
2nd Rev. Quartile	2,264	2,612
3rd Rev. Quartile	2,818	3,215
4th Rev. Quartile	4,397	4,649
Skopje	7,325	7,763
National Average	2,778	3,120

As can be seen from the Table, the revenues of the poorest two quartiles rise substantially faster than those of the richest two, and of Skopje. As a result, the ratio of total per capita revenues between the richest quartile of local governments to the poorest drops from 3 to 1, to 2.4 to one. Similarly, the ratio of Skopje to the poorest quartile decreases from 5 to 1, to 4 to 1, and between Skopje and the poorest jurisdiction from close to 10 to 1 to less than 6 to 1. Moreover, the new rules also significantly reduce the disparities across local governments within all quartiles.

The Simulator allows for the adjustment of both the general equalization rate, as well as the percentage of the residual of the General Grant allocated according to each criteria. The lower the equalization rate, the higher the residual that can be allocated according to other criteria. And the lower the percentage of the residual allocated according to area or through the lump sum mechanism, the more that can be allocated on a straight per capita basis.

What is extremely important to understand, however, is that higher the equalization rate, the more equitable the system will be for all jurisdictions that do not have either extremely large areas, or higher than average per capita revenues from the PIT share and the Transfer Tax.