



**USAID assistance to the  
Center for Economic Analyses**

**REPORT ON THE PROCESS OF  
DECENTRALIZATION IN MACEDONIA\***

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**Center for Economic Analyses (CEA)**

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## **1. Foreword**

This report is prepared under the contract provisions signed between CEA and USAID for nonexclusive services to USAID as part of the grant agreement and specifically after the USAID BEA project asked for assistance in the area of fiscal decentralization. This report is illustrating the status of the process of decentralization in Macedonia as of June 2007 with emphasis on the subsovereign borrowing issues and is based on previous projects conducted by CEA and the author.

This document will be published at the official CEA web site 3 working days after submitted to the USAID.

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## **2 Legal framework**

The process of decentralization requires not only that the Government has the political commitment but also has the capacity for implementation, coordination and sequencing of the process.

The speed of decentralization reforms greatly accelerated during 2004, as the Ministry of local self government moved forward with a number of initiatives and intensified its contacts with the Association of LGU (known by its Macedonian acronym ZELS). The Program of 1999 set out the activities for the implementation of the decentralization process in the period 2004-2007 and was adopted by the Government in November 2004. These activities are related to the transfer of competencies, employees, equipment and property from the central to the local level and to capacity building in the municipalities to enable them to successfully take over the devolved competencies.

The new Program for the implementation of the process of decentralization 2008 – 2010 is on the way and soon will be adopted by the Government. The new Program is based on the strategic objectives for the local self-government reform and the decentralization process and adheres to the Operational program for decentralization of power 2003-2004, the Program for the implementation of the decentralization process 2004 -2007 and the Detailed plan for the transfer of the competencies and resources in the decentralization process.

Since the start of the process 39 primary laws and many related by-laws have since then been adopted. In the meantime three laws were deleted from the list due to objective reasons. One Law (Law on waters) and nine By-Laws are still outstanding. In the meantime more than twenty additional initiatives, mainly changes in existing laws, and more than 40 related By-Laws were identified by the Decentralization Working Group - DWG and the proper Sub-Groups – SG (ten SG are operating for monitoring the process) and are already part of the 2007 Action Plan of the DWG which anticipates their adoption until the end of 2007.

### **3. Assignment of competences**

The Law on LGU regulates the competencies of the local governments. A wide range of responsibilities are listed in the provisions of Article 22 of the Law. The role of local governments and the central government are well defined.

#### **3.1 Subsidiarity principle**

The European Charter for Local Self-Government includes among its provisions the subsidiarity principle in Paragraph 3 of Article 4:

“Public responsibilities shall generally be exercised, in preference, by those authorities who are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy.”

Basically the provision of services should be exercised at the lowest possible level of government that is capable of providing them efficiently. This principle results in a situation where, as far as possible, the area which benefits from a government service coincides with the territorial boundaries of the level of government which provides the service.

This means that there basically are two dimensions of the subsidiarity principle which are relevant to Macedonia:

- 1) The size of the local governments;
- 2) The competences assigned to the local governments.

Conducting an analysis of the optimal minimum size of local governments is a difficult task because one has to measure the output of all services and their benefits. Empirical analyses show that the minimum size for an effective municipality might be between 5,000-8,000 citizens.

In analyzing the economies of scale in the administrative costs of local governments, a composite index is calculated from three variables:

1. Number of employees in the administration per inhabitant;
2. Salaries as a percentage of total expenditures;
3. Total municipal budget expenditure per inhabitant.

The calculated administrative cost composite index for each of the 123 local governments in Macedonia is illustrated in the next figure.

Cost

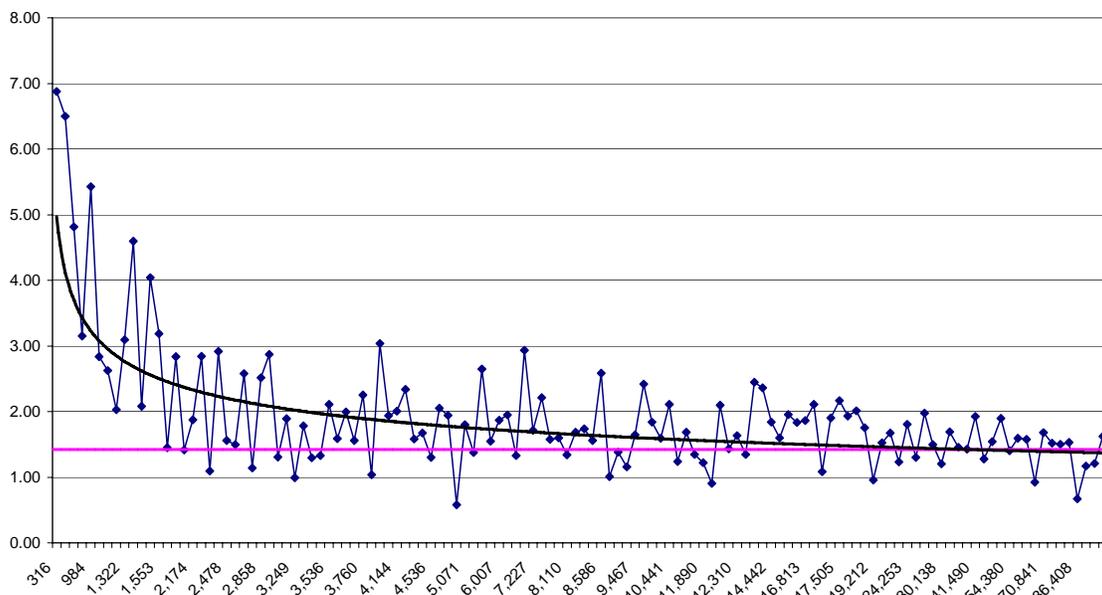


Figure 1. Economies of scale of administrative costs at LGU in Macedonia

Overall the figure shows that the greater the number of citizens in a local authority area implies lower average administrative costs. More specifically, the figure illustrates the increasing economies of scale of up to 4,000–6,000 inhabitants. Furthermore, the figure shows that the optimal minimal size of local government in Macedonia could be around 6,000 inhabitants if the criterion is the cost of providing administrative services.

### 3.2 Competences assigned and expenditure arrangements

One risk identified was the transfer of too little finance from central to local government to provide the assigned service. This situation could be improved by using the “principle of neutrality of earmarked transfer” i.e. that the central government transfers funding to the local government at the same level that it had previously cost the central government to provide the service. An example of this problem can be seen in the case of the Ministry of Education and Science where the transfers to local government in 2005 were less than it had spent in the previous fiscal year in providing the now assigned services. This fiscal misallocation was later solved but with certain political and socio-economic cost. Another anomaly that was not subject of research is the special status of the City of Skopje. The anomalies are resulting in problems like the one of the expenditures on electricity and the dispute between the central government and the City of Skopje and the City of Skopje with the LGU within the Skopje. This should be further explored as the situation with the competencies in the City of Skopje and the proper LGU is not sustainable.

### **3.3 Overall assessment**

Given the fact that some LGU in Macedonia are too weak to provide the assigned competencies to its citizens, it is worthwhile to consider the possibility of an asymmetric assignment of functional responsibilities. This should be based on firm analysis which in turn would require a strengthening of the analytical capacity within the Ministry of Finance and Ministry of LGU.

It is difficult to judge whether or not local governments in Macedonia provide a sufficient quality of service given the environment in which they operate and the short period of review to date.

The financing of services provided by local governments should follow a function, i.e. for each assigned responsibility there must be revenue assigned as well. If this rule is not followed, then the level of revenue transfer from central to local government should increase. In order to establish the exact current status within the system there must be a strong central ability to monitor and evaluate the process of decentralization. For that purpose and in accordance with the law, a Commission for Monitoring of the Development of the System for Financing has been established but the reports from that Commission contains little information on the problems encountered and lacks a sufficiently in-depth analysis of different aspects including:

1. Fiscal gap (needs assessment and fiscal capacity calculation) in providing local services for competencies that have been transferred
2. The problems with collection of own revenues by local governments (taxpayers' record transfer, development and distribution of tax returns system, etc).
3. Current status and measures to improve the situation regarding arrears
4. Whether earmarked grants are in line with the transferred competencies
5. The tendency to discuss problems at DWG-level without information being transferred to lower levels afterwards.
6. In dealing with the legal framework it appears that a list of problems identified and options for their resolution is required (the DWG and its subgroups through the Risk registers already have identified such a list by functions).
7. To clarify the VAT transfer as a source of stable financing for local government i.e. is it a equalization fund or a nonconditional grant.
8. The results that have been brought about by the Law on Local Self-Government through the implementation of fiscal decentralization. The main points being the criteria that were taken into account and the measurable indicators that were monitored and, in general, how the assessment of a "good result" was made.
9. The report should be timely.

### **4. Own revenues**

The major change brought about by the new legislation was the assignment of property-related tax administration to the local level. Moreover, it is not only the revenue from

these taxes that is assigned to local governments but the powers to determine the rate for these taxes and to collect them. By utilizing the possibility of inter-municipal cooperation (the new Law on inter-municipal cooperation is on the way), local governments can contract joint tax administration or one local government can contract out the tax administration to another local government.

Reportedly, the Public Revenue Office (PRO) has used low-quality data from the cadastre system for property taxes and lacks a good statistical information system. Moreover, these revenues were not directly distributed to the local governments where they were collected but rather transferred into the treasury system and then distributed among local governments in accordance with a formula within the so-called “cap system”. Clearly, there were no proper incentives for higher collection rates so that the system can provide a sustainable and predictable revenue stream.

#### **4.1 Structure – types of own revenues**

The sources of financing in accordance with the Law on Financing LGU – LFLGU identifies both own and shared sources of financing.

#### **4.2 Sufficiency**

Common wisdom is that the total revenues of local governments should be enough to cover the provision of services to citizens and to pay for capital investments. In Macedonia, it is difficult to judge if the current system is sufficiently well established to provide that given that no comprehensive analysis has been done on costs of providing local services including possible capital needs. Indicative in this regard are four main issues:

- The centralised system until 2005 has led to under-investment by local government and it should be realised that there will be high capital requirements and demand in near and distant future
- The requirements stemming from EU-related legislation on environmental protection, quality and standards of services
- The issue of viable size of local governments
- Expected increase in public awareness and expectation

These four issues alone should be sufficient to alert the central Government that the current system of revenues (own and transfers from the central level) is likely to be insufficient in the mid and longer terms. This is a further compelling argument for the building of a strong analytical unit within the Ministry of Finance and Ministry of LGU to develop and utilise an extensive data system.

#### **4.3 Overall assessment**

The overall assessment is that the property tax system in Macedonia is performing poorly and is in serious need of improvement.

What now remain are problems that can be solved easily, for example:

1. Expanding the property tax base with business premises included
2. Given the low initial base for the devolved taxes, it will help to increase the property tax collections in medium term after devolution
3. This initial momentum should not create space for comfort and allow local governments to forget the need for further development of the revenue system in the areas of assessment, audit, collection and monitoring
4. For local citizens to see progress that is meaningful to them, mayors and council members need to be able to see beyond the appointment of a primary accountant or the transfer of staff from the PRO
5. Self assessment of the tax base requires a strong system of monitoring
6. Building database of taxpayers
7. Building efficient tax administration
8. Increase in the tax effort

Given the previous work CEA have done in the area one can conclude as well:

1. **LGU Own Source Revenues are not representative in time, structure and as a system.** The LGU financial data so far are not representative given the two years of fiscal decentralization. Many problems are internalized in the data: transfer of taxpayer's registry data, equipping the tax offices in the LGU, lack of human resources just to mention few. The volatility, reliability, structure of the tax system should calm and then one can work on more credible quantitative analysis. Accounting problems should be addressed and solved (example: The fees for construction and infrastructure are earmarked for capital purposes and still are accounted as current revenues even though are capital revenues).
2. **Continuing and improving the collection of LGU financial data is of high importance.** The Ministry of finance should improve its own capacity for analyses and setting up procedures and standards for measuring fiscal needs, fiscal capacity, and fiscal gap and to set up a proper horizontal equalization system. Of special importance is to set up proper indicators as of monitoring the capacity of LGU to enter the second phase of fiscal decentralization.
3. **Importance of reliable and timely data is precondition for measuring fiscal decentralization.** Measuring fiscal decentralization is a challenge. There are some available estimates of LGU GDP at Purchasing Power Parity for 2002. In addition, the 2002 census was recently completed in Macedonia. However this is not sufficient as the data are relatively old and do not represent the changed economic-social structure in the LGU in Macedonia. In this regard the ignorance of the importance of State Statistical Office in pushing it to produce LGU data cannot be tolerated anymore. The NUTS 4 data are in need as soon as

- possible. The measure of fiscal capacity for example is sensitive to methodology and data used.
4. **Very high level of disparity across Macedonia's LGU.** Indeed the revealed level of disparity is too high to be ignored. The heterogeneity among LGU has a distorting impact on the results of the fiscal decentralization.
  5. **Financial and Fiscal planning is important.** Realistic planning at LGU is of crucial importance for measuring fiscal decentralization especially if the planned and collected revenues are used for calculation of fiscal capacity and fiscal effort for that regards.
  6. **The competencies between central and local government are still unclear.** There are legal gaps for LGU to update and administer properly their database of taxpayers. There are legal entities that are in a court procedure and not working, bankruptcy procedure, in a procedure of closure and exit of the market and the LGU are still planning them as a source of revenue.
  7. **The cooperation and coordination** between central and local government is important and desirable.
  8. **The sharing experiences among LGU** is important and desirable.
  9. **More initiatives from the administration** within the LGU should be encouraged.
  10. **Citizen's participation, information, compliance** are topics to be explored more by the LGU.

## **5. Inter-governmental transfers**

The nature and implications of inter-governmental transfer mechanisms can differ substantially. This section, as the ones before, presents a framework for evaluating different mechanisms.

### **5.1 Structure – types of transfers**

The phased approach to fiscal decentralization is closely connected with the inter-governmental transfers. The process of fiscal decentralization is envisaged by the LFLGU to evolve in two phases. The major principle of this phased approach is to allow a gradual devolution of responsibilities in line with the demonstration of greater capacity by local governments to undertake those responsibilities, and to provide an equitable and adequate transfer of funds for an efficient and ongoing execution of transferred competencies.

The LFLGU envisions the following channels of transfers from the central Government:

1. VAT revenues (total fund equal to 3 % of the VAT collections in the previous fiscal year). This unconditional grant will be distributed by a formula with at least 50 % according to population and not more than 50 % according to other criteria. These other criteria will be stipulated in a methodology to be defined by the government in agreement with the Commission for Monitoring of the Development of the Financing System. The proposal for the following fiscal year

- has to be prepared by 30<sup>th</sup> June of the current year. The methodology makes separate provisions for the City of Skopje.
2. Earmarked transfers of specific grants for operational costs in the areas of education, culture and social policy. The appropriate ministries and agencies monitor the use of the earmarked funds.
  3. Capital transfers. (In accordance with programs specified by the Government.)
  4. Block transfers. (In accordance with article 22 paragraphs 5, 7, 8 and 9 of the Law on LGU); the appropriate ministries and agencies are responsible for defining the methodology and criteria to be used in the transfer formula.
  5. Funds received for delegated competencies. In this case the amount of funds is determined by way of a contract signed by the mayor of the local government and the appropriate ministry responsible for the competency.

## **5.2 Vertical equalisation**

Both central and local governments are required to provide public services. It is common to find that the own-source revenue raising powers of local governments are insufficient to meet the costs of providing the services they have been assigned. The resulting gap can be filled only by increasing local revenue raising powers or by increased transfers. For reasons that include concern for macroeconomic stabilization, the lack of appropriate local revenue bases, and the low capacity to administer taxes locally, transfer mechanisms may be the more suitable way to achieve vertical equalization.

The procedures for calculating the earmarked grants are related to the budget process and the budget circular. However, the view of the Ministry of Finance is that even though the procedure for distributing the amount to the LGU is transparent for the education sector (by students), it is based on historical costs and there are indications of substantial under-funding. The situation is similar in the culture sector. The earmarked grants for the social sector and the kindergartens are found to be sufficient.

## **5.3 Horizontal equalisation and equity**

There are often wide differences in the ability of local governments to mobilize resources across localities. If only local taxes were available to finance local services, there would be substantial inter-jurisdictional differences in the quantity and quality of public services. Inter-governmental transfers can be used to help equalize those differences. The conflicting views concerning the VAT transfer were discussed earlier. ZELS and the Government should first agree if this is an equalization fund, and, if it is, then this should be stated so clearly in the LFLGU. It then needs to be decided how to proceed with the two steps in its implementation:

- 1) The estimation of the total pool;
- 2) The formula.

In this regard, it is strongly recommended to include a formula in the law for calculation of fiscal capacity of local governments for transparency reasons.

The equity criterion relates directly to the issue of horizontal equalization. The criterion is complex since it commonly involves a combination of factors that are not easily measured. Transfer systems should distribute resources between local governments in a manner that accounts for differences both in the expenditure needs (providing more to those with greater need where the need factor includes variations in the unit cost of producing public services) and in the fiscal capacity (providing less to those with greater capacity). Specifically, it should attempt to decrease or equalize these differences.

#### 5.4 Overall assessment

Local governments are likely to view the transfers as substitutes for their own resources and to decrease their efforts at raising local revenues. Also, since the existing public infrastructure is a part of the resources that must be “managed” by local governments, grant systems can have an adverse effect on the willingness of local governments to maintain such infrastructure. In Macedonia, the system of capping own revenues provided no incentives for greater fiscal efforts and public infrastructure was maintained by transfers from the line ministries and in the case of the communal services, from user charges. The cap system had adverse effect on the fiscal effort, the transfers from the line ministries were not transparent and the communal services continue to face revenue collection problems. This is a difficult situation and the new system which abolishes the old cap system for own revenues and introduces earmarked grants improved the situation.

As for the grants, if they are to be systematically distributed to local governments, several policy decisions need to be made. These include:

- Determination of the grant pool, i.e. how much will be available to be distributed to local councils;
- The method used to allocate that pool across all eligible local governments
- The degree of restrictions associated with how the grant funds can be spent by local governments.

In the next table, the typology of grants is utilized to discuss the Macedonian context for PIT and VAT transfers.

Table 1. Typology of grant programs

		Method of determining the total divisible pool		
Methods of allocating the divisible among	of the pool local	Sharing	Law decision	Reimbursement
			(Ad hoc decision)	

governments			
Origin of collection	A	N/A	N/A
Formula	B	F	N/A
Total or partial reimbursement	C	G	K
Ad hoc	D	H	N/A

Source: Bahl & Linn 1992.

The advantage of A-type is because it is a pure shared tax, it is certain and it simplifies the fiscal planning of the local governments. Further, it is not conditional and it can increase the fiscal autonomy. Sharing gives the local governments an income and inflation elastic tax base. The disadvantage is that it is an inflexible solution because it is difficult to change the percentages once they have been established, and thus the vertical balance. This might be important in the Macedonian context with its high economic uncertainty (prices of energy, weak economy, high unemployment etc). Another disadvantage is that the A-type does not provide equalization and in principle increases inequality. All in all, PIT-sharing is beneficial given the current level of tax administrative capacity at local level. The percentages can and should be revised after a comprehensive analysis of the fiscal gap and vertical imbalance is done. Higher percentages can provide greater incentives for compliance by the taxpayers and to decrease tax evasion if the taxpayers can consider it as “own”.

The PIT tax, even though considered as an own tax for the local governments, is actually a sharing type-A because:

- 1) The local governments have no control over determination of the rate and base;
- 2) The allocation is based on the origin of collection.

As for the VAT grants, the total divisible pool is shared and the allocation is by formula and thus it is a B-type grant. The VAT formula-based grant is transparent but the lack of timely and adequate data to be included in the allocation formula is a serious deficiency.

The way the formula is stated in the law at present makes it difficult to see what the Central Government is trying to achieve. Is it to equalize the fiscal capacity, to reduce the disparities in providing public services or to encourage a local government to mobilize its own resources? This confusion should be resolved as soon as possible. Also, the number of population requirements within the law for the VAT distribution formula (at least 50 % of the weight) probably shows the weakness of the state statistical system and lack of data (the population data being most credible).

## 6. Borrowing at LGU level

### 6.1 Sources of financing of infrastructure projects

The underlying purpose of the development of a municipal credit market is to increase the volume of local capital investment to support essential municipal services. Well designed investment and borrowing plans often can provide immediate finance the construction of infrastructure facilities that are needed and then to repay the debt from the future earnings of the facilities themselves, through user charges or through cost savings in service operations.

The next table illustrates the pros and cons of different sources of financing LGU projects.

Table 2. Sources of financing of infrastructure projects

Source	Pros	Cons
Own resources	Cheap	Less predictable, rarely sufficient
Grants from EU and central governments	Cheap	Restriction on the use of funds, slow pace of approval, strict control
MFO loans	Long-term, grace periods, amortizing repayment	Foreign currency risk, restrictions on the use of funds
Domestic bank loans	Local currency	Short-term, restricted capacity
Bonds	Diversity of investors, liquidity, depth of markets	Expensive depending on size, bullet repayments
Own sources or borrowings of enterprises	No direct costs	Contingent liabilities and more expensive
PFI/PPP deals	No direct costs, more effective private sector provision of services	Long-term agreement with concessionaires, off-balance sheet risks
Investment banks and funds for LGU	Deposit risk attenuation, lower interest rate, possibility of contributing to capitalization of the bank, LGU could provide guarantee with their current revenues as well, the Bank can provide consulting services to the LGU as an auxiliary service	Possible mix between having a role in the capitalization process and possibility of being granted a loan i.e. political interference, Local development fund could prove counter-productive to the objectives of sound, private credit market development.

Source: Felix Ejjel from S&P. Slight adaption by the author.

The next table illustrates the pros and cons for allowing LGU borrowing

Table 3. Pros and Cons for LGU borrowing

Pros	Cons
<p>1. Inter-temporal equity, meaning that with the borrowing we overcome the problem of inequitable burden costs among taxpayers i.e. the borrowing promotes intergenerational equity by having the generation of citizens that benefits from capital facility's services pay for its construction;</p> <p>2. Optimal allocation of resources, meaning that payments from current users are partially used to repay the loan because by financing a project through loan or through issuing bonds most users will pay for the benefits either through local taxes or directly through user charges;</p> <p>3. Benefits from accelerated local development are higher than the cost of borrowing. For example if a piece of land of interest to investors have no good access to a road the LGU can decide to borrow, to build the road and sale the land benefiting from higher price of the land or higher rent for it. Here are also other positive effects like higher employment, more tax revenues, attracting other potential investors etc.;</p> <p>4. Reduction of operational costs. This pro has the same logic as the third one. Namely, if the LGU wants to improve the condition with the public transportation by replacing old busses it can do this either by replacing the buses one by one using the current surplus from the budget or it can borrow and replace more buses at once.</p>	<p>1. The microeconomic con is in the potential indebtedness that may lead in default of repayment of the loan and decreasing the level of quality of provision of public services;</p> <p>2. The macroeconomic con is that the LGU debt is added to the overall national public debt that might become unsustainable;</p> <p>3. The special danger might come from borrowing for covering current operating expenses and possible cash flow problems. This type of borrowing can lead to rolling over loans;</p> <p>4. Borrowing can create a fiscal illusion that the voters/taxpayers are over-demanding the public services sponsored by borrowing and not by their tax effort;</p> <p>5. Possible crowding out effect to potential private investors since the LGU is more attractive to lend to;</p> <p>6. The borrowing by the LGU can cause an upward pressure of the interest rates;</p> <p>7. The budget deficits at LGU can cause rising of inflation and thus, increase of cost of capital i.e. interest rates;</p> <p>8. Political cycle driven borrowing in order to please the electorate.</p>

<p>The multiple positive effect is higher with the second public choice because there are positive externalities for the environment, health of citizens from lower level of pollution, higher reliability of the vehicles, financial savings in the cost of maintenance of the buses etc.;</p> <p>5. There is a tendency that longer projects cost more. If the projects are financed from the current revenues it will delay the completion of the project which might lead to higher fixed costs due to longer period of time for completing the project;</p> <p>6. Access to grant from EU and other development funds but the LGU will be required to participate in a matching funds scheme and/or to cover all the costs of the project and than to claim reimbursement after completion of the project;</p> <p>7. Debt finance typically has a positive effect on municipal planning and budgeting, financial management, capital investment planning, project management etc.;</p> <p>8. Borrowing allows a LGU to carry out a more ambitious capital program than otherwise would be possible.</p>	
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Source: Swianiewicz 2004.

## 6.2 The LFLGU in Macedonia

The LFLGU establishes a budget of the current revenues and expenditures and a budget of the capital revenues and expenditures.

The budget of the current revenues and expenditures consists of all revenues and expenditures, including the payment of interest on long-term borrowings but excludes capital donations, self-contribution revenues, revenues from property sales, block grants and borrowing inflows.

### 6.3 Financial market structure in Macedonia

Major capital spending at LGU level was financed by grants or soft loans and was directed by the central government or, in the case of smaller routine projects, financed on a pay-as-you go basis by the LGU. Donor help was not systematic but rather at their discretion. As a result of the format and purpose, financial reports often gave little insight into the financial condition of the local governments.

Table 4. Risk categories and levels by instruments

	Sovereign Risk	Exogenous Idiosyncratic Risk	Credit or Solvency Risk	Maturity Risk	Exchange-Rate Risk
Current Government Bonds	Moderate	Low		Moderate	
Future LGU bonds	Moderate	Low	Moderate	Moderate	
Government T-Bills and T-Bonds	Moderate	Low		High to moderate	
Current NBRM Bills	Low	Low		Very high	
Bank Deposits		Moderate	Moderate, heterogeneous	High	
Corporate Shares		High	High	Low	
Mortgage Securities		Low	Low	Low	
Corporate Bonds		Moderate	Moderate	Moderate	
Foreign Investments (Foreign Government Bonds)	Very low	Very low	Very low	Low	High: ST-MT (LT) deprec (apprec) risk

Source: Mr. Klaus Schmidt-Hebbel presentation on pension funds and capital markets in Macedonia. Adoption by the author.

Until now the only issuer of bonds has been the Government (except in 2004 when one private company issued bonds to a known buyer). The Ministry of Finance started issuing government securities in 2000, when big structural problems (frozen currency deposits

from the former Yugoslavia, denationalization, rehabilitation and privatization of the banking sector) in Macedonia were resolved through issuance of long term securities to the legal and physical entities concerned. However, the typical government securities (3 and 6 month) were first issued in 2004. Since then the Ministry of Finance conducts regular auctions for both short and long term government securities (primary market) allowing these securities to be traded afterwards on the Macedonian Stock Exchange and in the Over-the-Counter Market (secondary market).

One source of useful information regarding potential demand (as well as an overall measure of perceived sub-sovereign risk) is the weighting that banks must use to calculate their capital adequacy. Although these have varied internationally, they are increasingly coming into conformance with the BIS-Bank of International Settlement capital adequacy ratios. The ratio refers to the ratio of bank capital to performing loans (non-performing loans carry special provisions). The BIS minimum is currently at 8%.

Under the BIS regime, loans to the sovereign government of the same country as the bank are assigned a 0 sectoral risk weight (i.e. they are assumed to be domestically risk free) and those of private-sector firms are assigned a 1. The BIS recognizes that the relationship between the central government and sub-national governments vary from country to country and therefore allows the central bank in the respective countries to assign the appropriate risk weight. Thus, the weightings provide the central bank's opinion as to the relative risk of loans to the sub-national governmental sector in comparison to the sovereign and the private sector.

In the US, the BIS credit factors range from 0.1 for general obligations to 1 for private activity (corporate) bonds. In foreign countries, sub-national government obligations that have explicit central government guarantees have BIS ratios of 0 (which makes them tantamount to direct sovereign obligations) and those that do not, have ratios that can range up to 1 or even higher. Ratios can be changed to recognize overall changes in sectoral credit strength. This recently happened in South Africa, where the ratio was increased from 0.1 to 1 for sub-national governmental securities when the national government announced that it would no longer guarantee municipal and provincial debt.

#### **6.4 The demand side of LGU borrowing in Macedonia**

The challenge for Macedonia is to increase both private and public investment to support economic growth and modernize its infrastructure while maintaining a stable macro-economic environment. The LGU and municipal companies will play a critical role in this context, as they are responsible for undertaking a substantial portion of the infrastructure investments required.

Table 5. Stakeholders in municipal credit market development

Demand (Borrowers)	Side	General purpose LGU, municipally owned companies, public-private joint ventures
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Supply Side (Creditors)	Commercial banks, specialized banks, insurance companies, pension funds, wealthy individuals
Market Makers	Stock Exchange; Licensed Financial Intermediaries; Financial Advisory Firms; Credit Rating Agencies
IFIs	World Bank; European Bank for Reconstruction and Development; European Investment Bank
Overseers & Regulators	Ministry of Finance, Court of Accounts, Securities Commission, National Bank, IMF
TA Providers	USAID, US Treasury and SEC advisers, World Bank, EBRD, private consulting organizations and think tanks

Source: USAID and LGAP 2002. Adapted by the author.

LGU investments are well below what is required to meet EU infrastructure standards over the pre-accession period. Currently, most of local infrastructure is obsolete and a large amount of effort is required for its replacement and modernization. Services such as water, sewage and solid waste systems involve large unit costs. To increase the level of such services will require considerable investments. It is evident that large part of development, replacement, and renewal of local assets will need to be financed out of LGU budgets.

The EAR project on strengthening the capacity of the Ministry of environment and physical planning prepared estimates for meeting the capital and operational costs of the investments required to comply with European Union directives and policies in the “heavy investment” areas of environmental management. Within this project, the indicative estimates for the cost of accession in the heavy investment areas have been estimated as:

Table 6. Assessment of total investments in millions of euro/per capita in euros for approximation of Macedonia, Romania and Bulgaria to EU environmental legislation

	Macedonia	Romania	Bulgaria
Urban waste water treatment, sewerage	229/113	1,385/63	2,056/267
Large combustion plants	274/136	402/18	1,627/211
Municipal waste management, landfills	80/40	NA	NA
Municipal waste management, other installations	120/59	NA	NA
IPPC-air emissions	381/187	806/36	3,261/424
<b>TOTAL</b>	<b>1,084/537</b>	<b>10,593/475</b>	<b>6,944/902</b>

Source: EAR 2002-2003 and WB 2005. Adapted by the author.

## 6.5 The supply side of LGU Borrowing in Macedonia

Absorptive capacity of domestic capital market:

- Outstanding stocks of financial assets:
  - Government debt outstanding: EUR 669 m. (August 2006)
  - Total bank deposits: EUR 1.79 b. (June 2006)

At the moment, the securities law does not make any specific or additional requirements for the municipalities as potential issuers of debt (in a form of municipal bonds). The main obstacle for the supply/investors would be:

- untrustworthy financial statements of the municipalities
- lack of transparency and accountability in the local governance
- lack of skillful staff within the municipalities for long term financial planning
- lack of good ideas/projects to be financed with limited possibility to forces the revenues from the investment

## 6.6 The investment at economic scale

Economic scale can be analyzed by considering the regional balance, relative size of LGU, instruments to attract investors (inter-municipal cooperation for example) and institutional solutions (Municipal credit bank for example).

The next table reveals a wide disparity in expenditure level and composition among LGU in Macedonia. Disparities in expenditure per capita are quite dramatic. The poorest LGU spends in per capita terms only one-fourth of the average LGU and just a small fraction of that of the wealthiest LGU. Expenditure composition is also varies a lot. It appears that some LGU spend 100 percent of their current expenditures on the wage bill while other LGU have relatively high shares of investment expenditures. It seems that the situation improved in 2006 as the variability and discrepancy is lower.

Table 7. Disparity in LGU expenditure level and composition in 2002

	Min	Average	Max
<b>Expenditures</b>			
Current (as % of total)	22	84	100
Wage bill (as % of current)	7	45	100
Investment (as % of total)	0	16	78
<b>In per capita terms</b>			
Current (in \$ US)	3	12	102
Wage bill (in \$ US)	1	5	27
Investment (in \$ US)	0	3	38

Data Source: Ministry of finance. Author's calculations.

Table 8. Disparity in LGU expenditure level and composition in 2006

	Min	Average	Max
<b>Expenditures</b>			
Current (as % of total)	24	61	91
Wage bill (as % of current)	13	30	53
Investment (as % of total)	9	39	75

Data Source: Ministry of finance. Author's calculations.

Small municipalities frequently have financing needs that is of such a small scale that they cannot attract sufficient attention and gain access to various sources of capital. Additionally, the costs of debt issuance are a substantially higher percentage of project costs and are often prohibitive. Capital supply sources are often not interested in expending the effort to lend to such small-scale projects and to smaller municipalities. Thus, a Municipal Bond Bank could be created by legislation in order to:

- Borrow from the private capital markets on behalf of smaller municipalities,
- To lend capital to the smaller municipalities and
- To benefit economies of scale and share the costs of debt issuance among several projects.

The policy issue is whether a special intermediary should be created for jurisdictions that cannot access credit markets through existing market mechanisms. Special intermediaries should not replace existing commercial lending and underwriting institutions, but instead should complement them. Many kinds of intermediary models are possible, beside a Municipal Bond Bank, such as bond pools, revolving loan funds, and municipal lending institutions.

A fundamental consideration has to do with fiscal capacity. This relates to the ability and willingness to pay, and largely governs which units are candidates for debt issuance. Such considerations are not always correlated with size, but larger jurisdictions typically are of greater interest to private providers of credit for a number of reasons, including greater sophistication, the ability to draw upon more resources and the ability to spread the fixed costs of debt transactions over larger volumes of borrowing. Three groups of jurisdictions can be identified as regards to the likelihood for the issuance of sub-sovereign debt in private markets:

- Those units that because of size and financial and managerial resources already have access to capital markets;
- Those that either have none or only limited access to capital markets, but can generate revenues sufficient to their responsibilities and are otherwise capable of borrowing private capital. This group consists of those units that (a) are large and that have sufficient capabilities to attract private interest without direct central government help, and those (b) that are too small or that lack the managerial

capability to attract private lending at present, but with assistance could gain access;

- Those that cannot generate sufficient revenue either to provide the services they require or to build the needed infrastructure. Jurisdictions in this group, which for all practical purposes are "financial wards" of higher levels of government, do not have access to capital markets and most likely should not. That is why consideration should be given to the creation of a Municipal Bond Bank.

The above classification of the LGU in accordance with the creditworthiness is useful for analytic purposes, such as describing potential demand for credit access and the likely size and viability of a local government securities market. But, should such distinctions be codified into a law or regulation for purposes of predetermining which units can access the markets and obtain credit? In developed economies, freely operating credit markets effectively classify borrowers on their merits, and reflect their credit assessments in the prices charged for borrowing. Nonetheless, even in these mature markets, regulatory classification is sometimes practiced by central or state governments in order to provide certain privileges to some borrowers or to impose restrictions on others. For example, in the United States most state governments differentiate among local governments through various legal classification mechanisms, and these differentiations can include differential borrowing powers. However, the credit market itself further differentiates among governments, based on varying assessments of creditworthiness. These assessments are based on perceived differences in the jurisdictions' economic vitality, managerial efficiency, financial condition, and the necessity for and viability of individual projects. Such a detailed prescription of creditworthiness by the regulator can crowd out the self regulation of the efficiency of the capital market.

However small an LGU is, it will need capital investment and if it is not ready to finance its needs in order to provide a certain level of quality in its services, it becomes a central government obligation to step forward to fill the gap. If central government chooses to do so by subsidy for a loan or by guarantee, the potential exists for large amounts of failure which can lead to national bailouts, an increase in the supply of credits and to inflationary pressure.

Encouragement to investors from relatively small LGU can come from upgrading LGU financial management practices, reporting and disclosure in order to attract attention.

Table 9. Percentage of LGU having less than 2000 and less than 5000 inhabitants

	Percent of total	Number of inhabitants
Macedonia	1 LGU (1.2 %)	< 2000
Macedonia	15 LGU (17.9 %)	< 5000

In general those LGU with less than 5000 citizens are too small to build technical, fiscal and financial capacities. Also, such municipalities are too small to undertake investments at an economic scale. They are likely to have higher average costs than larger jurisdictions (one instance where economies of scale cannot be realized). They may find difficulty in retaining capable staff and are more likely to lack the capacity to provide public services effectively.

Having a large number of small municipalities is not an impediment to the undertaking and financing of investments at an economic scale as long as joint ventures can be formed, revenues can be assigned to them, and they have a right to borrow against these revenues streams to finance investments. Some forms of those joint ventures can be:

- Entities created by agreement by more than one municipality to accomplish a special purpose (e.g., to provide fire protection efficiently across a broad area). Their revenues and expenditures can be separated from those of the organizing municipalities. Their powers can derive solely from the municipalities ("joint powers"), or through legislation which can limit or extend such combining powers
- Quasi-municipal entities created by state or national legislation. These entities might provide municipal services (e.g., water development, disease control, or transport services) where needs do not necessarily relate to municipal boundaries.

Typically, in a transition economy such as Macedonia, LGU are highly dependent on transfers from the central government. While transfers can be very volatile and untested for sustained periods of time, they form a major portion of revenues and are attractive for interception to cover debt service payments. Intercepts can have a powerful impact on local borrowers, especially small and remote units.

**Annex 1: Strategic assessment of borrowing at LGU level**

<p>TABLE 10</p> <p>ASSESSING THE STATUS OF LGU BORROWING AND INFRASTRUCTURE DEVELOPMENT</p>					
	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector

<p>MACEDONIA Fast pace of decentralization process</p>	<p>Uncertainty about the LGU debt/arrears solution;  No insolvency definition and procedure;  Only financial instability definition.</p>	<p>Law on financing provides provisions for borrowing and instruments for controlling;  Borrowing allowed with prior consent from the central government based on the opinion of the Ministry of Finance.</p>	<p>Body for public debt management established;  Reporting forms for debt registry developed but not practiced;  Confusion on who should maintain debt registry for LGU.</p>	<p>Lack of initiative for solving the existing debt;  Need for assistance.  ZELS under political risk ethnically driven.</p>	<p>No participation of the private sector</p>
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TABLE 11

KEY LGU BORROWING AND INFRASTRUCTURE DEVELOPMENT INITIATIVES PURSUED

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector
	Borrowing legally allowed as of 1 <sup>st</sup> of July 2007	Law on regional balanced development a priority	NA	Solution for arrears	CEA initiative for studying LGU borrowing

TABLE 12

REFORM PRIORITIES FOR LGU BORROWING AND INFRASTRUCTURE

DEVELOPMENT					
	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central government institutional and regulatory framework	(D) Local government institutional and regulatory framework	(E) Participation by civil society and private sector
	<p>Development of a viable solution for the arrears;</p> <p>Development of insolvency law.</p> <p>Adoption of the new Program for implementation of the process of decentralization 2008 – 2010</p>	<p>Law on insolvency development;</p> <p>By Laws from the Law on balanced regional development developed</p>	<p>Debt management body of the ministry of finance to build capacity to manage LGU debt in the future;</p> <p>Commission for financing of decentralization should consider more in depth monitoring.</p>	<p>Capacity building for the financial management;</p> <p>Develop credit rating procedures;</p> <p>Developing a capacity for asset management.</p>	<p>Securities commission, banks, credit ratings agencies etc. intensify their activities;</p> <p>Independent /private consulting companies to start contracting with sub-national governments to provide TA.</p>

## Annex 2. The EU perspectives

Table 13. The EU perspectives in Macedonia, Romania and Bulgaria

	(A) Overall policy stance	(B) Administrative Capacity	(C) Institutions	(D) Financial capacity	(E) NUTS II
<p><b>MACEDONIA</b></p> <p>Fast pace of decentralization process.</p> <p>Initial momentum from 1999 boosted with the Ohrid Framework agreement</p> <p>Second phase of the process of decentralization started</p>	<p>National development strategy developed.</p>	<p>Low administrative capacity.</p> <p>Problems in recruiting and retaining qualified staff.</p> <p>Relatively lower wages in the public sector and low morale lead to high turnover and quit rates.</p> <p>Without changing these conditions, training of existing employees is not a solution because once the public employees have received skills that will gain them more lucrative employment they transition to a different job in the private sector.</p>	<p>EAR closure and transfer of functions to the Ministry of finance.</p> <p>Weak statistical information system.</p>	<p>To the extent that local governments are not able to generate the needed additional resources to execute the EU funds programs, the opportunity could be lost.</p> <p>New law on concessions and other types of PPP.</p>	<p>Law on balanced regional development.</p>

		Private consulting companies not yet began contracting with sub-national governments to provide TA.			
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Source: Adopted from Martinez 2005.

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**NOTES:**