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**NORTH MACEDONIA**

# **ASYMMETRIC DECENTRALIZATION:**

## **POLICY BRIEF FOR POLICYMAKERS**

### **OPTIONS FOR THE REPUBLIC OF NORTH MACEDONIA**

**USAID STRENGTHENING RESOURCE MOBILIZATION  
ACTIVITY (SRMA)**

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## TABLE OF CONTENTS

ACTIVITY INFORMATION .....	1
TABLE OF CONTENTS.....	2
1. INTRODUCTION .....	3
2. OBJECTIVE OF THE ACTIVITY .....	3
3. ASYMMETRIC DECENTRALIZATION.....	4
4. TERRITORIAL ORGANIZATION .....	5
5. TRANSFER OF COMPETENCIES .....	6
6. RESULTS FROM THE EXISTING SYSTEM.....	7
6.1. Population size .....	7
6.2. Total expenditures.....	10
6.3. Capital expenditures.....	12
6.4. Own-source revenues.....	14
6.5. Own-source revenues per capita .....	15
POLICY OPTIONS FOR ASYMMETRIC TRANSFER OF COMPETENCIES	17
7.1. The decentralization architecture.....	18
7.2. The principles of transferring competencies .....	19
7.3. What can be done .....	20
7.4. Asymmetric transfer of competencies.....	20
ANNEX I .....	23

# I. INTRODUCTION

The Republic of North Macedonia (RNM) aspires to be a prosperous, self-reliant, and inclusive democratic society. USAID Strengthening Resource Mobilization Activity (hereinafter referred to as “**the Project**”), 2021-2026, will assist North Macedonia’s government institutions to raise and independently manage the resources necessary to fund services demanded by its citizens. Facing challenges in revenue generation and budget execution, North Macedonia’s 81 municipalities are ready to act, and it is in the country’s interest to seize the opportunity presented by USAID Strengthening Resource Mobilization Activity. The project team will facilitate participatory and sustainable transformation, aiding North Macedonia’s local governments to generate, access, and effectively manage the own-source and external revenues necessary to fund the social services and programs that benefit their citizens.

The project team will work with local governments, the Government of North Macedonia (GoNM), and key stakeholders to: 1) enhance the quality of municipal tax and fee collection systems; 2) increase the capacity of local self-government units (LSGUs) to access external resources from the national government, international organizations, and/or capital markets and banks; 3) improve LSGUs’ ability to plan, manage, and implement public sector revenues in compliance with GoNM’s regulations; and 4) enhance the decentralization process.

## 2. OBJECTIVE OF THE ACTIVITY

There is a disparity in the RNM regarding LSGU capacity in many areas, such as fiscal capacity, human resources and knowledge, and quality of service delivery. The challenges are particularly severe in rural, underdeveloped LSGUs where the capacity is limited, and the number of administrative staff is insufficient. This results in part from transferred competencies that are resource-intensive and symmetrical to all LSGUs regardless of the preconditions and their potential to deliver the quality and scope of services to citizens.

As the GoNM is considering expanding the transferred competencies to LSGUs, this document offers timely options on asymmetric administrative decentralization that the Ministry of Local Self-government (MLSG) requires. It will help inform the MLSG and the GoNM about possible options for designing asymmetric decentralization. The asymmetry can be in the territorial organization and/or the expenditure assignments to the LSGUs.

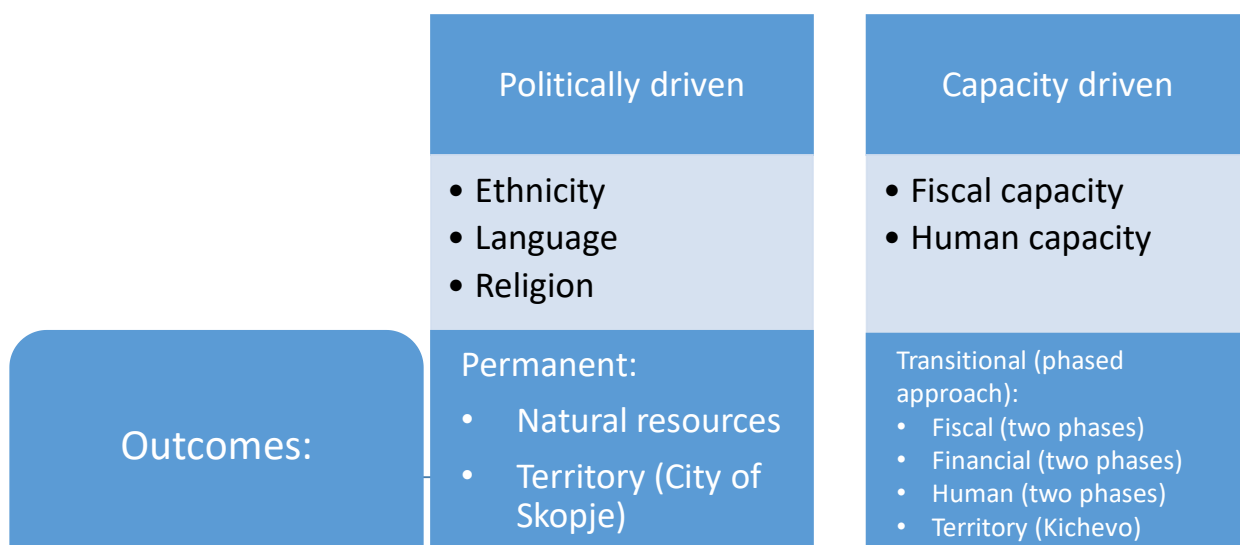
Although asymmetric decentralization offers options for both territorial organization and competencies, this report focuses on options related to the competencies. We briefly illustrate territorial organization of the LSGUs but offer more detail on options for the asymmetric expenditure assignments.

### 3. ASYMMETRIC DECENTRALIZATION

In the context of this report, *symmetrical* decentralization means that all LSGUs have the same competency responsibility for a decentralized function as defined in the Law on Local Government, regardless of pre-conditions. Thus, *asymmetric* decentralization means that LSGU responsibilities may differ depending on one or more pre-conditions of the LSGU. These preconditions can be the type of LSGU (urban vs. rural), fiscal and human capacity, size of population and/or territory, economy and wealth, access to natural resources, and territory.

Preconditions can drive asymmetry politically or asymmetry can be capacity-driven (see Figure 1). Political drivers are usually based on ethnicity, language, or religion, and these are not considered here. Capacity-driven asymmetry exists primarily when there is a lack of fiscal and/or human capacity at LSGUs.

The outcomes of the asymmetry can be permanent or transitional (phased approach). Permanent outcomes for asymmetry usually depend on political preconditions or those related to natural resources and territory, whereas transitional outcomes depend on preconditions related to capacity, such as fiscal and/or financial capacity, or human capacity, as illustrated below.



**Figure 1. Preconditions for asymmetry**

In RNM, for example, the City of Skopje represents a LSGU with permanent asymmetry that is driven by territory. The LSGU Kichevo is an example of a transitional territorial asymmetry (to be discussed below). Fiscal decentralization in RNM was transitional, with a two-phased approach that depended on fiscal, financial, and human capacities (see Annex 1).

The transitional approach was employed depending on LSGU capacities. As per the Law on Financing LSGUs, there were two phases of decentralization<sup>1</sup>. The first phase excluded salaries from earmarked grants. All Macedonian municipalities and the City of Skopje entered Phase I on July 1, 2005, if they met two conditions:

- Municipal administration employed at least two staff with qualifications for financial management, budget preparation and execution, and accounting and reporting
- Municipal administration employed at least 3 staff with qualifications for assessing and collecting taxes

Entry into the second phase of fiscal decentralization was conditional on the following:

- Municipality achieves good financial management under the first phase for 24 months
- Municipality reports correctly and on time to the Ministry of Finance
- Municipality has no remaining unpaid bills

On September 1, 2007, a total of 42 LSGUs entered the second phase of fiscal decentralization. By the end of 2011, all LSGUs had entered in the second phase except one (Plasnica).

## 4. TERRITORIAL ORGANIZATION

The RNM has a one-tier local government. With the 2004 **Law on Territorial Organization** (Official Gazette of the Republic of Macedonia, no. 55/04), local governments in Macedonia were restructured into 84 municipalities (15 of which have less than 5,000 inhabitants) with the City of Skopje defined as a special unit comprising 10 municipalities in accordance with a separate Law on the City of Skopje (Official Gazette of the Republic of Macedonia, no. 55/04). The 10 LSGUs within the City of Skopje are: Aerodrom, Butel, Gazi Baba, Gjorche Petrov, Karposh, Kisela Voda, Saraj, Centar, Chair and Shuto Orizari. City of Skopje is responsible for collection of its own-source revenues and communal activities for all 10 LSGUs. Operation and maintenance of roads are divided between the City of Skopje and the municipalities. In education LSGUs are responsible for primary education, while the City of Skopje is responsible for secondary education. In social protection, LSGUs are responsible for early childhood and education care, while the City of Skopje is responsible for care of orphans and the handicapped, and for houses for the elderly. The City of Skopje is responsible for fire protection. Thus, we have permanent political and territorial asymmetric decentralization related to the LSGUs and the City of Skopje.

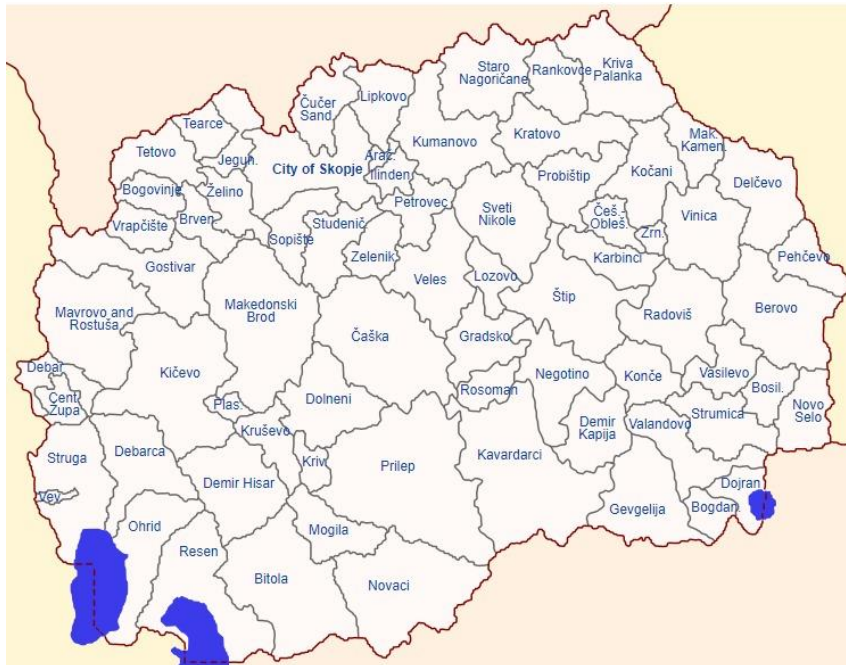
There was a transitional territorial phased approach as per the Law on Territorial Organization. In 2014, Kichevo LSGU merged with four surrounding rural LSGUs into one Kichevo municipality. These four LSGUs—Zajas, Oslomej, Vranestica, and Drugovo—were larger in

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<sup>1</sup> See Annex I for details.

territory but smaller in population than Kichevo. Thus, Kichevo became the urban center of this newly merged municipality.

The 81 LSGUs in RNM are shown in the map below (see Figure 2).



**Figure 2. LSGUs in the Republic of North Macedonia.**

## 5. TRANSFER OF COMPETENCIES

The Law on Local Government (Official Gazette of the Republic of Macedonia, no. 05/02) from 2002 regulates the competencies of the local governments. A wide range of responsibilities is listed in the provisions of Article 22 of this law, which includes:

1. Urban and rural planning
2. Protection of living environment and nature
3. Local economic development
4. Communal services (water provision, rubbish collection, public hygiene, public transport, cemeteries, local roads, street and traffic lights, parking, local markets, green spaces, riverbeds, naming of streets, squares, bridges, and other public places)
5. Culture
6. Sport and recreation
7. Social protection and child protection
8. Education (primary and secondary)
9. Protection of health

10. Emergency services (including war and natural disasters)
11. Fire protection
12. Monitoring of execution of own competencies
13. Other tasks listed in the legislation

In theory, LSGUs should be able to finance the competencies prescribed by the Law, but this is never the case. The fiscal capacity of LSGUs always falls short of financing needs. That gap should be financed by transfers from the central government. The ideal situation is for finance to follow function, but in RNM, transfers from the central government follows the institutional set up (e.g., transfers are planned and executed following the number of employees, need to heat schools and kindergartens and the operation and maintenance of existing assets, such as buildings and equipment).

## 6. RESULTS FROM THE EXISTING SYSTEM

We consider how various preconditions affect LSGUs under the existing system in RNM given that some of the preconditions may be a basis for considering asymmetric decentralization.

### 6.1. Population size

Population size might affect the efficiency of public service delivery due to:

- Economies of scale<sup>2</sup> and technical efficiency<sup>3</sup>
- Agglomeration effect, e.g., population density

Economies of scale and agglomeration externalities typically make the larger LSGUs more efficient. Moreover, small LSGUs are less efficient due to fiscal vulnerability, insufficient experience among local staff, or because fixed costs to provide services to fewer citizens are higher. Other reasons for greater efficiency in large LSGUs include having comparatively more skilled employees, better management control systems (financial, accounting, or external), and executing operating expenses more effectively. Efficiency here is defined as achieving the same or higher output with fewer inputs.

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<sup>2</sup> The greater the population, the lesser the fixed costs for providing public services.

<sup>3</sup> Providing more services with the same inputs or providing the same amount of outputs with fewer inputs.

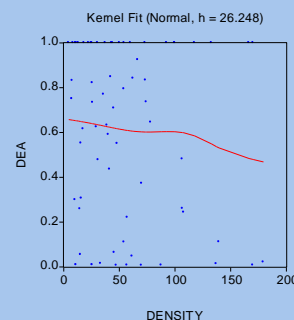


The agglomeration externalities can also be regarded as a proxy for the heterogeneity of property prices, which tend to differ substantially between rural and urban LSGUs. For example, high population density has cost advantages due to the concentration of services in a smaller area populated with more citizens.

On the other hand, higher relative prices in urban areas may render production of public services costlier. Population density is negatively correlated with efficiency of providing local services in RNM (especially for more than 100 citizens per square kilometer; see graph to the right)<sup>4</sup> indicating that a significant part of the observed inefficiencies is driven by scale inefficiencies rather than technical efficiencies of using inputs.

In RNM, the density effect in smaller areas has advantages up to around 100 citizens per square kilometer, but for densities greater than that, the effect of higher relative prices makes these places less efficient.

**Thus, in RNM smaller LSGUs are inefficient because of technical inefficiencies (e.g., high fixed costs) and larger LSGUs are inefficient because of agglomeration effects, (e.g., higher prices drive costlier public services). We elaborate further in the text.**



**X-axis = Population density**

**Y-axis = DEA efficiency scores (Data Envelopment Analysis)**

Technical efficiency scores consider financial input (e.g., the expenditures of LSGUs), the outputs of citizens, and the operation and maintenance costs for servicing local roads. Table I compares efficiency scores by category of municipal population size<sup>5</sup>.

<sup>4</sup> See Nikolov M. (2013); Cost efficiency of municipalities in service delivery: does ethnic fragmentation matter? Link: <file:///C:/Users/Marjan/AppData/Local/Temp/1-Book%20Manuscript-79-1-10-20150920-1.pdf>

<sup>5</sup> Ibid.

**Table I. Comparison of DEA-VRS<sup>6</sup> efficiency scores and SFA<sup>7</sup> efficiency scores by municipal size**

Size class	LSGUs	DEA efficiency scores	SFA efficiency scores
<b>All sizes</b>	80	0.596	0.573
<b>POP &lt; 5,000</b>	14	0.502	0.585
<b>5,000 ≤ POP &lt; 10,000</b>	16	0.831	0.585
<b>10,000 ≤ POP &lt; 15,000</b>	9	0.810	0.720
<b>15,000 ≤ POP &lt; 20,000</b>	10	0.720	0.614
<b>20,000 ≤ POP &lt; 60,000</b>	22	0.400	0.551
<b>POP ≥ 60,000</b>	9	0.218	0.345

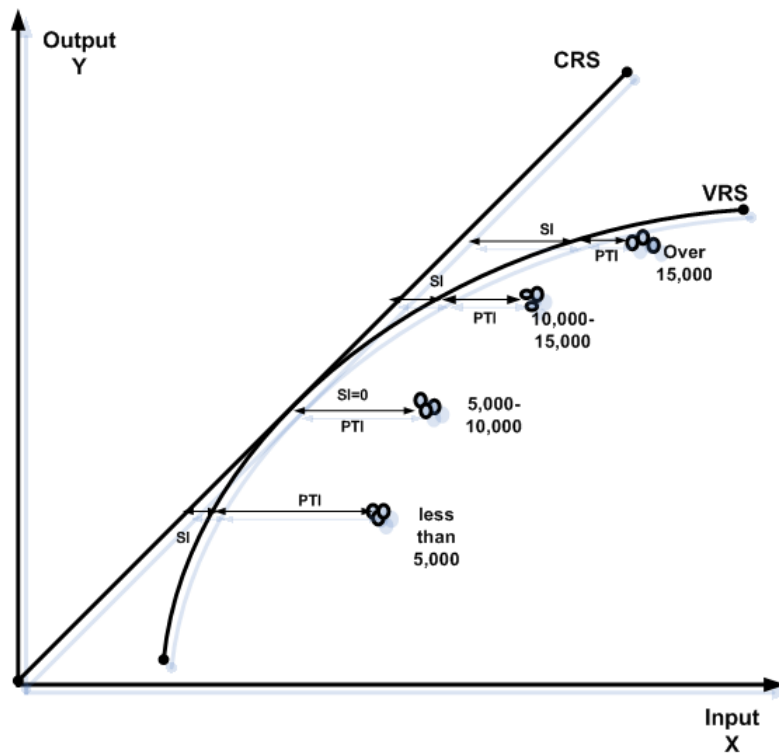
Note: Estimated efficiency ranges between 0 and 1; higher scores indicate better efficiency.

As seen in Table I, the large municipalities in RNM (population greater than 10,000) exhibit decreasing returns to scale, probably as they produce a wider symmetric range of more complex services. Conversely, small municipalities show increasing returns to scale because of the influence of fixed costs on current expenditures (e.g., mandatory requirements for administration to serve symmetrical competencies like the larger LSGUs).

The importance of scale efficiency is reflected in the cost efficiencies from the SFA estimates just as with the DEA-VRS estimates. Namely, we can see that the SFA cost efficiencies increase from a municipality size of less than 5,000 (SFA efficiency scores=0.585) to a municipality size of 10,000 to 15,000 (SFA efficiency scores=0.720)—that is, up to the moment when the increasing cost efficiencies plateau (see Figure 3). From a municipality with a size of 10,000 to 15,000 to the highest populated municipalities, the SFA efficiency scores decrease. DEA-VRS efficiency scores show that increasing scale efficiencies are exhausted for the 5,000-10,000-size class, whereas the SFA efficiency scores show that scale efficiencies level out for the 10,000-15,000-size class. Thus, the most efficient LSGUs in RNM are those with a population of around 10,000 population.

<sup>6</sup> DEA-VRS is data envelopment analysis-variable returns to scale methodology approach for efficiency analysis.

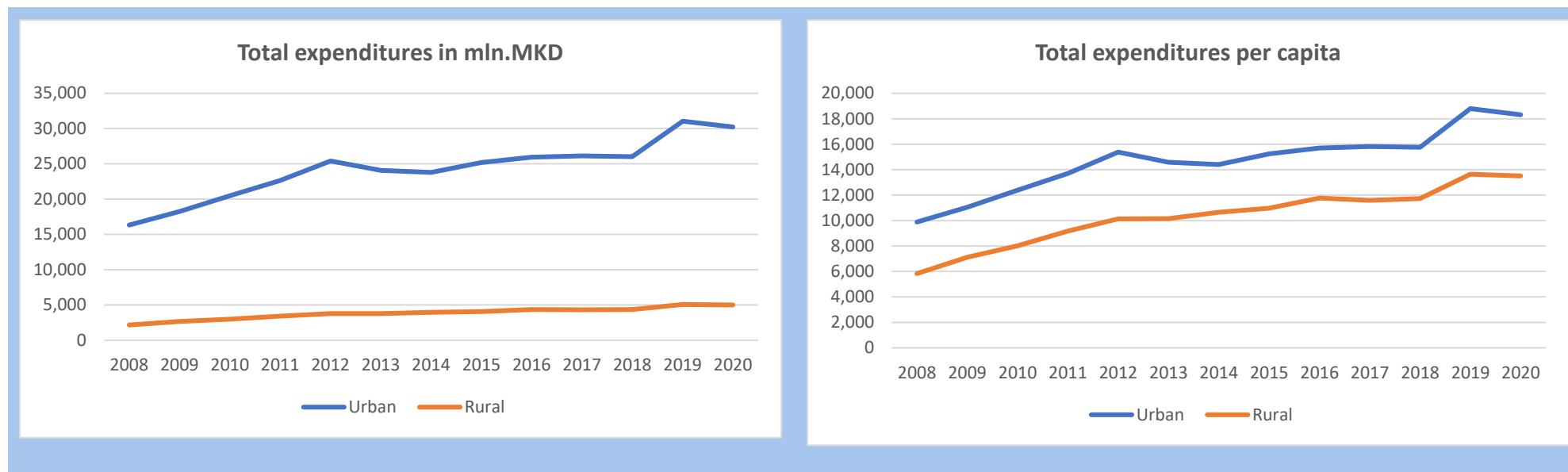
<sup>7</sup> SFA is stochastic frontier analysis methodology approach for efficiency analysis.



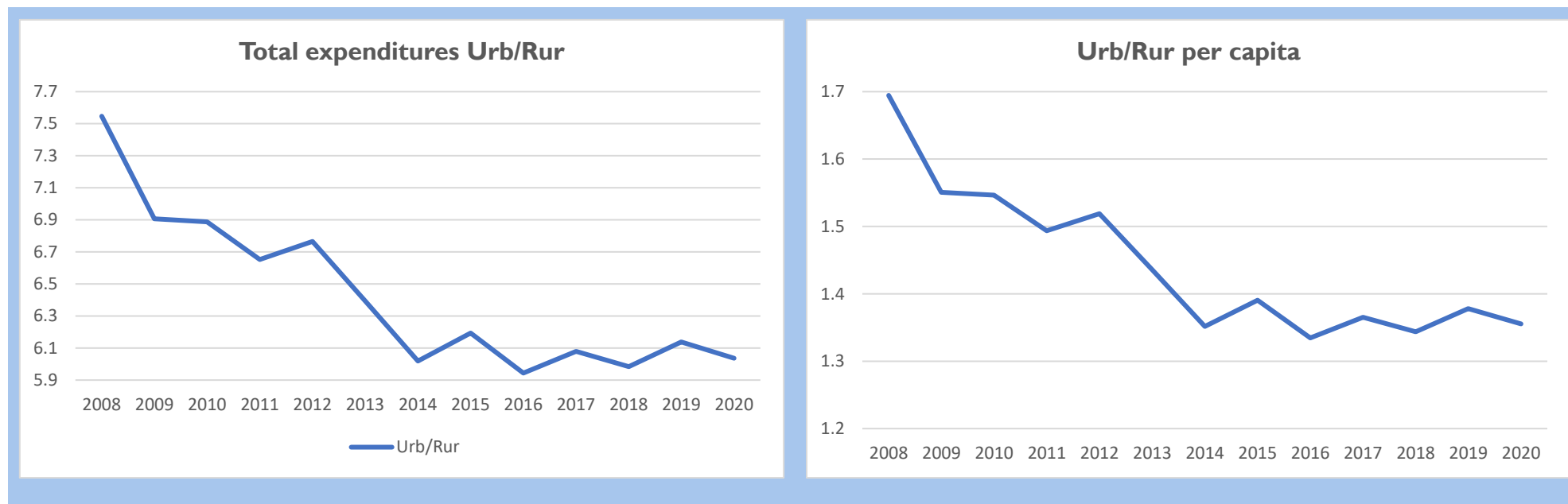
**Figure 3. Breakdown of efficiency by population classes.**

## 6.2. Total expenditures

The total expenditures gap between urban and rural LSGUs is relatively high but it declined for the period 2008-2020, as seen in the next graphs. Note that the 44 urban LSGUs make up 82% of the total RNM population, and the 37 rural LSGUs comprise only 18% of the RNM population. Thus, per capita data may provide a more useful basis for comparing urban vs. rural LSGUs, where we see that per capita expenditures are consistently higher—by approximately 5,000 MKD—in urban LSGUs during this period.



**Figure 4. Total expenditures for urban and rural LSGUs in RNM in MKD (left) and per capita (right).**

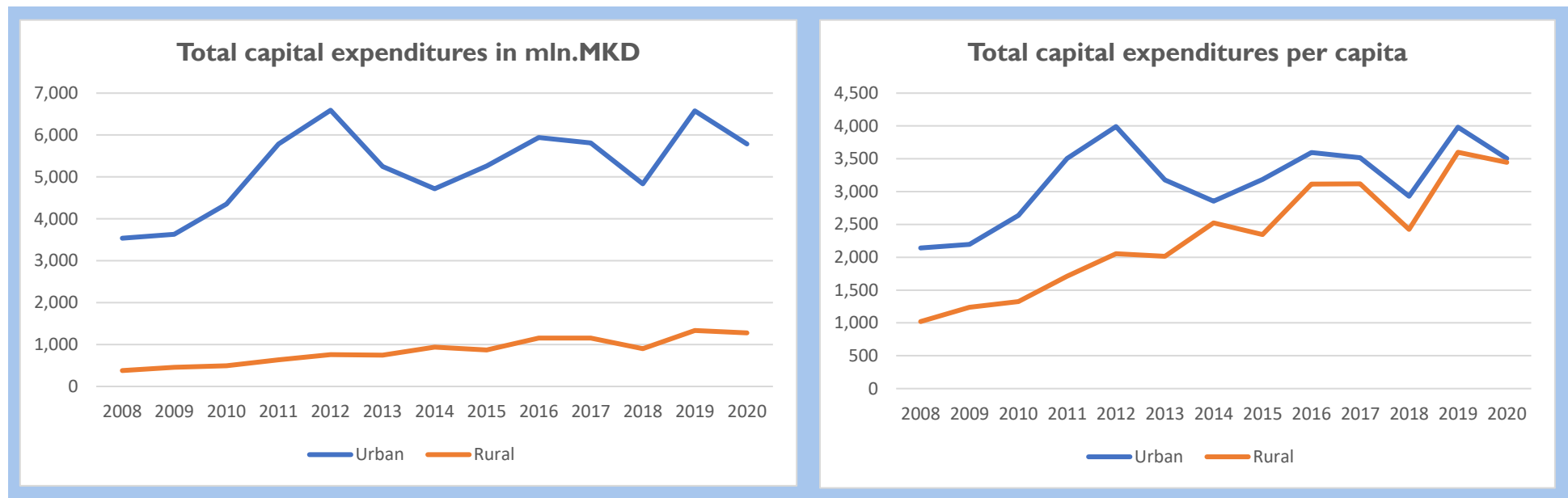


**Figure 5. Total expenditures urban over rural LSGUs in RNM in MKD (left) and per capita (right).**

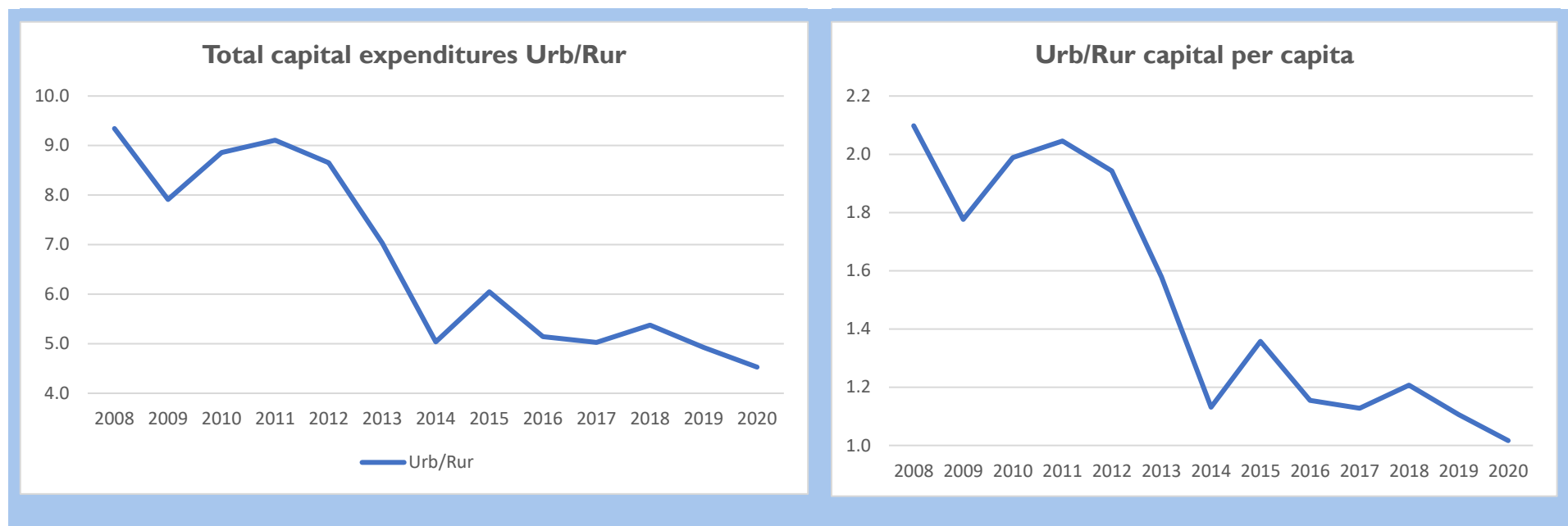
### 6.3. Capital expenditures

The total gap in capital expenditures between urban and rural LSGUs is relatively high but it declined for the period 2008-2020. The gap between urban and rural LSGUs for capital expenditures is less than that for total expenditures, and in 2020 is around four times as great.

Again, the 44 urban LSGUs make up 82% of the total RNM population, and the 37 rural LSGUs represent 18% of the population. Thus, we also present the per capita data for relative comparison.



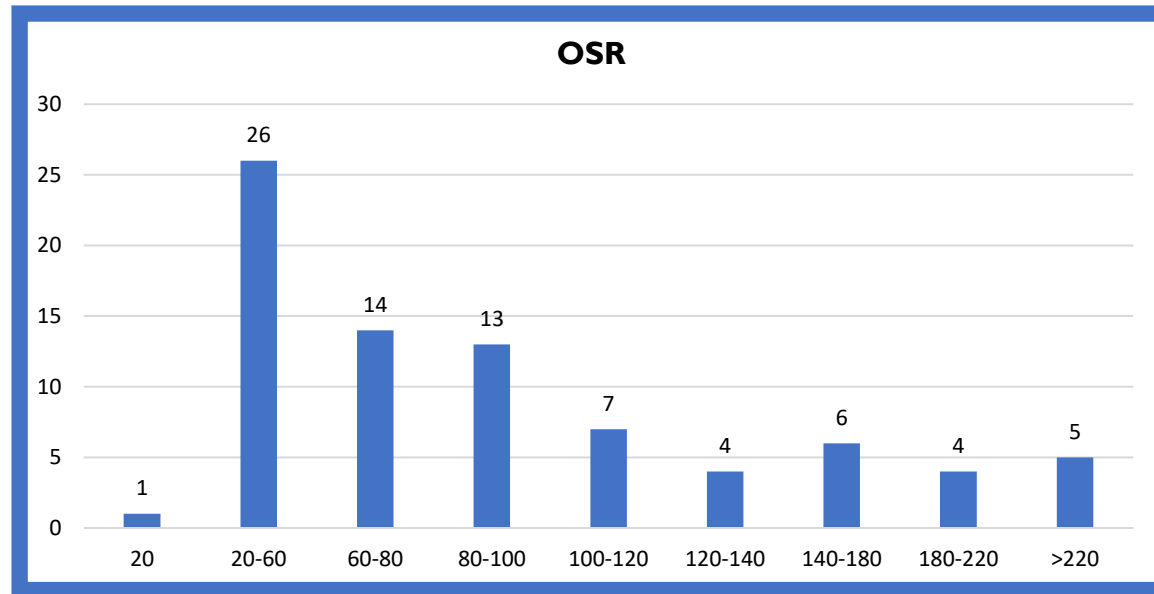
**Figure 6. Total capital expenditures for urban and rural LSGUs in RNM in MKD (left) and per capita (right).**



**Figure 7. Total capital expenditures for urban over rural LSGUs in RNM in MKD (left) and per capita (right).**

#### 6.4. Own-source revenues

More than half of the LSGUs (54 of 80) collect less than the average collected for RNM. The average for RNM is indexed at 100 and presented in Figure 8. We can see that the mode is for a collection rate of 20%-60%—that is, 26 LSGUs collect OSR between 20%-60% of the average OSR for all LSGUs in RNM.

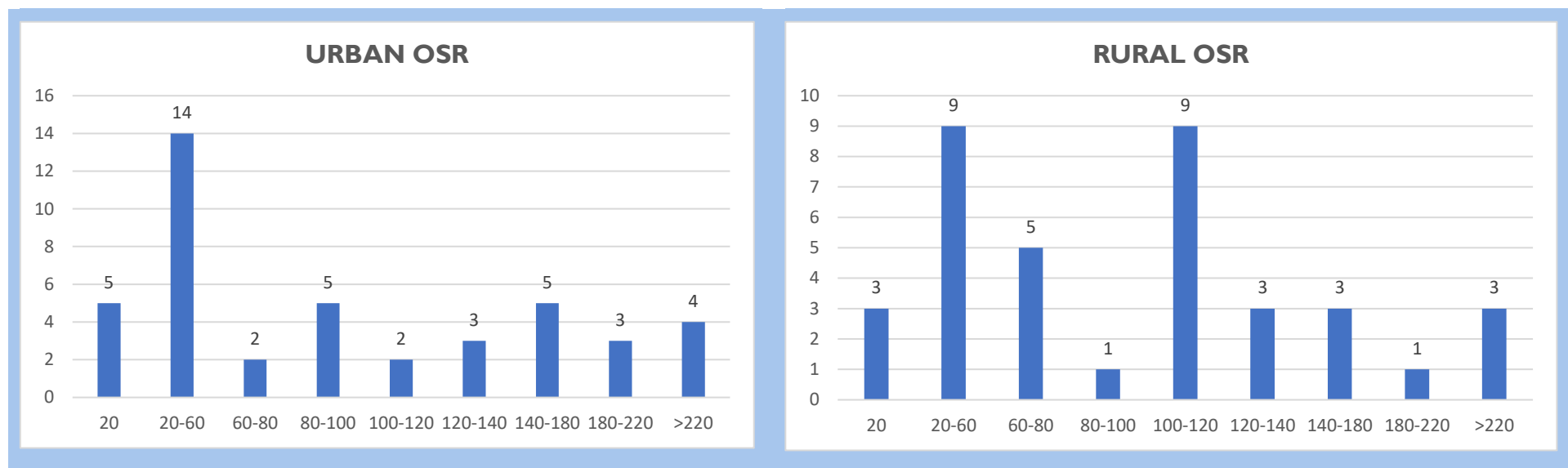


**Figure 8. Distribution of LSGUs by OSR collected compared to the average OSR for RNM.**

### 6.5. Own-source revenues per capita

Figure 9 presents the urban and rural OSR distribution of number of LSGUs as per the collection of OSR, compared to the average urban and rural OSR collection in RNM.





**Figure 9. Distribution of number urban and rural of LSGUs as per the collection of OSR compared to the average urban and rural OSR in RNM.**

Note that for urban LSGUs, more than 50% collect less than the average OSR per capita. The mode for urban LSGUs is a collection rate of 20%-60%—that is, 14 LSGUs collect OSR between 20%-60% of the average OSR for all LSGUs in RNM. For rural LSGUs, there are two modes. One is for a collection rate of 20%-60%—that is, 9 LSGUs collect OSR between 20%-60% of the average for all LSGUs in RNM, and 9 LSGUs collect between 100%-120% of the average OSR collection for all LSGUs. Thus, most of the urban LSGUs collect less than the average OSR collected in RNM, whereas the situation in the rural LSGUs is more variable.

# POLICY OPTIONS FOR ASYMMETRIC TRANSFER OF COMPETENCIES

We will consider some options for asymmetric decentralization given the preconditions below:

- territory size
- population size
- type of LSGUs (urban/rural)
- fiscal capacity (own-source revenues per capita)
- financial capacity (personal income tax per capita)
- human capacity
- economy and wealth (economies of scale)
- access to natural resources (list of LSGUs with natural resources)

We argue that what followed decentralization reform in RNM after 2005 was more of a deconcentration than a devolution. Also, financing was applied to institutions and paying wages and salaries rather than to function<sup>8</sup>. There are additional factors that policy makers should consider when making decisions on reforming further decentralization<sup>9</sup>.

**One** factor might be that voter preferences in RNM are not as readily translated into budget outcomes as in industrial countries simply because of the low fiscal transparency and accountability (one proxy for RNM can be the relatively low fiscal transparency scores as per the open budget initiatives (OBI; available at <https://www.internationalbudget.org/open-budget-survey/country-results/2019/macedonia>).

The **second** factor was apparent in the 2017 local elections in RNM. During the campaigns, mayors spoke more about national problems than about local ones (thus, the local preferences were not revealed). Most importantly, central level politicians are more active in local elections than the local politicians. Thus, local elections are seen as nothing more than a rehearsal for the parliamentary elections. Perhaps this is a reflection of having a relatively short history of democratic experience.

The **third** factor is that decentralization in RNM might in fact be more of a deconcentration of national power and less of a devolution of power and fiscal autonomy to municipalities. In this scenario, reliance on the central government's funds for grants/public goods is retained, and there are no mechanisms by which local voters can reveal their preferences. In the end, less can be gained from this form of decentralization than in other industrialized countries. This is simply

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<sup>8</sup> This also prevents using PPPs for functions in education and kindergartens.

<sup>9</sup> More detailed discussion in Nikolov M. (2013); Cost efficiency of municipalities in service delivery: Does ethnic fragmentation matter? Link: <file:///C:/Users/Marjan/AppData/Local/Temp/1-Book%20Manuscript-79-1-10-20150920-1.pdf>.

because the power remains in the center and is likely to lead to lobbying, continuous bargaining, uncertainty, conflict, and economic fluctuations between central and local government. It might also promote transactional behavior and favoritism for municipalities in which mayors' political affiliation aligns with those in the central government or create obstacles for municipalities with mayors whose political affiliation differs from those in central government.

The **fourth** factor can be the inadequate financial resource transfers for some services (e.g., education, firefighting, and roads) and forcing municipalities in RNM to provide services when they cannot do so efficiently. This hinders the ability to maintain the existing yet depreciated assets. Also, the non-optimal transfer of competencies to the local government (unfunded mandates on municipalities in RNM) might create unsustainable fiscal stress on local government due to the large fiscal gap.

The **fifth** factor is that there might be difficulties in decentralization management given the lack of proper experience, skills, and knowledge.

The **sixth** factor is that in RNM, there are constitutional post-Ohrid framework agreement requirements on equal representation of ethnic minorities in local public administration, language requirements, and education requirements to align country unity along ethnic lines that are the direct responsibility of the municipalities. Thus, decentralization can be considered the key policy choice for providing political stability and Macedonian national cohesion, not only promoting economic efficiency. But the preferential policies behind the decentralization are costlier and require additional financial resources (e.g., multilanguage administration of services).

These questions raise complex issues that must be considered in any decentralization reforms that transfer additional competencies to the LSGUs.

## 7.1. The decentralization architecture

Certain demographic and socioeconomic factors in the country should be considered when embarking on a reform to the structure of decentralization:

- Census and data availability
  - Census data
  - Other data availability
- Demographic age distribution and family characteristics
  - Aging population demands different types of services
  - Emigration is changing the scope and nature of demands for public services
  - Older population demands more health, parks, homes for elderly, better access to institutions, etc.
  - Younger population demands schools, sports, entertainment, etc.
- Spatial distribution of population
  - Urban population demands better infrastructure

- Rural population demands better access to education
- Economy and workforce
  - Home employment vs. administrative employment
  - Types and activity of businesses (SME vs. large industrial sites, agriculture/industry, etc.)
- Communications
  - Transportation
  - ICT and digitalization

## 7.2. The principles of transferring competencies

For each competency that policymakers consider transferring to LSGUs, they should ask the following questions, organized by principle:

- **Subsidiarity principle:** Functions should be assigned to that level of government whose jurisdiction most closely approximates the geographical area of benefits provided by the function.
- **Heterogeneity of preferences:** Persons or groups (depending on age, ethnicity, economic welfare, etc.) living in different parts of a country may require different degrees (more or less) of certain services, a different quality of service (for a given amount), and/or a different approach to public service delivery. Under such circumstances, local governments can be the appropriate service provider.
- **Economies of scale:** Public goods and services should be provided by the level of government that can best realize economies of scale in production of the good or service. Economies of scale refer to the unit cost of production. For any good or service, increasing the amount produced may result in increased, decreased, or constant unit costs. Other things being equal, the type of government that can deliver a good or service at the lowest possible cost should provide that service. Economies of scale generally exist when a capital-intensive enterprise can spread the high cost of capital over a large number of customers. For example, building a sewage treatment plant or a landfill that services a larger region may be more cost-effective than having each LSGU build its own capital-intensive treatment plant.
- **Intermunicipal cooperation:** If the activity of one LSGU has an important external effect, whereby its actions create added value (positive externalities) or costs (negative externalities) for individuals or businesses located in another jurisdiction, then the responsibilities for providing (or, in the case of negative externalities, limiting or compensating for) these services should be coordinated intergovernmentally. Mechanisms for cooperation can range from intermunicipal cooperation to using the centers for planning regions, e.g., the possibilities that balanced regional development regulation provides.
- **Public-private partnerships** (e.g., outsourcing, leasing, and other types of service contracts with private sector): Examples include billing, maintenances of assets, etc.
- **Regulatory and human capacity:** Functions should be assigned to a level of government that can effectively manage that function. Specifically, it should have adequate legal authority and management capacity to perform its assigned functions and be willing to pursue intergovernmental policies for promoting interjurisdictional cooperation. If there is a lack of capacity, then that lack of capacity can be managed with a phased

approach in decentralization reform when assigning new functions to the LSGUs or reconsidering the existing assigned functions to the LSGUs.

### 7.3. What can be done

These are existing instruments or mechanisms whose potential has not been fully realized:

- **Law on Financing LSGUs:** Use it to introduce hard budget constraints by enforcing the financial instability clauses.
- **Intermunicipal cooperation:** Consider introducing matching grants or other funds from the central government to employ this instrument for targeted services: a) administrative works for joined tax offices and other administrative services, such as internal audit, legal services; or b) for direct public service delivery in education, early childhood education and care, solid waste management, etc.
- **Delegation of competencies:** Delegation of competencies, in contrast to transfer of a competency, is voluntary. This means that both the line ministry and the LSGUs agree that there will be a competency delegated to the LSGU. Both must agree to the delegation and a voluntary agreement (e.g., contract) is signed by the parties.
- **Building fiscal capacity:** Improve local tax administration capacity and taxpayer morale and behavior. This can provide a higher collection rate of OSR without changes in legislation and without applying higher tax rates. Also, ICT support from the central government to LSGUs for the tax administration and the cadaster-LSGU connection.
- **Public private partnerships:** Take advantage of outsourcing, leasing, and other types of service contracts with the private sector (e.g., billing, maintenance of assets, etc.).

### 7.4. Asymmetric transfer of competencies

Given the preceding discussion, there can be two kinds of options for organizing asymmetric service delivery from LSGUs:

- Options that *do not* require territorial redefinition:
  - Intermunicipal cooperation
  - Administrative decentralization (e.g., deconcentration)
  - Delegation of competencies
- Options that *do* require territorial redefinition:
  - Consolidation of LSGUs
  - Introducing different types of LSGUs (e.g., introducing Cities-gradovi i municipalities-opshtini under some socio-economic criteria)

We outline these options in Table 2 below.

**Table 2. Matrix of options and characteristics.**

		Driven by precondition	Permanent or transitional	What is it	Legislation	How to implement	Comments	PROS and CONS
No territorial redefinition	Intermunicipal cooperation (IMC)	Fiscal and human capacity	Permanent or transitional	Horizontal service contract	Existing legislation	LSGUs with capacity sign contract with one or more neighboring LSGUs	Central government incentivizes IMC	Existing legislation provides good platform.  Not all competencies can be subject of intermunicipal cooperation
	Delegation of competencies	Fiscal and human capacity	Permanent or transitional	Vertical service contract	Existing legislation	Line ministry signs contract with one or more LSGUs for specific competency	Central government must have transfers/grants for delegated competencies	Clear list of competencies  No precedence yet in RNM and difficult to calculate the compensation
	Deconcentration	Fiscal and human capacity	Permanent	Shifts responsibility from central government by creating field administrations under the supervision of central government	Change of legislation	Central government offices of different ministries or government bodies are opened in LSGUs	Process can start in phases	Some competencies can be closer to the citizens given the socio-economic characteristic of the region (for example Strumica as agriculture center and  Ministry of agriculture, forestry and water economy)

								It takes good planning of transfer of human resources, assets, and equipment.
	Conditional decentralization	Fiscal and human capacity	Transitional	Gradual devolution of responsibilities proportional to the demonstration of greater capacity	Change of legislation	Central government assigns conditions for monitoring progress of development of LSGUs (human capacity, LSGU debt and level of unpaid bills/arrears)	This has already been regulated in the existing Law on Financing LSGUs	It recognizes the differences among LSGUs  Finding the proper conditions for monitoring the progress of the LSGUs
Territorial redefinition**	Consolidation of LSGUs	Territorial and urban rural differences	Permanent	Legal document	Change of legislation	Consolidating LSGUs to the 34 LSGUs as before the 1996	All 34 LSGUs before 1996 had a populations greater than 10,000 (except Demir Hisar with 9,497 population)*	Recognizes the economic efficiency of LSGUs  Does not cover all the political demands
	Different levels of LSGUs (introducing Cities (gradovi) and municipalities (opshtini))	Territorial and urban rural differences	Permanent	Legal document	Change of legislation	Consolidating LSGUs to the 34 LSGUs as before the 1996 as Cities (urban) and the other LSGUs as municipalities (rural)	Define as cities (urban) those 34 from before 1996 and introduce municipalities (rural) for the other 46  Assign different packages of competencies to cities and to municipalities	Recognizes the economic efficiency of LSGUs  Finding the proper criteria for defining cities and municipalities

\*Note that the empirical evidence shows that the most technically efficient LSGUs in RNM have a population of approximately 10,000.

\*\*Note: Territorial redefinition can be politically sensitive given the environment in RNM.

# ANNEX I

**Table 3. Illustration of the two-phased approach to fiscal decentralization in Macedonia.**

Phase	Starting date	Assignment of responsibility	Conditional on
Phase I	1 July 2005 (with amendments on 30 Dec 2004)	<ol style="list-style-type: none"> <li>1. TRANSFER OWN-SOURCE REVENUES FROM TAX SOURCES (PIT SHARING) TO MUNICIPALITIES (CENTRAL GOVERNMENT)</li> <li>2. DEVELOP A METHODOLOGY FOR TRANSFERRING CAPITAL AND EARMARKED FUNDS (CENTRAL GOVERNMENT)</li> <li>3. LOCAL GOVERNMENTS START IMPLEMENTATION OF THE PLAN FOR RESOLVING ARREARS UP TO 31 JANUARY 2001 (LSGUs).</li> </ol>	<p>90% OF THE TOTAL MUNICIPALITIES COMPRISING 90% OF THE TOTAL POPULATION PROVIDING:</p> <ol style="list-style-type: none"> <li>1. AT LEAST 2 FINANCIAL OFFICERS</li> <li>2. AT LEAST 3 TAX EXPERTS</li> </ol>
Phase II	Conditional	<p>ASSIGNMENT OF RESPONSIBILITIES (FOR BLOCK TRANSFERS):</p> <ol style="list-style-type: none"> <li>1. CULTURE</li> <li>2. SOCIAL WELFARE AND CHILD PROTECTION (KINDERGARTENS AND HOMES FOR ELDERLY)</li> <li>3. EDUCATION (PRIMARY AND SECONDARY SCHOOL)</li> <li>4. HEALTHCARE (PUBLIC HEALTH ORGANISATIONS AND PRIMARY CARE)</li> </ol>	<ol style="list-style-type: none"> <li>1. ALL THE CONDITIONS FROM PHASE I ARE SATISFIED.</li> <li>2. THE PROPER CAPACITY OF THE FINANCIAL OFFICERS (ALSO IN PHASE I).</li> <li>3. VIABLE RESULTS OVER 24 MONTHS FOR TIMELY AND REGULAR REPORTING CONFIRMED BY THE MINISTRY OF FINANCE.</li> <li>4. THERE ARE NO ACCOUNTS PAYABLE OTHER THAN USUAL ONES (UP TO 90 DAYS).</li> <li>5. A COMMISSION WILL EVALUATE IF ALL THE CONDITIONS ARE SATISFIED.</li> <li>6. THERE IS A WRITTEN REQUEST FROM MUNICIPALITIES TO THE PROPER MINISTRY THAT PLAN THE BLOCK TRANSFERS AND THE MINISTRY OF FINANCE TO GRANT BLOCK TRANSFERS AFTER ALL CONDITIONS ARE SATISFIED.</li> </ol>



Phase I related only to the construction, maintenance, and operation of premises for education, social services, and culture. This coincided with the introduction of earmarked grants from the central government. The system of earmarked grants was introduced, intended to cover the operation and maintenance costs of the designated competencies (actual operation and maintenance of existing buildings and tangible assets). These were comprised of utilities, heating, communication and transport, materials and tools, repairs, current maintenance, and contractual services.

Phase II was initiated in 2007, with devolution of teacher and other personnel salaries and with the introduction of block grants. Under the second phase, block grants are paid, also for operation and maintenance, but which now include employee salaries and benefits.

The phased approach to fiscal decentralization is closely connected to the transfers from central government. The major principle of this phased approach was to project a “hold harmless” gradual devolution of responsibilities proportional to the demonstration of greater capacity by local governments to undertake those responsibilities, and to provide an equitable and adequate transfer of funds for the efficient and ongoing execution of transferred competencies.