



USAID
FROM THE AMERICAN PEOPLE

**MACEDONIA LOCAL
GOVERNMENT ACTIVITY**

Local Government Finances and the Status of Fiscal Decentralization in Macedonia: A Statistical Review 2008-2011

Tony Levitas

The Urban Institute

May 2011

Macedonia Local Government Activity / USAID

This publication is prepared by Tony Levitas, The Urban Institute, with the support of the American People through USAID. The opinions contained in the publication are the author's own, and do not express the views of USAID or the US Government.

Executive Summary

In 2008, the USAID-sponsored Macedonian Local Government Activity, in cooperation with the Macedonian Municipal Association ZELS, and the Ministry of Finance, developed a relational data base on local government revenues and expenditures. 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.

In June 2009, the data base was used to produce a report on the evolution of local government finances in the years 2006-2008, and to make some proposals for further reform¹. The current report should be seen as a continuation and deepening of this earlier analytical effort. Like the first report, its primary objective is to monitor the overall development of Macedonia's decentralization efforts and to highlight the main problems of the country's intergovernmental finance system. The major findings of the report are as follows.

- As of January 1st 2011, 73 of Macedonia's 85 jurisdictions (including the City of Skopje) had entered the second phase of decentralization and assumed responsibility for major social sector functions, most importantly Primary and Secondary Education, Social Welfare (Kindergartens and Homes for the Elderly) and Culture (Libraries, Museums, and Theaters). They also assumed responsibility for fire protection.
- With the assumption of these responsibilities local governments began to receive grants designed to help them pay for the costs of managing and financing these institutions. These grants have led to a very significant increase in local government revenues both as a share of GDP and of total public expenditures. Indeed, between 2005, when the decentralization process really began and 2010 local government revenues as a share of GDP and of total public expenditures have risen from 1.7 and 5 percent respectively, to 5.4 and 15.3 percent.
- This growth is impressive. Nonetheless, most of it is being driven by the decentralization of pre-tertiary education to local governments, spending on which currently amounts to 2.8 percent of GDP, and which goes overwhelmingly to pay teachers' wages.
- More importantly, Macedonian municipalities continue to be underfunded when compared to municipalities in countries in which similar functions have been decentralized to local governments. On the one hand, total public spending on pre-tertiary education in Macedonia is at the low end of European norms where countries typically spend 3 to 5 percent of GDP and 12 to 15 percent of public expenditure on pre-tertiary education. On the other hand, and using these same sorts of (admittedly inexact) international comparisons, one would expect that Macedonian local governments would have –given the

¹ Tony Levitas, "Local Government Finances in Macedonia Today: Possible Reforms for Tomorrow" The Urban Institute/Macedonia Local Government Activity / USAID, June 2009, pp. 1-35

functions that have been assigned to them— revenues equal to between 8 or 9 percent of the GDP, and not 5 or 6.

- Since 2006, and particularly in 2008, the national government has taken a number of steps to improve the financial position of local governments. These include doubling the base of the Public Lighting Fee, extending property taxation to legal entities; sharing revenue from the sale of urban construction land 80/20 in favor of local governments; and amending the Law on Local Government Finances so that the share of the VAT Fund –used to provide local governments with general grants-- increases progressively from 3 percent of the national yield of VAT in 2008 to 4.5 in 2013.
- The national government’s commitment to improving the overall adequacy of the intergovernmental finance system is highly commendable. It will also have to be continued in the future.
- At the same time, little has been done to improve the equity of the system which remains a cause for serious concern. Indeed, the equity of Macedonia’s intergovernmental finance system has worsened since 2008. The richest 25 percent of municipalities now have 5 times more per capita revenue than the poorest, up from 3.2 times in 2006. Similarly, the ratio of the per capita revenues of the richest jurisdiction to the poorest has also increased from 12 to 1 in 2006, to 25 to 1 in 2010. The difference between the jurisdictions of the capital city and all other local governments has also increase from 2.3 to 1 in 2006 to 2.9 to 1 in 2010.
- Two forces are driving these differences. The first is structural: The basic budgets of local governments are highly dependent on three revenue sources: The Transfer Tax, the Land Development Fee; and --since the 2008 decision to share with local governments the value of the sale of urban construction land-- Asset Income. All three of these sources are tied to the real-estate market: The Transfer Tax is a national tax on the value of real estate transactions that is shared a 100% with local governments; the Land Development Fee is a local tax imposed as a per meter charge on new construction, with maximum rates capped by the national government; and Asset Income is a capital revenue from the sale of publicly owned land. All of these revenues go up and down together. But the distribution of real-estate activity in Macedonia is highly skewed, and heavily concentrated in Skopje. Thus the budgets of Macedonian municipalities are tied to their real-estate markets and the problem is that while some have these markets, many don’t. In this sense, the inequity of the system is being driven by the general economy and is structural.
- The second force driving these differences is the absence of effective instruments of fiscal equalization. Indeed, the existing instruments seem to be deteriorating. These instruments are the VAT Fund and Road Funds, which the national government allocates by formula to local governments, and various earmarked transfers and capital grants which the national gives according to particular programs (or on an ad hoc basis). The current allocation of these grants is paradoxical. Local governments, whose per capita revenues from other sources are low, get less support from the national government than their better off

counterparts. Indeed, government transfer policies are making a particular group of small – sometimes poor, sometimes not so poor— municipalities five times richer than their less fortunate counterparts. The main driver here is the formula for allocating the VAT Fund. This formula very strongly favors jurisdictions that have low populations, large areas, and multiple settlements.

- The gap between the richest and poorest quartiles of local governments has further widened since 2008 when the national government, on recommendation from the Intergovernmental Finance Affairs Commission, adopted new rules for the Fund and granted all local governments a lump-sum payment of 3 mln dnrs. This rule shifted more funds away from more densely inhabited jurisdictions to more sparsely inhabited ones. Given the difference in revenues created by these forces, it is not surprising that richest 25 percent of municipalities now spend ten times more on investment than the poorest 25 percent.
- A separate but related problem is the very significant differences in the per capita revenues of Skopje municipalities. As elsewhere, these differences are being driven by the real-estate markets of different parts of the City and the absence of a clear equalization system designed to address the problem. Three of Skopje's municipalities are among the poorest in the country, and three are amount the richest.
- The development of a viable system of fiscal equalization for all Macedonian municipalities should be among the top priorities of policy makers.
- Local governments are improving the collection of their own revenues. Since 2006, they have tripled the yield of the property tax on individuals. Most of this growth however occurred in 2006 and 2007, and there is almost certainly still room for improvement in most jurisdictions: The distribution of these gains is uneven, and doesn't track as closely as one would expect with the yield of the Transfer Tax, though the Transfer Tax does tend to yield more money in jurisdictions with active real-estate markets. The gains from the extension of the property tax to legal entities should continue for the foreseeable future as local governments deepen their registers of this important tax base. Local governments have also significantly improved their collection of other local fees, charges and taxes and in general seem to be taking the business of raising own-revenues seriously.
- The Second Phase of decentralization in Macedonia has entailed a massive shift in resources to local governments. But this shift has gone less to finance decentralized functions than to provide municipalities with the money necessary to pay for state run institutions that have been formally transferred to them. There are at least three problems with this type of institutional –as opposed to functional-- decentralization. The first is simply that if the state didn't run a particular type of institution in a given municipality prior to decentralization then the municipality gets no grants for this "institution" (function) after decentralization. Thus, and for example, only half of all Macedonian municipalities had kindergartens prior to

decentralization, meaning that after decentralization only half of all municipalities are receiving funding for the *function* of pre-school education. Similarly, only 25 percent of municipalities had libraries, or state run theatres or cinemas prior to decentralization, meaning 75 percent of municipalities are currently receiving no grants for the function of culture.

- Second, the distinction between block grants and earmarked grants that informed the Law on Local Government Finance seem to have broken down in practice. The initial idea was that local governments would first receive earmarked grants to support the non-wage operating costs of the function that were being decentralized to them and then, in the second phase of decentralization be graduated to receive freely disposable block grants that would allow them to allocate funds for wages and non-wage operating costs across functions as they saw fit. This however is not really happening. On the one hand, instead of a single block grant for education, we have three block grants, one each for primary and secondary education, and another one, administered by the Ministry of Labor and Social Welfare, for kindergartens.. Similarly, instead of a single block grant for culture we have separate programs within the grant for culture for Libraries, Museums and Theaters, that can only be spent for the specific programs. On the other hand, it seems that local governments have limited administrative authority to change the employment patterns in the institutions they have been assigned. As a result, most local governments are little more than the payroll agents of the institutions that have been decentralized to them.
- Third, local governments themselves seem to be reluctant to get seriously involved in managing either the institutions that have been decentralized to them, or more importantly the functions that –in theory—they have been made responsible for. With the exception of Fire Protection, few local governments who receive grants for decentralized functions contribute own revenues to support the costs of these functions. And with the exception of fire protection and some cultural activities the share of local government budgetary contributions to the costs of decentralized functions remains under 3 percent.
- It will take many years for Macedonia to begin to provide local governments with equitable funding for decentralized social sector *functions* simple because the national government does not have the funds to provide local governments who currently lack the associated institutions with money to create them. It will also take many years for local governments to become active managers of both these institutions and the functions that they really serve. At the moment however, there seems to be no plan for how to ensure that this process moves forward in an orderly way, and that the existing differences in public services across municipalities does not worsen over time².

² 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 as well as Levitas, op. cit.

Municipal Finances in Macedonia Today - Findings

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 persons³.

- 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 218 mln denars in 2006 (in 2010 dnrs), 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 revenues by about 937 mln denars (in 2010 dnrs) 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.

³ 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.

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 between the National government and local governments as a whole, and among them: Collectively, local governments have consistently argued that the VAT fund should be increased. Indeed, in 2009, ZELS succeeded in getting the government to amend the law so as to gradually increase the VAT Fund. These amendments require that the fund be increased to 3.4% in 2010, to 3.7% in 2011; to 4.0% in 2010; and to 4.5% in 2013⁴. At the same time, Skopje has argued that the allocation of the fund discriminates against the City while poorer jurisdictions have argued 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, the earmarked grant amounted to 13 percent of total local government revenues in 2006.

Under the second phase of decentralization, local governments who 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, roads⁵.

As of January 1st 2011, 76 of Macedonia's 84 local governments had entered the second phase. This has had profound consequences on the total amount of money flowing to

⁴ Official Gazette 159/2009

⁵ There are separate block grants for primary and secondary education. This was felt to be necessary because there are separate laws regulating the "primary school sector" and the "secondary school sector." It should also be noted that many secondary school age children attend secondary schools in jurisdictions other than in the one they live, most frequently in the closest, large urban jurisdiction in the area. Note to Janek's parallel analysis.

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. Indeed, because local governments were allowed to enter the second phase through-out the budget year, the data is not fully comparable across local governments even within a particular year.

More importantly, the transfer of social sector functions to local governments raises many critical policy questions that have yet to be fully addressed. Here two questions stand out. The first is whether under the second phase of decentralization, the national government is transferring social sector *functions* to local or 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 uneven distribution of municipal institutions inherited from the Yugoslavian past. 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.

The second major question is whether local governments have really begun to actively manage the schools, cultural institutions, kindergartens and old-age homes that have been transferred to them under the second phase of decentralization. Unfortunately, answering this question goes well beyond the scope of this review. At a minimum it would require case studies of how local governments are actually managing the social sector functions they have been assigned and whether they have in fact been given the regulatory powers –and in some cases the resources-- necessary to effect change. We will return at greater length to this is issue later in 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 in different socio-economic and institutional 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 the division of responsibilities between levels of government is similar. Table 1 and Chart 1 below, present the share of local government revenues in Macedonia as a percentage of GDP and of total public expenditures between 2004 –the year before the Local Government Finance Law went into effect-- and 2010, when 73 of Macedonia's 84 jurisdictions (90% of the population) had entered into the second phase of decentralization⁶.

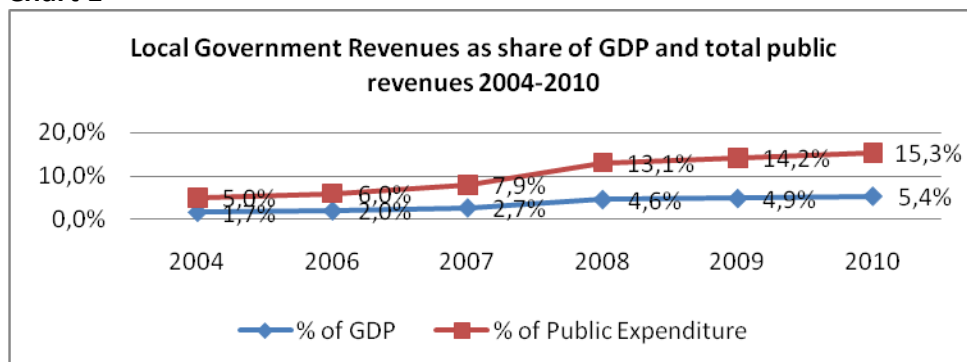
Table 1

Evolution of Local Government Revenue 2004-2010 (in 2010 dnr)						
	GDP (bln dnr)	Public Expenditure (bln dnr)	LG revenue (bln dnr)	% of GDP	% of Public Expenditure	per capita
2004	306.0	101.7	5.1	1.7%	5.0%	2,532
2006	358.3	119.9	7.2	2.0%	6.0%	3,553
2007	395.1	133.6	10.6	2.7%	7.9%	5,234
2008	435.1	153.1	20.1	4.6%	13.1%	9,933
2009	409.9	140.5	19.9	4.9%	14.2%	9,857
2010	430.6	151.6	23.3	5.4%	15.3%	11,510

Source: Ministry of Finance. *Transfers to local governments from the Central government have not been netted out of the calculation of total public expenditures; For 2004 total public revenues were used instead of total public expenditures.

⁶ 2005 has been left out of the series because the Law on Local Government Finance actually went into effect in the middle of the year, meaning half the year was spent under the old system, and half under the new. The eleven jurisdictions that had not entered the second phase of decentralization before the end of 2010 are: Vinica, Vranesnica, Delcevo, Zelino, Ochrid, Plasnica, Krivogastani, Lozovo, Vrapciste, Aracinovo, and Probistip.

Chart 1



As can be seen from the Table and Chart, there has been an impressive growth in local government revenues both as a share of GDP and of total public expenditures. Indeed, both have more than tripled since the beginning of Macedonia's decentralization process, while the per capita revenues of local governments have more than quadrupled. In short, and on the face of things it seems that progress with decentralization in Macedonia has proceeded quite rapidly and successfully.

A closer look at the numbers, however, suggests that while the gains have undoubtedly been substantial, there are serious reasons to believe that local governments remain underfunded. Between 2004 and 2006 local government revenues increased from about 5.1 bln dnrs to 7.1 bln dnrs (in 2010 denars). More than half of this growth came from the new "VAT fund" and the new PIT shares created by the Law on Local Government Finance (937 mln VAT, 218 mln PIT) with the remainder coming from new earmarked grants for social sector functions. Taken together this growth raised local government revenues from 1.7 percent to 2.0 percent of GDP, and from 5.0 percent to 6.0 percent of public expenditures. This growth appears modest in relation to what comes later when local governments enter into the second phase of decentralization. But in fact it is during this period that local governments receive their single largest increase in freely disposable revenues.

In September 2007, the first 42 local governments entered the second phase of decentralization and began receiving block grants for social sector functions. The fact that they entered the second phase in the third quarter of the budget year explains why their revenues grow only modestly in 2007, with the really dramatic increase coming in 2008 when their budgets come to constitute 4.6 percent of GDP and 13.1 of public expenditures. Then growth slows down as other most of the other jurisdiction enter the second phase. By the end of 2010, all but 11 jurisdictions have assumed responsibility for social sector functions and total local government revenues rise to over 23 bln denars, or 5.4% of GDP and 15.3 percent of public expenditures.

In short, after 2006, the real driver of local government revenues is block grants, particularly the grants they receive to pay the wages of primary, secondary and pre-school teachers.

Indeed, total education grants --block grants for wages and school operating costs for those in the second phase of decentralization, and earmarked grants for school operating costs for those who are not) grants amounted to close to 12 bln denars in 2010, or 2.8 percent of GDP. As a result, more than half of all local government revenues are earmarked for education purposes.

Here two things should be noted. The first is that total public spending on pre-tertiary education in Macedonia is probably around 3% of GDP, after we factor in the wages of teachers working in jurisdictions that have yet to enter the second phase of decentralization and the still trivial contributions to education that local governments make to the sector from their other revenues (more on this later). This puts Macedonia on the low side of European norms, where most countries spend between 3 and 5 percent of GDP on education. Or put another way, education has been decentralized but it probably also remains underfunded.

The second thing to be noted is that local government are funding all their other expenditure responsibilities with revenues that are equal to less than 2.6 percent of the GDP and less than 8% of total public expenditures. Unfortunately, this means that local government revenues in Macedonia remain very low. This can be seen from Table 2 below. The Table presents local government revenues as share of GDP and public expenditures 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.

Table 2

Local Government Revenues as a Share of GDP in Select European Countries			
Country	% of GDP	% of Public Expenditure	Year
Countries in which Local Government DO pay teachers wages			
Macedonia	5.4%	15.3%	2010
Bulgaria	8.2%	20.3%	2009
Hungry	12.3%	23.7%	2009
Poland	14.7%	33.0%	2006
Countries in which Local Government do NOT pay teachers wages			
Albania	2.9%	10.9%	2008
Greece	3.1%	8.8%	2009
Serbia	5.1%	10.9%	2009
Turkey	5.4%	15.0%	2009
Croatia	5.8%	16.00%	2006
BiH - FBiH	4.3%		2007
BiH - RS	7.0%		2007

As can be seen from the Table, Macedonian local governments revenues are significantly lower --as a percent of GDP-- than those of other transitional countries in which local governments are

responsible for teachers pay. Moreover, if we remove education grants from the Macedonian figures, local government revenues as a percentage of GDP would be lower –2.6% of GDP– than in all the countries in which local governments are not responsible for teacher’s pay.

For us, these measures --as inexact as they may be-- strongly suggest that despite the progress which has been made since 2004, Macedonia is still underfunding its local governments and probably underfunding pre-tertiary education as well⁷. 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. Even this sort of increase, 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.

III. The Composition of Local Government Revenues

The structure of local government revenues has changed radically since the beginning of the second phase of the decentralization process. Table 2 below illustrates how the block grants for social sector functions developed have radically increase total local government revenues.

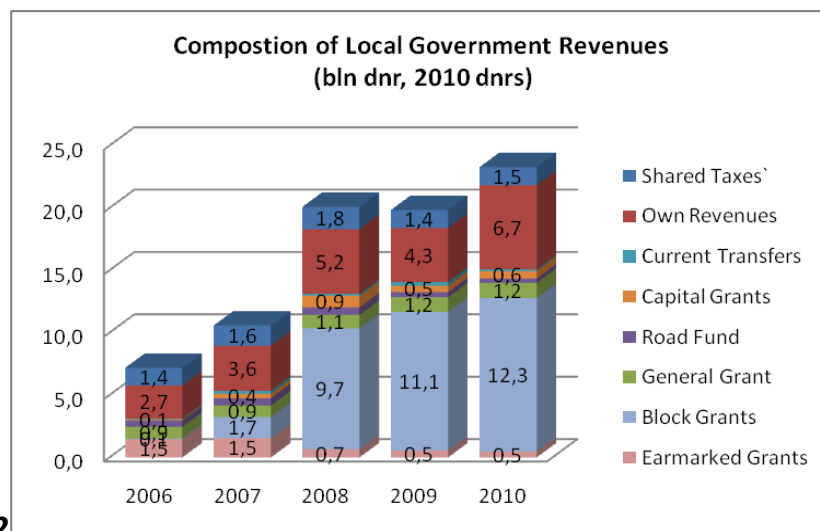
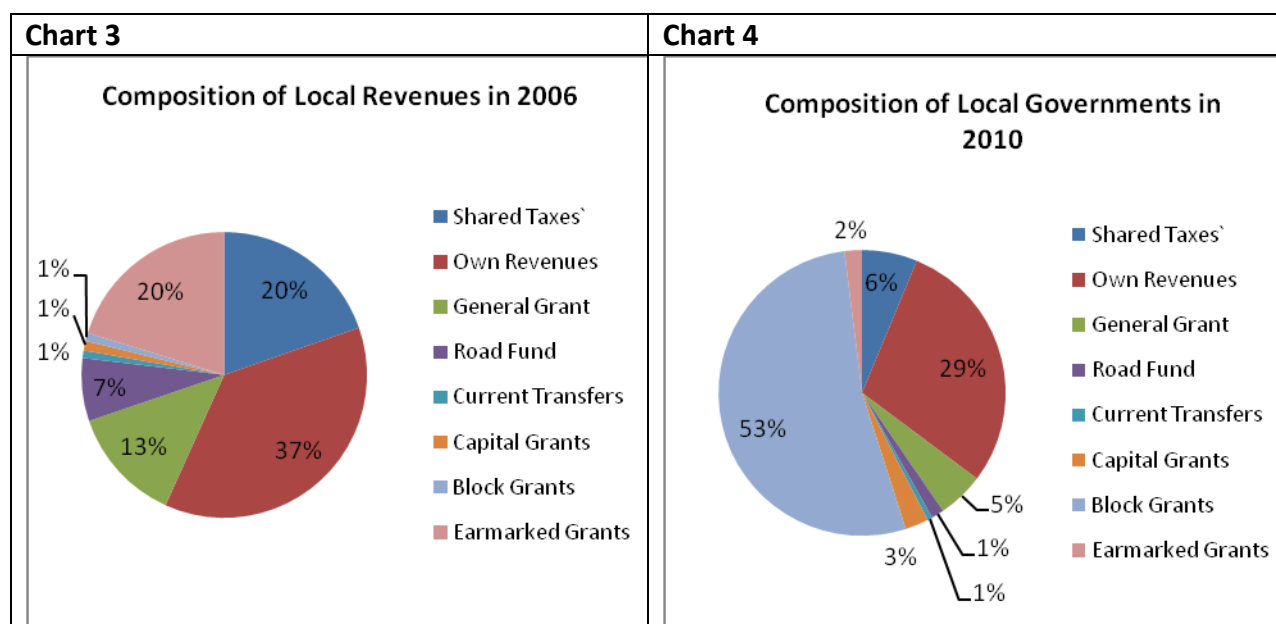


Chart 2

⁷ 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 GDP.

Charts 3 and 4 below show how they have affected the composition of local government revenues. As can be seen from the Charts, block grants increased from almost nothing in 2006 to over 53 percent of local government revenue in 2010. Meanwhile, earmarked grants for social sector functions have fallen from 20 percent of local government budgets in 2006 to less than 2 percent over the same period, because –as we have already mentioned–once local governments enter into the second phase, earmarked grants for the non-wage operating costs of social sector facilities get consolidated into the block grants they receive to support the full costs of running these institutions. Here, the driver of this growth is teachers’ wages which constitute well over 90% of all block grants.



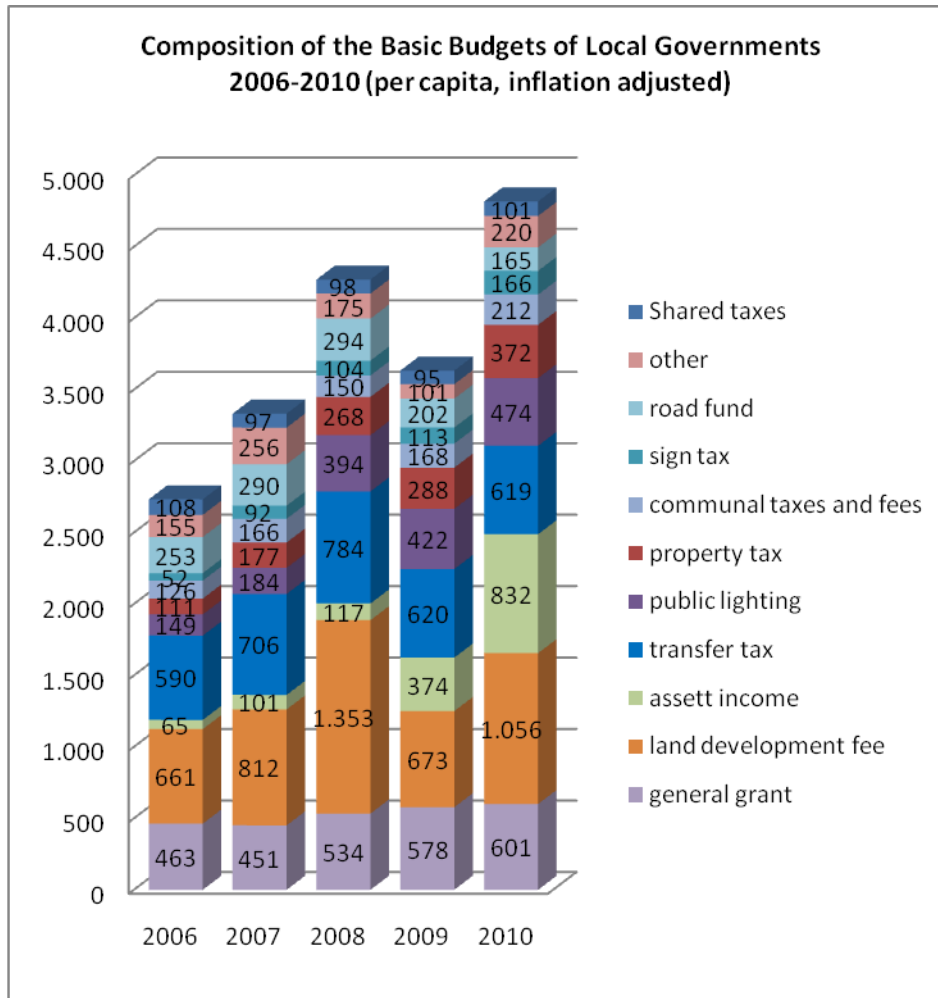
More interesting is what has happened with the “basic revenues” of local governments. By “basic revenues” we mean revenues from all sources other than capital grants and grants for social sector functions. We call these revenues “basic revenues” because all local governments receive them on a regular basis; because their yields are fairly predictable; and because unlike earmarked or block grants, they are not designated to fund particular social sector functions. Moreover, this group of revenues has been “stable” for all local governments for the past 6 years, meaning that unlike with earmarked, block, and/or capital grants, the amount of money local governments receive is not dependent on whether they have entered the second phase of decentralization, or whether the national government has decided to support a particular investment project in their jurisdiction.

Chart 5 below shows the per capita basic revenues of local governments between 2006 and 2010 in 2010 denars. As can be seen from the Chart, total local government revenues have increased every year since 2006 with the exception of 2009. In this year, local government revenues from real estate transactions --the transfer tax-- and new construction --the land development fee-- plummeted as the global recession hit Macedonia. In 2010, revenues from the transfer tax remain depressed, but revenues from the land development fee recovered –

though not to 2008 levels, while revenues from asset income shot up. This growth in revenues from Asset Income marks a significant change in government policy: Beginning in 2009, the national government began to share the revenue earned from the sale of urban construction land 80/20 in favor of local governments.⁸

Since 2008, the national government has also been putting less money into the Road Fund and as a result revenues from this source –allocated by formula to local governments on the basis of their area and kilometers of road—fell in both 2009 and 2010. But with the exception of the Road Fund, and the Transfer Tax and Land Development fee –whose yields were temporarily depressed by the overall economic downturn of 2009-- all other types of local government revenues have increased every year since 2006. As a result, total basic revenues are now 70% higher than they were in 2006 (2,732 dnrs per capita vs 4,817 dnrs per capita). Most of this growth has come from the land development fee, the transfer tax, and more recently from the asset sales and rentals.

Chart 6



⁸ Within the Capital City the local government share of the sale is split 50/50 between the City of Skopje and the relevant municipality. (The data suggest this is not happening.)

Local governments have also made significant progress in improving their collection of their fiscal own revenues. Of particular importance here is the property tax whose yield has more than tripled from 111 dnrs per capita in 2006 to 372 dnrs per capita in 2010. As can be seen from Table 3 below, local governments radically increased the yield of the property tax from citizens by over 50 percent per year in 2007 and 2008. Growth then slowed to about 7 percent a year in 2009 and 2010. Whether this decline in the growth rate is because local governments have more or less succeeded in fully registering the base of the property tax for citizens or for other reasons is unclear. Meanwhile, in 2008 the Law on Property Taxation was amended to allow local governments to tax legal entities and in 2010 local governments had collected 135 mln dnrs from this source. Significant growth in the revenues from the property tax on legal entities will probably continue over the next few years as local governments improve both the registration of the base and collection.

Table 3

Evolution of the Collection Property Tax 2006 (in 2010 dnrs)			
	Property Tax from Citizens	Property tax Legal Entities	Property Tax from Citizens --% growth over previous year
2006	224,149,639	n.a	n.a
2007	357,611,221	n.a	160%
2008	541,879,130	n.a	152%
2009	580,534,151	1,353,939	107%
2010	616,671,070	135,966,407	106%
2010 per capita dnr	305	67	n.a
2010 in Euros	€ 5.00	€ 1.10	n.a

Local governments are also doing a better job of collecting both Communal Fees and the Sign Tax. The yield of Communal Fees tax increased from 126 dnrs to 212 dnrs per capita between 2006 and 2010, while the Sign Tax grew from 52 dnrs to 166 dnrs per capita over the same period. Revenues from the Public Lighting Fee have also tripled and now stand at 474 dnr per capita. Much of this growth is the result of the national government's 2008 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.

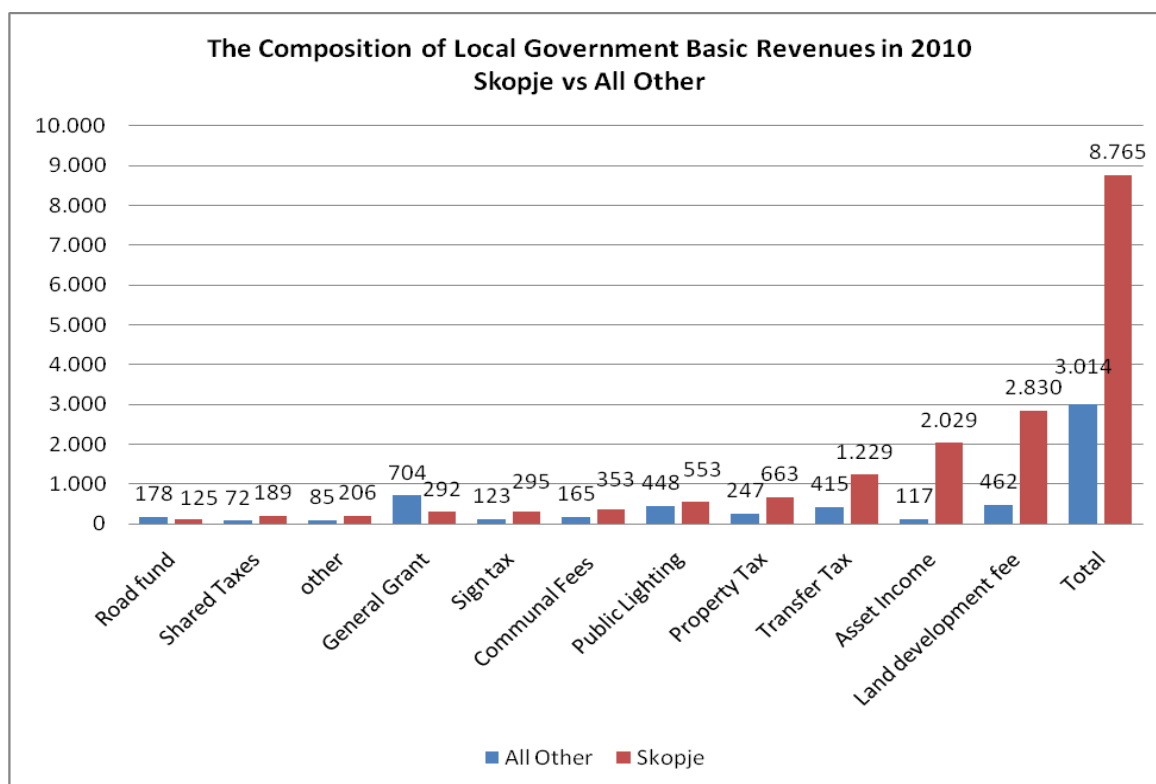
Revenues from the very modest PIT share have not increased significantly. In part this is because the government introduced a flat 10 percent personal income tax rate in 2007 and in part it is because the GDP actually declined in 2009, and did not fully recover to 2008 levels in 2010. Meanwhile revenues from the General Grant (VAT) have increased from 463 dnrs per capita in 2006 to 610 dnrs per capita in 2010. Here, it is important to note that the increase in the VAT share earmarked for the General Grant and mandated by the 2008 amendments to the Law on Local Government Finance did not produce as much revenue growth as might have been expected because of the falloff in overall economic over the last few years. This however,

should change as the economy improves and the share increases to its currently projected level of 4.5 percent of the national VAT yield in 2013.

In sum, the basic revenues of local governments have substantially increased since 2006. Moreover, this has occurred despite the economic downturn of the last two years. In large part the increase has been the result of policy decisions taken by the national government. Here we mean the decision to double the base of the Public Lighting Fee; the extension of the property tax to legal entities; the amendments to the Law on Local Government Finances that increased the size of the General Grant, and the decision to begin sharing the revenue from the sale of urban construction land 80/20 in favor of local governments. At the same time, local government basic revenues have increased because local governments have improved the collection fees, charges and taxes, particularly the property tax.

This generally positive picture of revenue growth however obscures some serious issues about the equity of the intergovernmental system when we begin to look at how local government basic revenues differ across the entire population of Macedonian municipalities. Chart 7 below shows the average per capita revenues of the jurisdictions of Skopje, plus the City of Skopje on the one hand, and the average per capita revenues of all other jurisdictions. As can be seen from the Chart, the average per capita basic revenues of Skopje are almost 3 times those of all other jurisdictions (8,765 vs 3,014). Moreover, the lion's share of this very substantial difference is being driven by three particular types of revenues: the land development fee, asset income, and the property transfer tax.

Chart 7



In Skopje these three types of revenue account for a remarkable 70 percent of the basic revenues accruing to the jurisdictions of the capital (6,088 dnr of 8,765 dnrs per capita). Meanwhile, outside of Skopje, these three revenues generate only 994 dnrs of per capita revenue and account for only 33 percent of total basic revenues (994 dnrs of 3,014).

Moreover, the disparities in the per capita income between the capital and all other jurisdictions seem to be increasing. This can be seen from Table 4 below which shows the growth (or decline) of basic revenues inside and outside of Skopje between 2006 and 2010. The last line of the table shows the revenues of Skopje in relation to all other jurisdictions. In 2006 and 2007, Skopje's per capita revenues were about 230 percent of the per capita revenues of all other jurisdictions combined. In 2008, this ratio increased to 275 percent, primarily because of the city's already high revenues from the Land Development Fee almost doubled. Then in 2009, the ratio fell to 155 percent because the economic downturn slashed the city's income from the Land Development Fee and the Transfer Tax. Finally, the ratio increased to 291 percent in 2010, as revenues from the Land Development Fee shot up again, revenues from the Transfer Tax stabilized, and revenues from Asset Rental and Sales exploded.

Table 4

The Growth of Basic Revenues 2006-2010 Skopje vs. All Other (2010 dnr)										
	All Other	Skopje	All Other	Skopje	All Other	Skopje	All Other	Skopje	All Other	Skopje
	2006		2007		2008		2009		2010	
Shared Taxes	82	186	71	177	72	176	115	176	72	189
Property Tax	93	165	128	323	172	554	302	501	247	663
Transfer Tax	349	1,309	466	1,424	491	1,659	620	1,246	415	1,229
Public Lighting	125	220	171	222	365	481	501	506	448	553
Sign tax	50	58	106	49	110	85	130	104	123	295
Land development Fee	279	1,804	318	2,286	442	4,078	536	1,807	462	2,830
Communal Fees	115	157	133	267	124	228	193	231	165	353
Asset Income	65	64	52	99	127	77	380	825	117	2,029
Other	73	271	93	187	78	176	109	181	85	206
Road fund	256	244	306	244	306	257	254	163	178	125
General Grant	558	181	542	180	629	248	735	271	704	292
Total	2,044	4,660	2,384	5,457	2,916	8,021	3,876	6,012	3,014	8,765
Skopje as a % of All Other	228%		229%		275%		155%		291%	

This growth in revenues from Asset Rentals and Sales is a result of the government's decision to split the revenue from the sale of urban construction land 80/20 in favor of local governments. What is interesting here is that despite the fact that Skopje municipalities get only 50 percent of the value of these sales while non-Skopje jurisdictions get 80 percent, the gains from this change in policy are overwhelmingly concentrated in the capital because this is where the demand for urban construction land –and the prices for it—are highest. Either way, what the Table makes clear is that the relative wealth of Skopje dwarfs that of all other jurisdictions and

that the per capita budgetary income of the jurisdiction of Skopje is, collectively, somewhere between 2.5 and 3 times the average of all other jurisdictions. Indeed, in 2010, the jurisdictions of Skopje accounted for 47 percent of all the basic revenues of local governments in Macedonia, despite the fact that only 25 percent of the population lives in the capital⁹.

As such, it is fair to say that the current equalization system is doing relatively little to ensure that the revenues of non-Skopje jurisdictions keep pace with those of the capital. In fact, non-Skopje jurisdictions derive more revenue per capita than the jurisdictions of Skopje from only two sources, the Road Fund and the General Grant (VAT share). In 2010, non-Skopje jurisdictions received about 40 percent more per capita from the Road Fund than the jurisdictions of Skopje (178 dnrs vs. 125 dnrs). This difference, while significant in percentage terms does little for equalization because the size of the Road Fund is both small and declining.

More importantly from this perspective are revenues from the General Grant. Here, non-Skopje jurisdictions received about 2.4 times the amount of revenue per capita than the jurisdictions of Skopje in 2010 (704 dnrs vs. 292). This is certainly significant. Nonetheless, the general trend in the formula used to allocate the VAT Fund has become less equalizing over time. In 2006 and 2007, non-Skopje jurisdiction received about 3 times more than the jurisdiction of Skopje from the Fund. By 2010, however, this ratio had fallen to 2.4. In part, this is because in 2008 the share of the Fund earmarked for the jurisdictions of Skopje was increased from 10 to 12 percent. And in part it is because in 2009 all local governments began to receive from the Fund a lump sum payment of 3mln dnrs which effectively the reduced the amount of money distributed to non-Skopje jurisdiction by 33mln dnrs (11 jurisdiction of Skopje time 3 mln equals 33 million).

In most countries, the per capita revenues of capital cities far exceed those of other jurisdictions simply because the tax bases and asset markets of capital cities are almost inevitably much stronger than elsewhere. Moreover, these higher revenues are in many ways not only inevitable but justifiable. After all, capital cities have to pay higher costs for many types of services because wages and other inputs typically cost more than in the rest of the country. They also have to provide services to citizens who live elsewhere and come to the capital for any number of reasons. Moreover the official census numbers almost surely understate the real number of Skopje's inhabitants and 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 having close to 50 percent of all public revenue accrue to the capital city where – at least officially—only 25 percent of the population lives. Indeed, it seems to us that

⁹ 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, at least two 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.

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 Capital's 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 Skopje¹⁰.

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

The problem of disparities in the basic revenues of local governments is not confined to the differences between Skopje and other jurisdictions. Indeed these problems are quite profound and are getting worse if we look at the per capita revenues of all jurisdictions –without the City of Skopje, but including the municipalities of Skopje—by quartile. What this means is that we have ranked all jurisdictions –without the City of Skopje, but including the municipalities of Skopje-- into four equally sized groups (of 21 municipalities) based on their average per capita income from basic revenues. Table 5 below presents the results for all years between 2006 and 2010 in 2010 denars.

Table 5

Per Capita "Basic" Revenues of Local Governments by Quartile 2006-2010 (2010 dnrs)						
	2006	2007	2008	2009	2010	2010/2006
	Per Capita	Per Capita	Per Capita	Per Capita	Per Capita	% Growth
1st Quartile	1,208	1,437	1,511	1,681	1,849	53%
2nd Quartile	1,841	2,236	2,668	2,731	3,184	73%
3rd Quartile	2,425	3,218	3,456	3,485	4,033	66%
4th Quartile	3,905	4,653	5,633	6,718	9,200	136%
All	2,762	3,447	4,348	4,083	5,186	88%
Ratios						
Poorest to Richest Municipality	12	11	14	16	25	114%
4th to 1st	3.2	3.2	3.7	4.0	5.0	54%
All to 1st	2.3	2.4	2.9	2.4	2.8	23%
4th to All	1.4	1.3	1.3	1.6	1.8	25%

As can be seen from Table, the revenues of all quartiles of municipalities in Macedonia have increased between 2006 and 2010, but the revenues of the 4th quartile have increased at a much faster rate than the other three. Moreover, the growth in the revenues of the poorest quartile has been the slowest of all. As a result, the ratio of total, per capita, basic revenues of

¹⁰ It should however be noted that other Balkan countries have similar problems. For example, 21 percent of the population of Serbia resides in Belgrade, but the capital city (and its jurisdictions) receives over 40 percent of all local government revenue. Similarly, the per capita revenues of Belgrade are about 2.7 times the per capita revenues of all other jurisdictions. 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.

the 4th quartile of local governments to the 1st quartile has increased from 3.2 to 1 in 2006, to 5 to 1 in 2010. Or put another way, municipalities in the 4th quartile now have basic budgets 5 times greater than those in the 1st quartile, up by more than 54 percent since 2006.

The position of the 1st quartile has also worsened in relation to the national average, and the average municipality now has 2.8 times the revenue of municipalities in the 1st quartile, up from 2.3 times in 2006. At the same time the revenues of the 4th quartile of municipalities have increased in relationship to the national average from 1.4 times in 2006 to 1.8 times in 2010, a rise of 25 percent. Moreover, the ratio between the richest municipality to the poorest municipality has more than doubled from 12 to 1 in 2006 to 25 to 1 in 2010.

Table 6 below presents the composition of basic revenues of all local governments by quartile in 2010. The second column presents the average population of the municipalities in each quartile. As can be seen from the Table, the average population of the 4th Quartile is significantly lower than the others, while quartile with the highest average population is the 2nd Quartile. This is unusual because in most countries more populous jurisdictions tend to have larger per capita budgets.

Table 6

The Composition of Basic Revenues by Quartile in 2010												
Quartile	Average Pop. of LG in Quartile	Shared Taxes	Property Tax	Transfer Tax	Public Lighting and Sign Tax	Land Development	Asset Income	Local Fees Taxes and Charges	VAT Fund	Road Fund	Capital Grants and Other Transfers	Total
1 st	20,819	80	129	197	296	162	80	119	511	133	142	1,849
2 nd	34,092	78	258	413	574	482	179	289	534	134	245	3,184
3 rd	22,126	108	417	588	642	352	386	475	661	185	145	3,959
4 th	14,897	115	406	779	502	2,306	2,443	511	641	207	1,289	9,200
4 th without 4 largest LGs	5,335	69	225	498	551	767	1,979	760	1,645	467	329	7,290

In Macedonia, however, this is not the case. Indeed, the situation becomes even more striking when we look more closely at the individual jurisdictions in the 4th quartile. What we find is that 17 of the 21 municipalities in the quartile have populations of less than 10,000 people, and the four largest jurisdictions are, quite large in that they have over 40,000 inhabitants (Aerodrom, 72,009, Centar 45,362, Karposh 59,666 and Strumica, 54,764). In other words, the distribution of jurisdictions in the 4th Quartile is bi-polar, with a lot of very small jurisdictions at one end of the spectrum and a handful of very large ones at the other. Thus, to have a better understanding of what is going on in this group we have added a line to the Table containing data for the 18 small municipalities in the 4th Quartile.

If we look across the shared taxes (the Personal Income Tax) and own revenues of the first three quartiles, we see more or less what one would expect: The poorer the quartile, the lower the level of revenues from both own and shared taxes, a fact which reflects the weaker tax bases of these jurisdictions. But when we come to revenues from the VAT Fund, the Road Fund, and from Capital Grants and Current Transfers --but not block and earmarked grants-- the picture changes. Here, we would expect to see poorer jurisdictions receiving more money from the national government as a part of a policy designed to help them compensate for their weaker tax bases. Instead, we have absolutely the opposite result: The poorest quartile of local governments receives the least amount of money per capita, from the national government from the VAT Fund, the Road Fund and from Capital Grants and Current Transfers. Moreover, the second quartile receives less than the third, and the third less than fourth. In other words, the allocation of funds that one would expect to see used to equalize the revenues of local governments is actually having the opposite effect.

This becomes particularly clear when we look at the 4th quartile of municipalities without the four large urban jurisdictions. This group of municipalities has own and shared revenues that are generally comparable to the municipalities in the second or third quartile, though they have distinctly higher revenues from the Land Development Fee and from Asset Income. Nonetheless, they receive more than three times the amount of money per capita from the VAT Fund and from the Road Fund than the poorest quartile, and almost twice as much in Capital Grants and Current Transfers. Indeed, it is probably fair to say that many of these very small municipalities are only in the 4th quartile because of the large amounts of funding they receive from the national government. Here, in other words, the transfer policies of the national government are pushing a group of small, middle income jurisdictions --at least judging from the yields of their own and shared taxes-- into the group of the richest jurisdictions.

It is not clear why, in general, poorer jurisdictions are getting lower shares of the Road Fund and of Capital Grants and Transfers from the national government than richer ones. But the reasons for this perverse distribution are fairly obvious with respect to the VAT. The formula for allocation of the VAT Fund works as follows. First, all local governments are given 3 million denars in a lump sum payment. Second, the remainder is divided 88 percent in favor of non-Skopje jurisdictions, and 12 percent in favor of the jurisdictions of Skopje. And third, the two pools are then allocated respectively to non-Skopje and Skopje jurisdictions according to a formula in which 65 percent is allocated per capita (for Skopje municipalities -- per capita share of the total population of the Skopje region), 27 percent on the basis of a local government's share in the total territory of Macedonia (for Skopje municipalities -- total territory of the City), and 8 percent on the basis of a local governments share in the total number of settlements in Macedonia (for Skopje municipalities -- total number of settlements in Skopje).

The theoretical justification for the lump sum payment --introduced in 2009-- is to provide additional support to jurisdictions with very low populations that might not receive enough funding through a per capita mechanism of the formula to support their basic functions. The theoretical use of territory in the formula is that the physical size of local government is a proxy

for its “rurality” and by extension a measure of its relative wealth. And 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.

All these theoretical justifications are defensible and in fact combinations of these measures can be found in other countries. What is less defensible is how these measures are being used in Macedonia today. In short, the weighting of these measures works so strongly in favor of jurisdictions that have low populations, large areas, and multiple settlements that rural municipalities with average or above average revenues from other sources are transformed by the transfer system into some of the richest jurisdictions in the country. Meanwhile, jurisdictions with weak tax bases, large populations, average areas, and compact settlement patterns languish.

Moreover, this situation has actually worsened since 2009 when, at the request of ZELS , the lump-sum mechanism was added to the formula. The reason for this is that the lump sum mechanism reduces the amount of money in the VAT Fund that is being allocated to local governments on a per capita basis and it is this per capita distribution that is the only mechanism in the formula that actually pushes funds towards more densely populated areas. Indeed, the introduction of the lump sum mechanism in 2009 goes a long way towards explaining why the relative position of the 1st Quartile of municipalities has deteriorated over the last few years. What should be clear is that Macedonia has yet to develop an effective mechanism for equalization, and that while the adequacy of the intergovernmental finance system has improved somewhat over the last few years, the equity of the system has not.

V. The Finances of the City of Skopje

Table 7 below presents the composition of the basic revenues of the jurisdictions of Skopje in per capita terms for 2010. The last line of the Table shows the revenues of the Capital City of Skopje as an independent jurisdiction; the first ten lines show the revenues of the municipalities the function within the City.

Table 7

The Composition of the Per Capita Basic Revenues of the Jurisdictions of Skopje in 2010

	Pop.	Shared Taxes	Property Taxes	Transfer Tax	Public Lighting & Sign Tax	Land Development Fee	Local Fees, Taxes, Other	Asset Income	VAT Fund	Capital Grants and Transfers	Road Fund	Total
SHUTO ORIZARI	20,800	160	84	167	204	83	129	0	253	0	59	1,138
CAIR	64,823	151	100	271	245	287	32	122	130	48	56	1,441
SARAJ	35,408	151	29	93	127	29	224	66	485	218	92	1,513
GAZI BABA	72,617	151	349	384	376	466	87	67	204	63	81	2,227
BUTEL	37,371	146	178	397	331	265	990	8	226	472	95	3,108
KISELA VODA	57,236	151	349	724	441	773	127	104	160	468	183	3,481

GJORCE PETROV	41,634	151	375	416	415	1,015	400	470	232	500	106	4,079
AERODROM	72,009	151	307	745	363	1,072	411	3,843	136	0	82	7,111
KARPOSH	59,666	151	454	1,025	439	4,097	206	1,263	158	51	89	7,933
CENTAR	45,362	151	1,012	1,602	417	4,160	615	2,451	158	8,533	149	19,249
GRAD SKOPJE	506,926	38	324	611	497	1,524	331	1,034	97	5	26	4,487

As can be seen from the Table there are profound differences in the per capita revenues of the jurisdictions of the Capital City. Most of these differences are being driven by the real estate market: from the Transfer Tax, the Land Development Fee and from Asset Rentals and Sales.¹¹

Revenues from the local government share of PIT are calculated for the entire city, and then divided on a per capita basis with 75 percent going to the municipalities and 25 percent going to the Capital City. This has an equalizing effect because the sharing is not done on an origin basis, but is based on the yield of the tax for the entire City. This is good, but it does relatively little to equalize the financial situation of the poorest jurisdictions because the amount of money involved is small. Meanwhile, the allocation of the VAT Fund within the city also does little to equalize the revenues of the poorest municipalities because the City is getting, besides the lump sum, only 12 percent of the total VAT Fund, and of that 40% is going to the Capital. Saraj however gets substantially more than other municipalities in the city because it occupies the most amount of land and has 22 settlements. The lack of an effective means of equalization within the city means that the jurisdictions of Shuto Orizari, Saraj, Cair are among the poorest municipalities in the country.

VI. Local Government Expenditures between 2006 and 2010

In this section, we examine the expenditures of local governments between 2006 and 2010. The focus of the analysis is on expenditures made from the basic budgets of local governments. There are three reasons for this. The first is that another report is looking more closely at education, by far the most important of the newly decentralized social sector function. The second is that comparative analysis is difficult because not all local governments have entered the second phase of decentralization, and because those that have, have entered in different waves, including waves in the middle of the of the fiscal year. This means the data is not comparable either across or within years

Chart 8 below, presents the growth and composition of local government expenditures from 2006 to 2010. The Chart illustrates the magnitude of the financial effects of the second phase of decentralization. The bottom four segments of the columns show spending on the newly decentralized functions of Primary and Secondary Education, Social Welfare (Kindergartens and Homes for the Elderly) Culture and fire protection. Expenditures on these functions now constitute 61 percent of all local government expenditures. Of obvious particular importance

¹¹ Centar's revenues in 2010 are extremely high because of a capital grant from the national government to refurbish the downtown area of the city and to build monuments.)

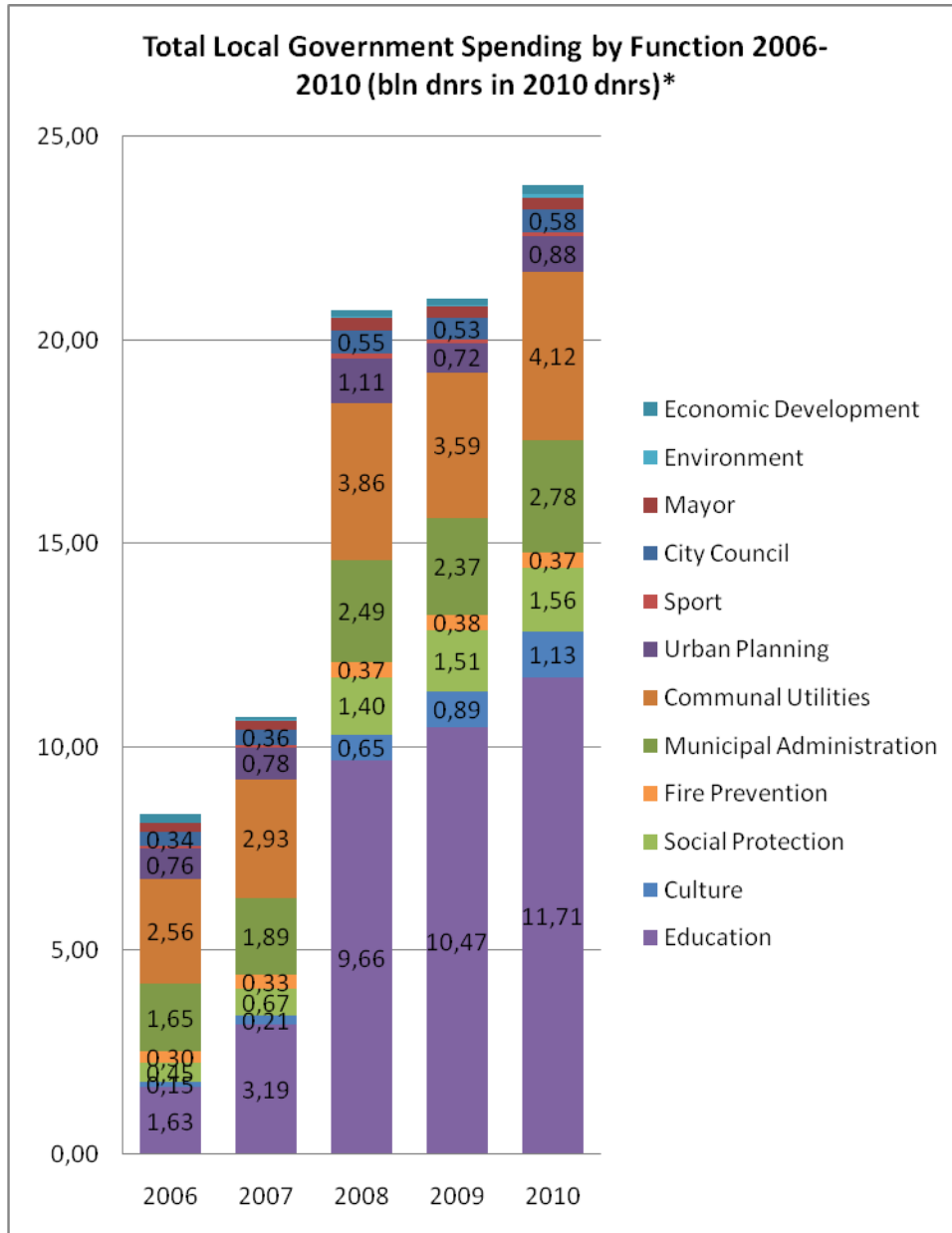
are education (primary and secondary schools) and social protection (primarily kindergartens). Together, these two functions now account for 57 percent of all local government expenditures.

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 importance of this formula for the future of Macedonia's overall decentralization effort cannot be underestimated. This analysis however is undertaken in another report¹³ and is not treated here. With that said however, it is important to note that the Ministry of Education has taken concrete steps to meet its obligation under Article 12 of the Law on Local Government Finance to the allocate block grants "in line with appropriate measures of need."

Chart 8

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.

¹³ See, Jan Herczynski, Financing Decentralized Education in Macedonia: Review of the national allocation system, Macedonia Local government Reform Activity, May 2011, pp 1-39



*Table includes spending by schools, kindergartens and other direct budget beneficiaries financed from own income. In 2010, spending from the self financing of budget users amounted to about 900 million dnrs.

Unfortunately, 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 funding for maintaining them, while local governments who don't have these institutions, receive little or nothing.

Table 8 below illustrates what is going on with the newly decentralized social sector functions. The first column contains most of the programs (functions) which have been decentralized to local governments under the Law on Local Self-Government. The second indicates the number of local governments who receive grants for these functions from the national government. As can be seen from the Table, the percentage of local governments receiving funding for these functions is low with the exception of primary education. The reason for this, is that what are really being funded are not really “programs” or “functions” but state institutions whose management has been transferred to local governments. Or put another way, if there were state run institutions in a given jurisdiction before the decentralization process began, then the concerned local government receives a block or earmarked grant to run them. If however, no institution existed, then the concerned local government receives no state funding to support the function.

For example only half of Macedonia’s local governments have kindergartens. These kindergartens, in turn, function in local governments that “serve” 78 percent of Macedonia’s total population (column 6). Thus, while we don’t know what percentage of preschool children have easy access to pre-school education, we can be sure that the children of the 22 percent of the population which lives in jurisdictions without a preschool, have no access at all. Similarly, about 25 percent of all Macedonian local governments have decentralized cultural institutions for which they receive national government grants¹⁴. These jurisdictions serve about 50 the total population, which means that about 50 percent of the population don’t have easy access to libraries, museums, or concerts.

Three local governments receive grants for the elderly, and two seem to be supporting Homes for the Elderly out of their own budgets but access to elderly care is clearly unavailable to most of the population. Thirty local government receive grants for fire protection and another 6 support the function without national government help, but at least 20 percent of the population still live in jurisdictions in which no public money is spent on fire protection. Finally, 32 local governments receive grants for secondary schools. These schools are located in municipalities that contain 80 percent of Macedonia’s population but in principle pupils from the entire country.

The uneven distribution of social sector institutions is problematic because it means that people living in those jurisdictions that do not have these institutions do not have easy access to the associated services. Correcting this problem however is difficult and almost inevitably requires putting new money into the system: If the money that is currently being spent on a limited number of institutions in a limited number of jurisdictions is allocated more fairly --for

¹⁴ 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.

example, by allocating money for preschool education on the basis of the number of pre-school age children in a given jurisdiction-- than those jurisdictions that already have these institutions may not receive 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.

Table 8

Program	# of LGs Receiving Grants	% of LGs receiving Grants	# of LGs spending w/o Grants	# of LGs w/o Own Spending	% of pop. "served"	Total Spending mln dnr	Grants as % of Spending	Budget as % of Spending	Self-Financing as % of Spending
Libraries	23	27%	1	19	56%	99	89%	2%	9%
Museums/Kinos	17	18%	3	9	49%	98	77%	9%	14%
Theatres	22	26%	1	13	48%	141	67%	9%	24%
Elderly Care	3	4%	2	3	41%	98	63%	5%	32%
Fire protection	30	35%	6	1	81%	364	79%	21%	0%
Kindergartens	43	51%	0	33	78%	1,408	76%	1%	23%
Primary Education	85	100%	0	33	100%	7,869	96%	2%	3%
Secondary Education	32	38%	0	21	80%	3,767	90%	3%	7%

Indeed, the current allocation of funding for preschool education, culture, and elderly care clearly expresses at least one dimension of the larger problem of the underfunding of municipalities in Macedonia today¹⁵. It is also extremely inequitable. In the immediate, the national government simply doesn't have the funds to provide all municipalities with similar levels of funding for the concerned functions. Over time however, it will have to move in this direction.

But if the national government has really decentralized social sector institutions –and not functions-- to (select) local governments, Table 8 also gives us reason to think that local governments not only are looking at these “functions” primarily as insitutions, but are extremely reluctant to get actively involved with them –or the wider function. This can be seen in two ways: The low number of local governments who actually contribute their own revenues to the financing of decentralized institutions or functions, and the low share of total spending on these functions that comes from local government basic budgets.

Column 4 of Table 8 gives the number of local governments who do not contribute any of their own basic budget revenues to support a function for which they are receiving in a national government grant. Thus 33 of the 43 local governments who receive preschool grants make no contribution from their own funds. Similarly, 33 of the 85 local governments who receive

¹⁵ Elderly homes differ from kindergartens and cultural institutions in an important respect. While it is fairly clear that the vast majority of jurisdictions should have at least one preschool facility and some sort of cultural institution or center, this is not so obvious with respect to homes for the elderly. Elderly care yes. But not necessarily homes, which are probably more appropriated controlled by a higher level government, or at least until local governments can finance and manage such services jointly.

grants for primary education and 22 of the 32 who receive them for Secondary Education make no contributions from their own budgets. This is also true for the three local governments who receive grants for elderly care; for 19 of the 23 who receive grants for libraries; for 9 of the 17 who receive grants for museums; and for 13 of the 22 who receive grants for Theaters. Indeed, the only program to which local government routinely contribute their own revenues is Fire Protection. Here, only one local government who receives a grant for the function doesn't contribute something from its own budget, and six support the function without money from the state. At the same time, and as can be seen from the next to last column in the Table, the only program to which local governments contribute more than ten percent of total funding is Fire Protection while in education they contribute less than three percent.

All this suggests that local governments remain to reluctant to get actively involved in financing and managing the institutions for which they have been made responsible under Macedonia's decentralization effort. In part, this is undoubtedly because they have limited funds. And in part it may be because the line ministries responsible for these functions have not given local governments the administrative powers necessary to really run them. But either way, it looks as if local governments are rather passive managers of the institutions they now run, and that in many cases, money is simply passing through their budgets to institutions that are more or less running on autopilot.

Chart 9 below presents the growth and composition of expenditures by economic type¹⁶. As can be seen from the Chart, expenditures on wages have increased more than 9 times since 2006. This is because of the overwhelming significance of teachers wages. Meanwhile, total investment spending has increase every year except 2009 –when the real estate market damped in response to the down turn in the world economy. But investment spending as share of total spending has declined from over 30 percent in 2006 and 2007 to around 20 percent in 2009-10.

Chart 9

¹⁶ The difference in the total amount of expenditures in Chart 8 and Chart 9 is that Chart 8 contains the expenditures of budget users that are financed from own revenues (self-financing) while Chart 9 contains only spending from the City budget. In 2010, there was about 900 mln denars of spending financed by the own revenues of municipal budget users (e.g. money earned by schools and spent on education by them).

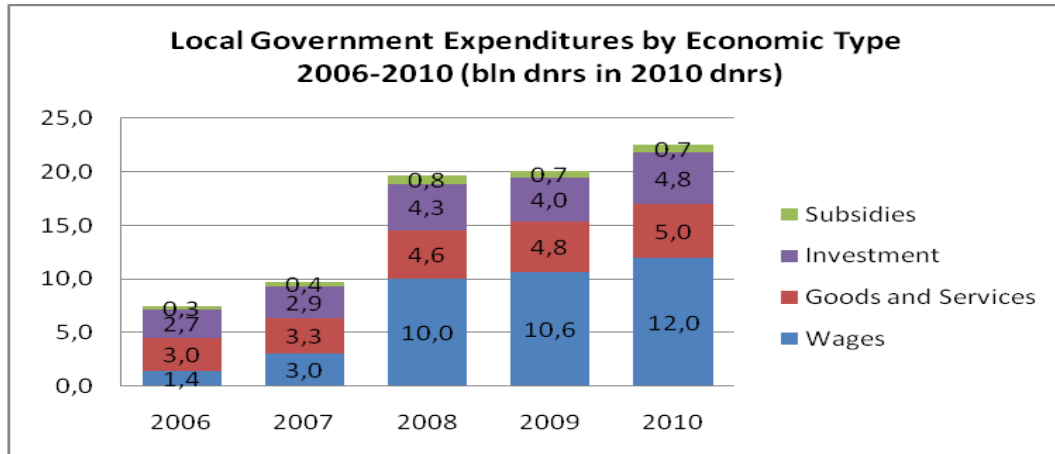
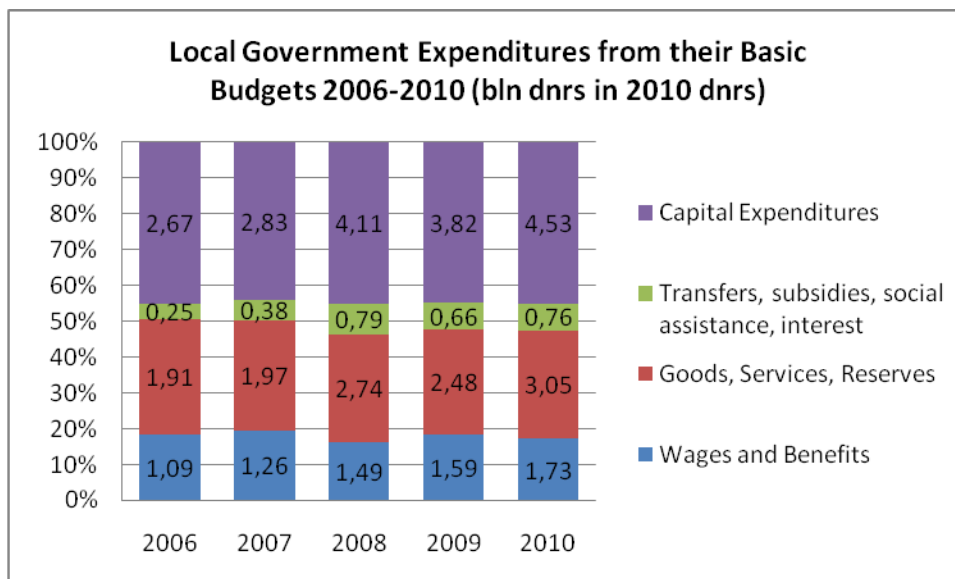


Chart 10 below presents the composition of local government spending from their basic budgets between 2006 and 2010. As can be seen from the Table, the shares of spending on wages, goods and services, investments, and subsidies and transfer payment to third parties have remained remarkable stable over the entire period. More importantly, investment spending has consistently been about 45 percent of all spending from local government budgets. This is relatively high and suggests that Macedonian municipalities are trying to seriously address the infrastructure deficits they have inherited from the past. Conversely, wages for city workers—at less the 20 percent of all spending—seems to be under control. Finally, it is worth noting (by comparing Charts 9 and 10) that with the exception of 2009, almost all investment spending is being financed from the basic budgets of local governments and not by capital grants. In 2009, own investment spending drops because of the economic downturn, but remains high primarily because of the large capital grants to municipality of Centar..

Chart 10



But again, this relatively positive picture of stable wage expenditures and reasonably high in investments rates begins to break-down a bit when we look at how investment spending is distributed across municipalities. Chart 11 below shows the per capita expenditures of local governments for Skopje and all jurisdictions between 2006 and 2010 and in 2010 denars. As can be seen from the Chart 11 the per capita investment spending of Skopje is more than 3 times that of all other jurisdictions. The City can also afford to spend at least twice as much on goods and services, and on subsidies and transfers as other jurisdictions. At the same time, its per capita wage costs are only about 20 percent higher than those of the rest of the country.

Chart 11

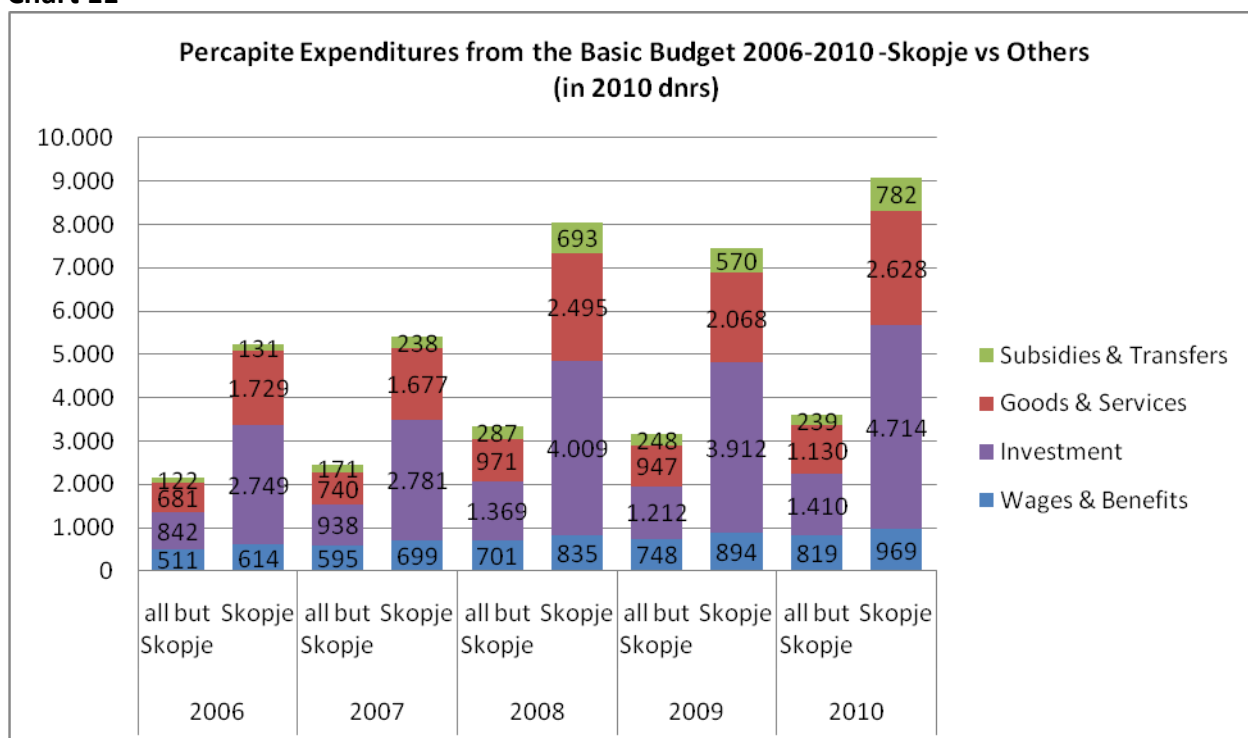
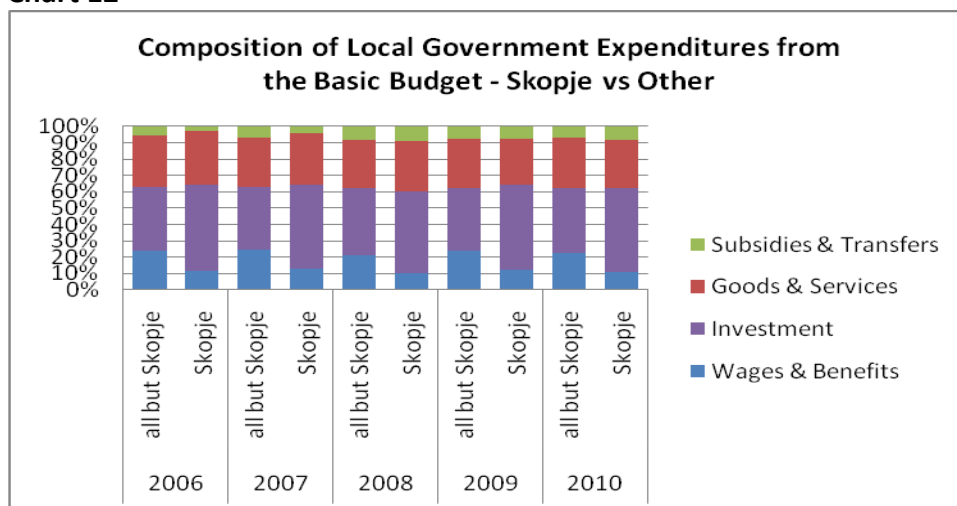


Chart 12 presents the same information as Chart 11, but in terms of the shares of different expenditures in the budgets of Skopje and all other jurisdictions over the same period. In the Capital, wages represent 10 to 12 percent of all spending and investments about 50 percent. Meanwhile in the rest of the country wages represent about 23 percent of all expenditures and investments spending falls to 40%. This is not surprising, given that the average size of the jurisdictions of Skopje are significantly larger than those of the rest of the country, and thus the (relatively) fixed cost of city administration are lower.

Chart 12



More problematic, is the distribution of investment spending across quartiles. Chart 13 below presents the composition of Basic Budget Expenditures by quartile in 2010. The quartiles in the Chart are based on the per capita revenues of the basic budgets of local governments as presented earlier in Table 5 and 6. And the result is much as one would expect. The much higher per capita revenues of the municipalities in the 4th Quartile are resulting in dramatically higher per capita investment rates, indeed rates 10 times higher than those of the poorest quartile, and more than 3 time higher than the 3rd Quartile.

Chart 13

