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FISCAL DECENTRALIZATION AND ALTERNATIVE FINANCIAL SOURCES FOR THE LOCAL SELF-GOVERNMENT IN REPUBLIC OF NORTH MACEDONIA - OVERVIEW

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ABSTRACT

Local governance in developing countries demonstrates many problems related to financial sources and good governance of their finances. Local Self-Government (LSG) units in the Republic of North Macedonia are very small which results in a lack of capabilities to raise enough funds to offer delegated services. The local government in the Republic of North Macedonia centralizes almost all public finance. Local budgets depend heavily on state transfers and donations from the central budget. The lack of funds remained a crucial problem even though there were some attempts for the decentralization process. Practically, governments in many of the local governments in North Macedonia could not secure their resources. In this way, they could come with specific charges, but all taxes are decided by the central government. The practice showed that local governments before borrowing needs to be approved by the Ministry of Finance.

The Republic of North Macedonia as a potential candidate to join the European Union should make several changes regarding the legislation during the process of accession to benefit from being a small candidate country. The main aim of this paper is to investigate alternative

financial sources such are *Municipal Bonds, Partnership Sukuk securities, and PPP*. Unfortunately, many financial alternatives have not been able to be implemented due to failures in reforms and good financial governance. But they remain an open opportunity for developing a local government in the future.

Key words: *fiscal decentralization, alternative financial sources, municipality, LSG, LED.*

INTRODUCTION

The process of fiscal reforms, in the Western Balkan countries with special emphases on the Republic of North Macedonia, was conducted in unfavourable socioeconomic and political circumstances. The reforms of fiscal decentralization should assign fiscal decision-making powers and management responsibilities to local government while transferring adequate sources of financing. The experience of many transition economies shows that adequate revenue nonavailability leads to inefficiencies of public services and causes the failure of local government such are municipalities.

One of the crucial problems that local authorities face in managing public finance is the lack of coordination including the planning of public budgetary revenues and the implementation of the plan. The process of fiscal consolidation, in general, is a very complex process that depends on many endogen and exogenous factors and determines the success of fiscal reforms on the local and central levels (Mazllami & Osmani, 2016).

The objective of this research is to offer an overview of opportunities for financing the LSG with alternative financial sources such as *Municipal bonds, Partnership Sukuk securities, and PPP* in addition to institutional resources of financing.

FISCAL DECENTRALIZATION PROCESS IN REPUBLIC OF NORTH MACEDONIA

The decentralization process in the Republic of North Macedonia was implemented in two phases including the null phase. The null phase is necessary for the reconstruction and consolidation of necessary capacity for financial management at the local level to improve the collection of fiscal revenues by the municipality. For initiating the start of the decentralization process there are two reasons: The Ohrid Framework Agreement (OFA), a peace treaty that ended the 2001 ethnic conflict in North Macedonia and to comply with the requirements for a candidate's status to join the European Union.

The first phase of fiscal decentralization started in July 2005, and the central government delegated its authority to collect municipal income tax, drafted methodology for transferring capital, and earmarked grants from central to local governments. It should be noted that in this period some laws in the field of financing have been amended, such as The Law on Property Taxes, the Law on Communal Fees, and the Law on Administrative Fees (*Law on financing LSG*, 2004).

The Government of the Republic of North Macedonia shall establish a commission for monitoring and assessing the fulfilment of the conditions for transition to the second phase of fiscal decentralisations, according to the Law of financing LSG (2007) "…*fulfilled the conditions of the first phase; good financial results in at least 24 months, there are no outstanding liabilities to suppliers or any other creditors that exceed the usual payment terms, and other conditions provided by law".*

The second phase of fiscal decentralization began in January 2007, as municipalities are fulfilling the assessment of key criteria stated above. The successful municipalities (LSG) will be enabled to receive block transfers for culture, social welfare and child protection, primary and secondary education, and primary healthcare (*Law on financing LSG*, 2007).

During the transition period, the Republic of Macedonia and from 2019 as a Republic of North Macedonia (according to the Prespa agreement), the number of local self-governments was changed from 34 (1976) to 123 (2003) and 80 (from 2013) (Figure-1).

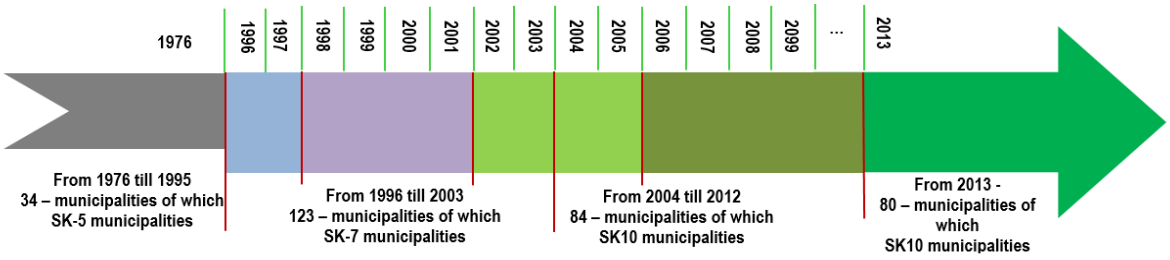


Figure 1. Administrative division of the Republic of North Macedonia (1976–2021)
Source: Created by the author, Ministry of Local Self-Government – RNM.

The Republic of North Macedonia from the year 2013 is divided into 80 municipalities (according to the Law of territorial organization of self-government and Law for the city of Skopje). According to the second level of fiscal decentralization, to which are delegated many important educable, property, judicial, social, and economic functions.

Local self-governments can derive their revenues from a vast array of sources. The budget code lists approximately 300 such sources, the most significant of which can be grouped into the following categories (Word Bank, 2019):

- *Block grants from the central government to finance specific services (Education, Culture, Social)*
- *Unconditional grants and shared taxes (WAT transfer*, Shared PIT)*
- *Locally administered taxes and fees (Recurrent Property Tax, Property Transfer Tax, Fees*
- *Revenues from the sale or development of land (Land development Charges-Sale of Land)*
- *Other sources (Grands, Transfers, etc.)*

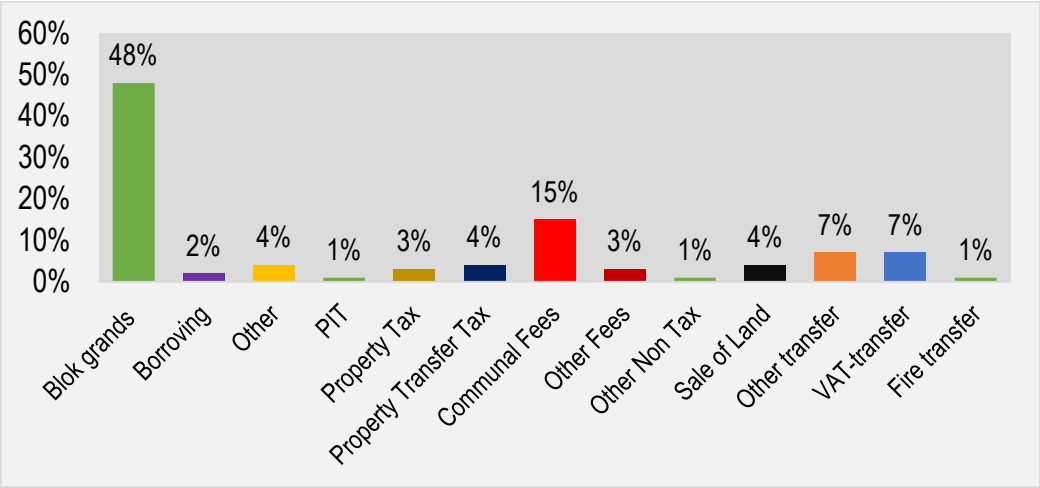


Chart 1. Sources of municipal receipts in Republic of North Macedonia (2017)
Source: *World Bank (2019), author's design.*

*Article 9 (1) of the current municipal finance law (2019) specifies that the total amount of the grant should be 4.5 per cent of VAT revenues in the previous year. VAT transfer consists of two parts: 12-15% for the Skopje municipalities and the City of Skopje, and 88-85% for other municipalities.

All Progress Reports for Macedonia published by the European Commission so far have stressed the fact that fiscal decentralization is inadequate, that administrative capacity is insufficient, and that local economic development does not yield the expected results and desired effects, which ultimately should contribute to greater economic growth and development with increased employment (Hristov et al, 2013). In general, in the EU, almost 55% of revenues are met by local governments from their own sources, while in the Scandinavian countries it is around 75%. Unfortunately, in North Macedonia, LGS does not have control over tax rates and in this case, LGS revenues generated from own sources are less than 20%, such as transfers from the central government (see Chart 1).

Kay Spearman (2007) in his book *Financial management for local government* underlines that the decentralization process should offer conditions and opportunities for funding the municipalities with an optimal structure of financial resources, led by municipalities to maximizing their income. This strategy aims to create a self-sustaining municipality, without being assisted by the central government, except in the case of some capital investments that are of interest to the whole country.

After this decentralization process, the Republic of North Macedonia remained the most centralized country compared to the EU countries. The local self-government (municipalities) in the country unfortunately are under-funded compared to municipalities in the EU. The Republic of North Macedonia should take serious reforms to begin to provide local governments with equitable funding for decentralized functions, simply because the central government has a lack of funding to LSG.

ALTERNATIVE FINANCIAL SOURCES FOR MUNICIPALITIES – LOCAL SELF-GOVERNMENT (LSG)

If we analyse the financial problem of LCG in North Macedonia and if we search for a solution within the existing economic literature and practice among the more developed economies, we will see that the latest methods for financing the municipalities are also alternative sources from which we would single out: Municipal bonds, Sukuk securities and Public-Private Partnership (PPP).

Municipal bonds

Bonds are debt instruments where the lenders are the bondholders, and the bonds are securities issued on the primary market and traded on the secondary securities market. The bond is a long-term debt security, by which the issuer of the bond undertakes to pay to the bondholder one-time or in instalments (annually, semi-annually, etc.) the amount of the nominal value of the bond and interest on the specified day (CES, 2011).

According to the "Procedure for issuing municipal bonds" SEC Republic of North Macedonia, Municipal bonds are defined as long-term bonds issued by LSG units to finance projects of general interest or to finance the current needs of the budget. Municipal bonds provide municipalities with initial funding for local capital projects and investments in the construction of schools, roads, bridges, gyms, playgrounds, gasification and other alternative energy sources, water supply, treatment plants, multi-story garages, and other infrastructure projects.

Municipal bonds are loans securities. Issuing municipal bonds represents the easiest way to attract investors outside of the banking sector. By issuing bonds, local self-government gets immediate access to the private capital market. In general, municipal bonds should be the most transparent, but also the most efficient way of local government borrowing (Petersen & Crihfield, 2000).

According to Dave Geschke, President of Hilltop Securities Independent Network, in the United States, central and local governments and public entities like universities, hospitals, and utility districts issue municipal bonds to fund vital infrastructure development. According to some records, the first general municipal bond in the U.S. came about in the early 1800s, when New York City issued the first municipal bond to finance the construction projects (canals from the Hudson River to Lake Erie and Lake Champlain).

According to the economic literature, in general, there are two basic types of public debt securities issued by municipalities: ***general bonds*** and ***revenue bonds***. General bonds are backed by the "full faith and credit" or full taxing capacity of their issuers, whereas the revenue bonds are normally issued as "term bonds", in which the payment of the principal falls on the date of maturity (Galiński, 2013). Depending on the activities of the local authorities, these bonds can be RANs ***(revenue anticipation notes),*** TRANs ***(tax and revenue anticipation notes)***, as well as ***industrial development bonds*** (Feldstein & Fabozzi, 2008)**.**

Common to most municipal bonds are general's characteristics, as the following:

- Attract fresh capital and initiate local economic growth,
- The municipal bonds can grant tax relief from central or local authorities,
- Have lower interest rate,
- Low level of liquidity which has an impact on inefficient functioning of the securities exchange market,
- Municipal bonds are issued in the short and long-term ranging from 1 to 30 years based on the national law.

The benefit of Municipal bonds is multidimensional. They are being used by the local authorities for collecting new financial capital for current needs (a local budget deficit), and that is done through general bonds which offer *low-risk level to the investors, because the municipality is going to return this capital by increasing the local taxes, limitation of local expenses or decreasing of the local budget* (Shukarov and Ivanovski, 2005). Usage of municipal bonds has real financial character. It means emitting bonds for specific projects: *construction of infrastructural facilities - roads, bridges, sport entertaining buildings, projects*

with a public character like those concerning tourism, public institutions, and projects for constructing a specified number of apartment buildings which will be owned by the municipality and which latter are going to be sold to private buyers (Bowman & Kearney, 2013).

The experience of the neighbouring countries and the Western Balkans countries compared to North Macedonia are sending positive signals regarding the efficient and effective usage of this financial alternative source. Croatia for example uses municipal bonds since a long time ago (e.g. municipalities Koprivnica, Zadar, Rijeka, Split, Osijek, and Vinkovci). Bulgaria has also emitted municipal bonds, as is the case with Svilengrad Municipality, etc. (Bexheti et al., 2008).

According to the Law on Financing of the Local Self-Government unites, the municipalities can be indebted by concluding a loan agreement or by issuing securities. Municipalities may borrow money by Municipal bonds with the prior consent of the Government of the Republic of North Macedonia, provided based on a positive opinion from the Ministry of Finance. The positive opinion from the Ministry of Finance on municipalities borrowing by issuing bonds includes:

- ✓ Harmonization amount of borrowing under the limits in the Law on Financing of the Local Self-Government Units.
- ✓ Harmonization of the amount of borrowing with the targets in the Public Debt Management Strategy.

The local self-government units start the procedure for borrowing with Municipal Bonds by submitting a Request for Opinion for borrowing to the Ministry of Finance. The LSG borrowing process can be briefly described as follows:



Figure 2. The LSG borrowing process in the Republic of North Macedonia
Source: CES, author's design.

The local self-government units start the procedure for borrowing with Municipal Bonds by submitting a Request for Opinion to the Ministry of Finance. With the request for each new borrowing, the LAG submits the following data:

- The decision of the Municipal Council;
- Purpose of borrowing;
- Proposed conditions under which the municipality wants to borrow;
- Completed borrowing forms;
- Information on the sources of funds;
- Statement of the mayor notarized, with personal criminal responsibility
- Whether there are outstanding liabilities to creditors within 90 days from the date of arrival;
- Notification from the Mayor of the municipality for the occurred financial instability;
- Notification from the Mayor of the municipality that the Borrowing Request is under the Strategic Priorities of the Government of the Republic of North Macedonia.

Depending on for whom the issue of municipal bonds is intended, the municipalities initiate a procedure to the Commission of Exchange Securities of the Republic of North Macedonia for obtaining approval for issuance of securities by private or public offering.

- *The private offering* is an offer of municipal bonds intended for a limited number of investors, with whom the issuer has agreed in advance to buy the municipal bonds that are the subject of the offer.
- *Public offering* of municipal bonds under 25,000 euros does not require approval from the Securities and Exchange Commission but is obliged to comply with all other provisions of the Law on Securities in the Republic of North Macedonia. The public offering of securities is done through the stock exchange; the municipality should contract an agreement with an authorized participant in the securities market (brokerage house or a bank with a license from the CES).

Municipal bonds are missing from the Macedonian Securities Exchange Market. The explanations from local government for these circumstances can be various. Some of them are the local financing law and the inadequate legal regulations, insufficient information regarding the importance of the municipal bonds, lack of professional knowledge of the local authorities about bonds, political instability in the country, sanctions imposed from the central authorities, military-instability in the surroundings as well as other reasons.

The municipalities in the Republic of North Macedonia will have the right to offer municipal bonds only after decreasing their debts and after receiving positive feedback. In the past, there were some initiatives for providing training to the Mayors for utilization of the municipal bonds, who then did not have the opportunity to do the emitting. Whereas today, when bond usage is legal, most of the Mayors for these sources hear for the first time, while only a small part of them is thinking about how to put them among the priority sources. According to the Commission of Exchange Securities. Unfortunately, since the independence

of the Republic of North Macedonia till now (April 2021) any issue of Municipal bonds has not been registered.

Partnership SUKUK securities

Sukuk structures are new and among the most attractive financial instruments in the Islamic world. The speed through which they win the world is impressive. According to the different authors, Sukuk is different from conventional bonds in terms of co-movement with the global and regional market and they are considered complementary and not substitutes securities. The Securities Commission Malaysia (2012) define Sukuk as e financial document evidencing the transfer of funds between investors and the Sukuk issuer – in return for ownership and a share profits on/ from specified assets owned by the issuer using Shariah principles and concepts endorsed by the Shariah Advisory Council (Hasan, R. et al. 2019).

According to some records, their issues began some years ago in Islamic countries, but in the meantime, they also went towards non-Islamic markets. Research papers dedicate to Sukuk (Morny, 2019) underline that Sukuk can classify into two categories:

- Exchange-based Sukuk and partnership Sukuk. Exchange-based Sukuk (*murabahah, ijarah, bay' bithamanajil, musawamah*) are Sukuk that involve a transfer of assets from the issuer to investors.
- Partnership Sukuk (*mudharabah and musyarakah*) are Sukuk where investors engage funds into the issuing company and become partners with the company. Depending on the contract investors form a partnership among themselves and appoint the issuer as their agent.

Some authors have written "pro" and "contra" about Sukuk. In this case, Haron & Ibrahim (2012) are among the authors building a positive case while finding Sukuk has a significant impact on the Malaysian bond market development and companies use them to manage and adjust their capital structure to achieve their objectives.

Because many municipalities (LSG) in the Republic of North Macedonia are inhabited by Muslim citizens, it gives us the right to believe that the "Partnership Sukuk securities" can be attractive to issue by municipalities company and other companies (with fulfilling the conditions set by the Securities and Exchange Commission - Republic of North Macedonia). Related to this idea that Sukuk can be attractive for the Muslim companies or citizens, was our project "Sukuk – Muslim interest-free bonds and their possible application in the Republic of North Macedonia" implemented by professors of the Faculty of Business and Economics at the SEEU, where we concluded that in the future, municipalities should pay attention over the

possibility of issuing Partnership Sukuk securities, which so far haven't been issued in Balkans or wider in the region (Shukarov, Selimi, Mazllami and Zeqiri, 2008).

Public-Private Partnership - project

From the literature review, we can find various definitions of Public-Private Partnership (PPP). The content and objectives of PPP are different depending on the specifics of the country. A lot of them described the PPP as complex and very ambitious with a wide variety of arrangements whereby the responsibilities of LSG sharing the risk between the public and private sectors, realizing their common goals (Mazllami, 2014).

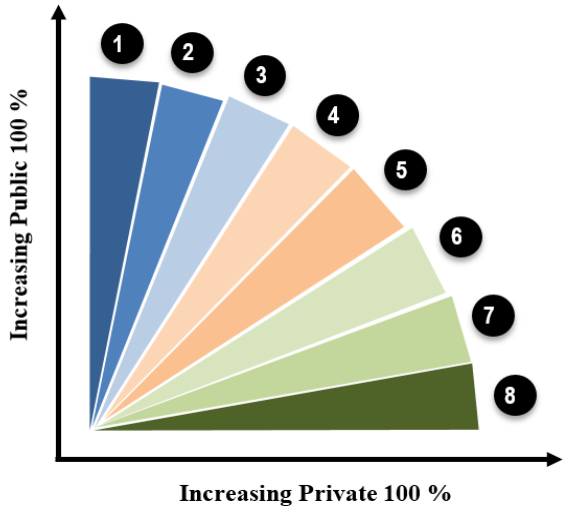
Public-private partnerships (PPP) in European Union legislation are defined as "cooperation between public authorities and the business sector which aim to ensure the funding, construction, renovation, management, or maintenance of an infrastructure or the provision of the service" (European Commission, 2004). These arrangements have been developed in several areas of the public sector and within the EU and are used particularly in the areas of transport, public buildings, or the environment (European Commission, 2004).

According to John R. Allan the PPPs in his paper "Public-private partnerships: a review of literature and practice" (1999), spoken broadly on PPP but here we will mention the main benefits of PPP, which are as follows:

- Leveraging of public funds
- Better management and allocation of risk
- Better incentives to perform
- Improved effectiveness
- Alternative revenue sources
- Access to economies of scale or scope
- Encouragement of multi-use infrastructure
- Improved service responsiveness

Authors Borzel and Risse (2002) explain the PPP spectrum where at one end of a public-private range (vertical axis) is defined as 100% publicly regulated while the other end is only 100% privately regulated. At one end of the spectrum, the authors define public regulation without the involvement of private parties, and at the other private self-regulation with non-public involvement. (Figure 3).

Between these two extremes Private or Public there are eight forms of organization such as:



1. *Public regulation: no involvement of private parties.*
2. *Lobbying of public parties by private parties.*
3. *Consultation and co-option of private parties.*
4. *Co-regulation of public and private parties (e.g., private parties as negotiation partners): joint decision making by the public and private parties.*
5. *Delegation to private parties (e.g., standard setting): participation of public parties.*
6. *Private self-regulation in the shadow of hierarchy (e.g., voluntary agreements).*
7. *Public adoption of private regulation: output control by public parties.*
8. *Private self-regulation (purely private regimes):*

Figure 3. The spectrum of Public-Private Partnership (PPP)
Source: Author's design based Borzel and Risse (2002) Public-private partnerships: effective and legitimate tools of international governance.

If we want to see the more extended spectrum of PPP between the Private and Public sectors, that is enabled by Bennett's model (Bennett et al., 2000) (Figure 4).

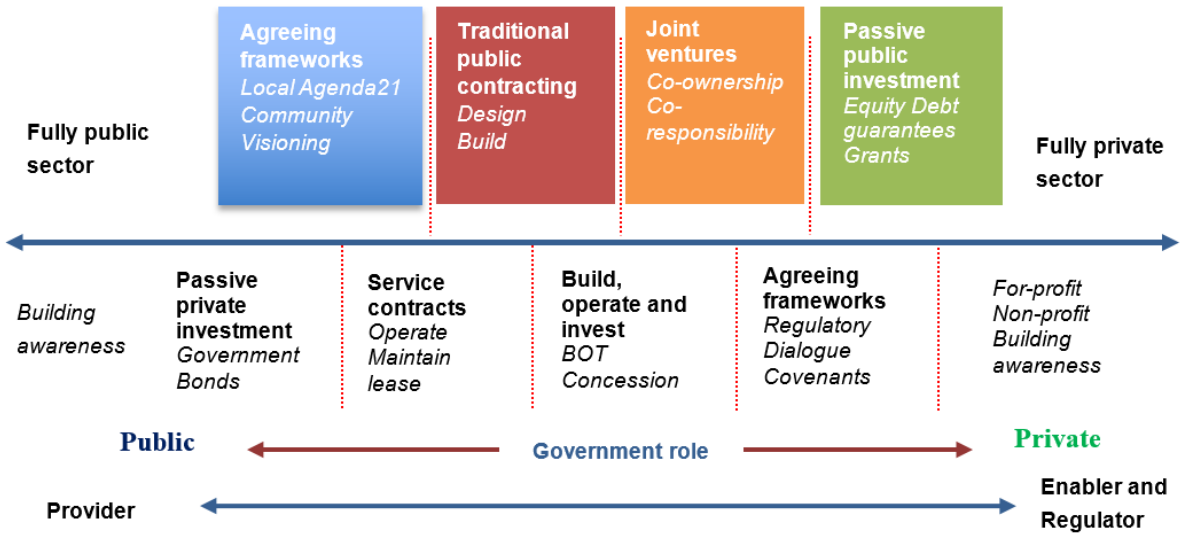


Figure 4. The extended-spectrum of Public-Private Partnership (PPP)
Source: Bennett's model, author's design.

From the Legal framework of PPP in the Republic of North Macedonia and reports of the World Bank, is noted that are adopted a set of concession, PPP, sectorial, and public procurement laws for PPPs at both the national and local levels, which are in alignment with

EU directives on public procurement (Hristovska & Spasova, 2018). The PPP policy is developed and supported by the Ministry of Economy and assisted by the Council on PPPs. However, familiarity with technical and practical aspects of PPPs remains low in government agencies, and experience in risk management is limited (Gallop et al., 2018).

According to the Law on Concessions and PPP in the Republic of North Macedonia, central and local government are used three types of PPP as following (Spasova, 2018):

1. Public works concessions *(airport, landfill for waste disposal);*
2. Public services concessions *(waste management, parking system, and public lighting);*
3. Public works contracts *(administrative offices buildings and green markets).*

The opportunities which are offered by BOT contracts are being used on large scale worldwide. They are also very appropriate for municipalities, of course, if they can define projects which at the same time can be useful for the municipality and attract interest towards the private investors for their utilization. BOT transactions can be very popular in the municipalities (LSG) where there are not enough funds, where there are restrictions in issue municipal bonds, where the incomes in the municipal budget are insufficient to settle the liabilities, or when the municipality has accumulated liabilities since earlier, and cannot demand e new debt. Usually, the municipality announces the offer for BOT transactions or directly invites eligible investors who have an interest in building and utilizing the project.

Public works and/or services concession contracts according to the international terminology are concession contacts, such as Build – Operate – Transfer (BOT) or Design – Finance – Build – Operate – Transfer (DFBOT) projects i.e., the user pay principle projects. The PPP law in the Republic of North Macedonia provides contracts for a period of up to 35 years (Hristovska & Spasova, 2018).

The Republic of North Macedonia has been realized some successful types of PPPs in the field of power and transport. According to the PPP law, the country in several important projects has allowed the private sector to make public partnerships with concessions (divestitures and greenfield). On this occasion, we can underline two projects such are: The international airports "Alexander the Great" in Skopje and "St. Paul the Apostle" in Ohrid. However, there is some potential sector that has an opportunity to use PPP to increase the conditions and services of touristic ski centres such as Kodra e Diellit (Popova Sapka), Mavrovo, recreation centre lake Treska and many services provided by public companies.

CONCLUSION

The decentralization and especially fiscal decentralization in the Republic of North Macedonia, in general, was a very complex process and passed with crucial political reforms with high risks to economic and political stability that in a certain case resulted even in inter-ethnic conflicts in the year 2001. This process in most cases has been supported by the EU and international institutions but unfortunately, the process of fiscal decentralization during the transition period of the Republic of North Macedonia has been very politicized and characterized by permanent inter-ethnic strained relations. The Republic of North Macedonia is characterized as the most centralized compared with EU countries. The municipalities (LSG) unfortunately are under-funded compared to municipalities in the EU. The municipalities lack sufficient resources to perform the functions assigned to them.

To improve or increase the functionality of local government (LSG), the Republic of North Macedonia immediately should take a serious reform to continue with new phases of fiscal decentralization to provide local governments with equitable funding for decentralized functions. In other words, the central government has "failure" with the funding process of municipalities (LSG). This unfavourable financial situation of LSG in the Republic of North Macedonia is proved by the information released by the Ministry of local self-government that 11 of 80 municipalities have blocked accounts (February 2021).

How to improve the financial sustainability of municipalities (LSG)? There is an alternative of financial sources which till now have not been used by LSG? The answers to the many questions of these problems would be a recommendation for the next step of fiscal decentralization in the Republic of North Macedonia, which is needed to realize in the period 2022-2026, as follow:

- ✓ Creation of Key Performance Indicators (KPI) for municipalities which would measure municipality's financial performance and helped central government for their underfunding (according to a methodology incorporate in Municipal financing law).
- ✓ Making a municipal budget based on a strategic plan for 4 years made by Mayer and approved by the municipal council.
- ✓ Increase local government revenues:
  - Increase of the local share of the VAT from 4,5% to 7% on the year 2022 and +1,5% for each next year, so in total 13% on the year 2026;
  - Increase of the local share of the municipalities' share from the Personal Income Tax (PIT) from 3% to 10% on 2022 and +2.5% for each next year, so in total 20% on the year 2025.
- ✓ Increase of the transfer funds or grants for education, culture, social, treatment of elders, sport, and recreation.

- ✓ Establish the national fund (2% of GDP) for 8 planning regions with their municipalities related a balanced regional development, LED, and sustainable local economic development.
- ✓ Expansion of new Local fees determined by law (to be covered by new Law of Municipal financing):
  - Introduction a charge fee for owning second-hand motor vehicles;
  - Introduction a charge appropriate compensation for citizens who use public parking space for their vehicles (in some municipalities).
  - Introduction a charge appropriate compensation for citizens who withdrawal from agricultural land use.
- ✓ Increasing the possibility to use of alternative financial sources for LSG, such as Municipal bonds, Partnership Sukuk securities, types of Public-Private Partnership (PPP).
- ✓ The level of projected expenditures or realistic spending should be not more than +10% of the mean amount of realized revenues during the last 4 years. If the budget execution is over 90%, municipalities retain the right to projected expenditures till +20% of the mean amount of realized revenues during the last 4 years.
- ✓ Creation of realistic municipalities' financial statements by local government.

The Republic of North Macedonia goes ahead toward opening official negotiations with the EU. In this way establishing the EU local office for IPA, IPARD, and other funds from the EU on urban municipalities is necessary. Those can develop projects and applications to attract those potential funds. Central authorities should create a team of expert who that will train the staff of the EU local offices to provide higher levels of efficiency of applications.

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