Aleksandra Maksimovska – Veljanovski, PhD*
Elena Neshovska, LL.M**

Building Local Fiscal Autonomy in the Republic of Macedonia (1991-2011)

Introduction

Ever since the proclamation of its independence in 1991, the Republic of Macedonia regarded the local self-government as one of the highest constitutional values. This status imposed the need to undertake numerous steps in the direction of establishing the local self-government. At the other side, during these early years of independence, the central government faced numerous political and economic challenges which postponed the process of decentralization.

In the period 1991- 1995 the degree of centralization was high. Despite the fact that the first Law on Local Self-Government was enacted, a low degree of local, in particular financial autonomy was achieved in practice.

In the period 1996-2004, the initial phase of decentralization, or, more likely, deconcentration occurred.

A real, more intensive process of fiscal decentralization began in 2005. It may be considered as a period of fiscal decentralization. Until that moment, Macedonia has experienced periods of different degrees of decentralization, as well as different models of financing the local self-government. Consequently, it has obtained a great experience with different models of decentralization, i.e. systems for local funding.

This paper aims to provide a historical account, as well as a critical analysis of the stages of fiscal relations between central and local government in the period 1991 - 2011. The paper will focus in particular on the current stage of development of local self-government. This stage is characterized by strong and autonomous budgets, a wide range of its proper funding resources, an access to the capital markets and a transparent system of fiscal transfers.

1. *Local self-government in the Republic of Macedonia (1991-2005).* In the period between the proclamation of independence and the real beginning of the fiscal decentralization in 2005, several phases occurred. During each of these phases, the local government had its own characteristics, developing from extreme centralism (1991-1995), through fiscal deconcentration (1996-2001) and modest fiscal decentralization (2002-2004)[1]. The next section of the paper focuses on the analysis of each of these phases.

** Associate Professor at the Faculty of Law Iustinianus Primus in Skopje.
** Teaching Associate at the Faculty of Law Iustinianus Primus in Skopje.
[1] Pendovska, Vesna, Maksimovska-Veljanovski, Aleksandra, Mangova-Ponjavik, Kiki, *Financial Law,* 2010, p. 216.

1.1 *Extreme centralism (1991-1995).* In the first five years of independence, as a result of the lack of appropriate legislation, the local self-government found itself under extremely unfavourable circumstances. The long tradition of paternal behaviour on the part of central authorities resulted in a legal framework which could not respond to the local needs. There was no legal instrument regulating the local self governance. Although the provisions of the Macedonian Constitution guaranteed the value of local self-government to all citizens, during this period the local self-government was highly centralized. The central authorities and their regional units were responsible for all of the services. The centralism was strengthened by the territorial division of the state in 34 municipalities, although this number of municipalities was estimated as insufficient. None of the municipalities had its own financial sources or any financial empowerment. In fact, during this period no form of decentralization existed.[2] These circumstances resulted from a political decision and they were justified by the requirements of the processes of nation-building and institution-building, emphasizing the central government's need to strengthen and concentrate all powers at the central level. During this phase, the experts' analysis emphasized the importance of drafting legislation in the field of local government. The opponents argued in favour of maintaining a certain degree of centralization, as a precautionary measure and for reasons of defence.

1.2 Deconcentration (1996-2001). In this period, the most important legal act was the first Law on Local Self-Government[3]. It shed new light on the relations between central and local level, bringing qualitative changes in providing local services and financing local activities. One of the crucial novelties was the new territorial division and the establishment of 123 new municipalities (instead of previous 34). They were empowered with three major local competencies, including their own, independent functions (cleaning chimneys and landscaping of parks and parking lots); common functions (urbanism, culture, social and child protection, establishment of kindergartens, primary health care and environment protection) and transferred functions.

However, the units of local self-government experienced weak financial powers and financial instability. This resulted from the fact that the municipalities had no real sources of income. According to the Law, their financial resources derived only from property taxes, land fees, communal fees and some modest incomes from services. Rarely, a small part of municipal revenues came from a self - contribution, money, profits from public enterprises established by the municipality, fines and other revenues[4].

[2] Maksimovska-Veljanovski, Aleksandra, *Fiscal Decentralization and Financing Local Self-Government in the Republic of Macedonia*, Skopje, 2007, p. 267-269.
[3] Law on Local Self-Government, *Official Gazette of Republic of Macedonia*, 52/95.
[4] Maksimovska-Veljanovski, Aleksandra, *Fiscal Decentralization and Financing Local Self-Government in the Republic of Macedonia*, Skopje, 2007, p. 271-272.

De jure, these revenues were considered sufficient for the local self-government's needs. De facto, they were insufficient. Most of the municipalities' needs were funded through fiscal transfers from the central budget, whereupon tax revenues were administrated and collected by the central government (Public Revenue Office and its regional units).

Despite the existence of the Law on Local Self-Government, there was no real provision of services at local level, neither transfer of responsibilities, due to the lack of proper local financial resources on municipal level.[5]

<u>1.2.The origin of fiscal decentralization (2002-2004).</u> The period of lobbying in favour of fiscal decentralization began in 2002. The proper incentives came after the adoption of the Strategy for reforming the local government in 1999. Actually, this instrument opened the way for an ambitious commitment to reform the local self-government, as well as the current local financing system[6]. From today's prospective, one may view this phase as a preparatory period for fiscal decentralization, especially having in mind the fact that although until 2002-2004 a new system of financing local self-government was not enforced, efforts were made to introduce important legal provisions which redefined the local government.

The process of fiscal decentralization developed in a positive direction due to the provisions of the Ohrid Framework Agreement of 2001 which envisaged constitutional amendments, as well as a new Law on Local Self-Government (2002)[7]. According to the new Law on Local Self-Government, the municipalities became responsible for: public services, urban and rural planning, environmental protection, local economic development, culture, local finances, education, social and health care. All of these guaranteed a general empowerment of the municipal level - right to collect taxes and fees, as determined by the Law; right to debt; control over the local budget, administration and property.

However, there were no real changes in the implementation of local competences. The municipalities experienced several problems in the area of financing, due to the lack of adequate legislation on funding local self-government. Namely, the decentralized local authorities, as well as the lack of proper financial regulation created a legal vacuum. Its largest negative effect was disregarding the principle '*finance should follow function'*, i.e. the inability to implement in practice the local rights and responsibilities.

As a result of the legal provisions which increased dramatically the range of local competences, new legislation was enacted: Law on Territorial Organization of Local Self-Government in the Republic of

---

[5] Phuong, Chuong P., Maksimovska-Veljanovski, Aleksandra, *Technical Support to Second Phase of Fiscal Decentralization in Macedonia*, EAR funded project, Skopje, 2008, p. 8-9.

[6] Pendovska, Vesna, Maksimovska Veljanovski, Aleksandra, *Financing Communal Activities and Local Public Enterprises – Case of the Republic of Macedonia*, 2008, p. 3-4.

[7] *Official Gazette of Republic of Macedonia, 5/2002.*

Macedonia[8], Law on the City of Skopje[9] and Law on financing local self-government units.[10] The Law on Territorial Organization of Local Self-Government reduced the number of municipalities to 84, while the City of Skopje gained the status of a special unit of local self-government. The Law on financing local self-government units established an adequate system for financing local competences through municipalities' own revenues, shared revenues and transfers from the central budget. Municipal revenues included tax revenues (property tax, tax on inheritance and gifts and tax on transfer of real estate), utilities fees, transfers from the central budget and donations.

Thus, it can be concluded that in the period 2002-2004 the Macedonian authorities have finalized all of the necessary preparations for the beginning of a serious process of fiscal decentralization, scheduled for 2005.

2. Financing local self-government in the Republic of Macedonia in the period 2005-2011.

The fiscal decentralization process in the Republic of Macedonia was stimulated by:

- The pressure of the Ohrid Framework Agreement, 2001 (which ended an armed conflict imposing local government's reorganization as a crucial requirement);
- Ratification of the European Charter on local self-government (Article 8, concerning a higher degree of local fiscal autonomy);
- Stabilization and Association Agreement (2001) and European Partnership (2004);
- The Government's categorical commitment to the European Union integration and the local democracy as its most important value.

For that purpose, a wide variety of legal acts were enacted. These provided the units of local self-government new powers and a higher financial autonomy. In addition, they redefined the relations between central and local government.

After the establishment of the normative preconditions, in July 2005, after the local elections, the process of fiscal decentralization began. The decentralization was envisaged in several phases, in order to circumvent the potential risk of the process of delegating responsibilities and adequate fiscal resources from central to local government for the fiscal and macroeconomic stability of the national economy.[11]

The two-phased approach was envisaged by the Law on Financing Local Self-Government Units. Its provisions envisaged transition from lower to higher phase of fiscal decentralization, once the municipality has fulfilled certain legal conditions. An additional reason for the phased or asymmetric transfer of fiscal authority from central to local government was the diverse level of administrative,

---

[8] *Official Gazette of Republic of Macedonia, 55/2004.*
[9] *Official Gazette of Republic of Macedonia, 55/2004.*
[10] *Official Gazette of Republic of Macedonia, 61/2004.*
[11] Daskalovski Zhidas, Nikolovska Ana, Risteska Marija, *Guide to budgets*, Fridricht Ebert Fondation – Office Skopje, 2006, p. 60.

technical and financial capacity of the local authorities. The accepted model of decentralization was intended to give equal opportunities to all municipalities and to prepare them gradually for their new, expanded powers and fiscal empowerments.

The basic and most important benefit of the fiscal decentralization is the new system of financing local self-government with the following features:[12]

- Autonomous local budget process;
- System of hard local budgets;
- Wide range of sources for financing local self-government. Beside the traditional revenues from local property taxes, the system includes shared revenues from the personal income tax and value added tax, as well as five types of dotations/grants/donations from central government; and
- Various possibilities for successful local financial management through a new system of accountability and control.

2.1 First phase of fiscal decentralization. A key condition for the beginning of the first phase of fiscal decentralization, which lasted 2 years (2005-2007) was employing two experts and three experts for taw administration and collection in 90 percent of municipalities which cover 90 percent of the state territory. Until July 1, 2005, the municipalities had to begin the implementation of the plan for resolving outstanding debts to contractors and other creditors incurred until December 31, 2004. At this point, the municipalities obtained only a part of the allocated legal responsibilities (communal services), while most of the competencies were supposed to be transferred to the local authorities after their transition to the second phase of fiscal decentralization. Besides this transferred jurisdiction, the municipalities are entitled to administrate their own resources i.e. the municipal authorities have the right to decide the tax or fee rate, to administrate and collect them (some municipalities took the advantage of this right fully, some collected revenues in collaboration with others, while some other delegated this right to PRO) and decide on the purpose of their use. According to the Law, municipality’s proper revenues come from revenues from property (rents, interests, dividends from enterprises owned by the municipality, revenues from sales of assets), fines, self-contribution and donations.

Apart from the revenues from local taxes, fees and user charges, the municipalities had been assigned with four types of fiscal transfers (earmarked grant, capital grant, VAT grant and grant for delegated competences). The transfer was envisaged, in the place of the earmarked grant, for the second phase of fiscal decentralization. Earmarked grant is intended for financing a concrete activity in elementary and secondary education, social protection, fire protection and culture, or in order to cover the maintenance and facility management costs in these areas, but only for the purpose for which it

[12] Phuong Chuong P., Maksimovska-Veljanovski Aleksandra, *Technical Support to Second Phase of Fiscal Decentralization in Macedonia*, EAR funded project, Skopje, 2008, p. 10-11.

is granted. Capital grant is a grant intended for financing municipal capital investment project. Shared revenues come from personal income tax (3.0% of the personal income tax from salaries of natural persons, collected in the municipality where they are registered with a permanent domicile and residence) and from VAT (3% of the total amount collected by the central government is transferred to the municipalities, in accordance to a well-defined methodology, taking into account the criteria of population, territory and settlement).

2.2 Second phase of fiscal decentralization. It was intended that second phase begins two years later, i.e. in 2007, regardless of the fact that some municipalities fulfilled the defined criteria before this two years period. Thus, the second phase began in September, with a delay of three months, when the Ministry of Finance, on the basis of the findings of the Commission for monitoring and assistance, established in January 2007, allowed 42 municipalities which met the criteria provided by the Law, to move toward this, higher phase.

These criteria were:

-Fulfilment of criteria for the Phase 1, referred above;

-Adequate financial management and tax administration systems and staff;

-Satisfactory financial management and accounting during the previous two years;

- Timely reporting to the Ministry of Finance during the previous two years; and

- No arrears to suppliers and creditors.

The maximum number of points that one municipality can obtain in order to move to the second phase of the fiscal decentralization is 100 and they are distributed according to the following criteria[13]:

- 40 points: the municipality has shown good financial results in its operations in a period of 24 months at least, whereby this element is divided in three sub-elements: inflow of local taxes and fees in the local budget – 20 points; adopted budget for the respective year by December 31 – 15 points; and changes to the budget during the fiscal year – 5 points;

- 42 points: the municipality has shown good results in its operations. It has reported to the Ministry of Finance timely and properly and this has been confirmed by the Ministry of Finance; and

- 18 points: the municipality has no arrears toward the suppliers or towards any other creditors, exceeding the usual payment requirements.

Those municipalities that conquered at least 85 of the maximum number of points gained new responsibilities, such as: full school budget management (elementary and high schools) including payment of salaries; management and financing of social institutions or institutions for social protection and childcare; institutional and financial support for the cultural institutions and management of public health institutions (primary health care) through participation in

[13] Phuong Chuong P., Maksimovska-Veljanovski Aleksandra, *Technical Support to Second Phase of Fiscal Decentralization in Macedonia*, EAR funded project, Skopje, 2008, p. 13.

the boards of directors of these institutions. The successful performance and the quality of decentralized competences implied that the municipalities can acquire the right to block grants, used for salaries of employees in elementary and high schools, culture clubs and childcare institutions. The fulfilment of criteria does not imply an automatic transfer of block grants, but a subsequent request submitted by the municipalities is required.

2.3 Access to capital markets. Municipalities, also, obtained the right to incur short-term and long-term debt in the country or abroad, through bonds and credits from commercial banks. Municipalities can incur short-term and long-term borrowing in the country, while for long-term borrowing abroad the consent of the Government is required, upon a proposal by the Ministry of finance. Short-term lending in the state through taking a credit should be repaid by the end of the current fiscal year. The total amount of short-term borrowing in the course of the fiscal year must not exceed 20% of the overall revenues from the current operational budget of the municipality in the preceding fiscal year. Short-term borrowing shall be used for covering temporary cash deficits of the municipalities and not for payment of fines and penalty interest. With regard to the long-term borrowing, the Law provides numerous and rigorous conditions and rules. Therefore, the payment of the debt should be done in equal or decreasing annuities. The Municipal Council approves the proposed long-term borrowing only after a public hearing has taken place at which the main features of the project and its terms of financing are explained. And finally, the total amount of the annual debt-service from the long-term borrowing in one fiscal year can amount up to 15% of the overall revenues in the current operational budget of the municipality in the preceding fiscal year. In relation to the limit of the long-term borrowing, the Law envisages another condition according to which the total outstanding long-term borrowing of the municipality, including all guarantees should not exceed the total amount of revenues in the current operational budget of the municipality in the preceding year[14].

3. *Conclusion: conditions and perspectives*

In the subsequent years of the second stage of fiscal decentralization, the Macedonian authorities responded to the demands of the local self-government units and implemented several legal acts that increased revenues from taxes and utilities fees. Hence, in 2008 the amendments on Law on Property Tax abolished the tax exemption for business building and premises. These provided an opportunity for a significant increase of municipal revenues from this source; amendments on the Law on Communal Fees that determine larger amount of utility tax for street lighting were introduced; amendments on the Law on mineral resources which provide the right of the municipality to allocate 78% of contribution for exploitation of

[14] Maksimovska-Veljanovski Aleksandra, Neshovska Elena, ‘Municipalities and Access to Capital Markets: Application of Experience from Comparative Law’, *Proceedings in Honor of Professor Mangovski*, Faculty of Law Iustinianus Primus, Skopje, p. 6-7.

mineral raw materials obtained with Act on Concession were introduced; the new Law on Environment envisaged additional sources of revenues for municipalities; amendments were enacted on the Law on Value Added Tax which reduced the VAT rate from 18% to 5% for local services related to maintenance of public cleanness and waste disposal and, thus, created conditions for financial consolidation of local public enterprises delivering these services.[15]

Despite the increased revenues, municipal authorities made additional efforts toward further enlargement of the existing and introducing new sources of funding local competences. They justified these requirements with the need for more finances in order to ensure public services with higher quality. Therefore, in the last two years additional financial resources have been provided and the responsibilities of the Macedonian municipalities have been enlarged.

Consequently, the amendments of the Law on Financing Local Self-Government Units of 2009 provided that an increased share of VAT should be transferred to the municipalities i.e. 4,5% instead of the previous 3% of the total amount of VAT collected by the central government. Furthermore, in early 2011 new Law on Construction Land[16] was introduced and the municipalities obtained the right to manage the state-owned undeveloped land which remains in state ownership. The Law was enacted earlier the previous year, but the municipalities began to use this right since July 1, 2011. The state monitors the municipalities' operations i.e. the Ministry of Transport is supposed to monitor the procedure for disposal of the construction land. In case of violations of the Law, it may suspend the municipality's powers in this field for a specific period of time, either in the specific case or completely. The revenues from the sale of land are divided - 20% belong to the central budget, while 80% belong to the local budgets.[17]

---

[15] *Program for Implementation of Decentralization Process 2008-2010-revized,* Ministry of Local Self-Government, December 2009.

[16] *Official Gazette, 17/2011.*

[17] Maksimovska-Veljanovski Aleksandra, Neshovska Elena, 'Fiscal decentralization in the Republic of Macedonia: 2005-2011', *Proceedings in Honor of Professor Netkov,* Faculty of Law Iustinianus Primus, Skopje, p. 9-12.

Bibliography:

1.Daskalovski, Dzidas, Nikolovska, Ana, Risteska, Marija, *Guide to budgets*, Fridricht Ebert Fondation – Office Skopje, 2006.

2.Levitas, Tony, *Current state of the municipality's finances in the Republic of Macedonia: Possible future reforms*, USAID/ program for local self-government, July 2009.

3.Maksimovska-Veljanovski, Aleksandra, *Fiscal decentralization and financing local self-government in Republic of Macedonia,* Skopje, 2007.

4.Maksimovska-Veljanovski, Aleksandra, Neshovska, Elena, *Municipalities and access to capital markets: application of experience from comparative law,* Proceedings in Honor of professor Mangovski, Faculty of Law "Istinianus Primus", Skopje.

5.Maksimovska-Veljanovski, Aleksandra, Neshovska, Elena, *Fiscal decentralization in the Republic of Macedonia: 2005-2011*, Proceedings in honor of professor Netkov, Faculty of Law "Istinianus Primus", Skopje.

6.Pendovska, Vesna, Maksimovska-Veljanovski, Aleksandra, Mangova-Ponjavik, Kiki, *Financial Law,* 2010.

7.*Program for implementation of decentralization process 2008-2010-revised*, Ministry of Local Self-Government, December 2009.

8.Pendovska, prof. Vesna, Maksimovska Veljanovski, ass.prof. Aleksandra, *Financing Communal Activities and Local Public Enterprises – The case of Republic of Macedonia,* 2008.

9.Phuong, Chuong P., Maksimovska-Veljanovski, Aleksandra, *Technical Support to second phase of fiscal decentralization in Macedonia*, EAR funded project, Skopje, 2008.

Legislation:

1. Law on Local Self-Government, *Official Gazette of Republic of Macedonia,* 5/2002.

2.Law on Financing Local Self-Government Units, *Official Gazette of Republic of Macedonia*, 61/04, 159/09.

3.Law on Construction Land, *Official Gazette of Republic of Macedonia*, 17/2011.