North Macedonia: Sustainability of Delivery, Financing for Municipal Infrastructure & Services

This Paper analyzes the financial situation of local government in North Macedonia and proposes options for reform. The findings and suggestions in this Report are informed by missions conducted in November 2018, December 2018, and May 2019, and draws upon a range of background documents, including the North Macedonia Public Finance Review (March 2019) and a detailed analysis of North Macedonia’s system of block grants, completed in December 2018. The report is intended for World Bank and Government consideration.

Executive Summary

Municipalities are the principal providers of urban infrastructure services (including water supply, sewerage, solid waste management, and local road construction and maintenance) and of pre-schooling, primary and secondary education. They also have a critical role in disaster risk management (DRM), including in risk identification, community preparedness, risk reduction and post-disaster recovery.

This Paper explores the following questions:

(1) Are municipalities under-funded?
Given their wide-ranging functional responsibilities, North Macedonia’s municipalities appear to be less generously funded that their regional counterparts. Spending on urban infrastructure, as a percent of GDP, is about 64% of the regional average, and spending on social services is about 84% of the regional average.

That North Macedonia’s municipalities spend comparably less on public services and urban infrastructure suggests that the level of local funding is a cause for concern. The case is reinforced by evidence of deficiencies in local services. While 93% of households have piped water and 89% have flush toilets, only 13% of sewerage systems are connected to sewage treatment plants. Further, municipalities do not currently systematically contribute toward investments to reduce disaster and climate risk for communities; examples of such investments would include, for example, regulating river beds, the establishment or training of a DRM Task Force for each municipality, and up-to-date fire protection equipment (i.e., sufficiently long fire hoses, resources to confirm hydrants work to fight fires).

Any increase in municipal revenues would need to come at the expense of either the central government (if funded through transfers) or taxpayers (if funded through local taxes and fees). If the Government of North Macedonia were to decide to increase local funding for infrastructure services, it should focus on instruments that will also increase the stability of local revenues. At present, the particular nature of the revenues assigned to municipalities results in a high degree of financial instability at the local level. In recent years, revenues from the property transfer tax, land sales, and ad hoc central government grants have fluctuated widely in individual jurisdictions. Revenues from the formula-driven equalization transfer (based on the VAT), the personal income tax, and the property tax have been much more stable. As a result, the most promising ways to increase local revenues would be through (1) an increase in the local share of the VAT, (2) an increase in the local share of the personal income tax, and/or (3) an increase in...
local property tax rates. To increase property tax revenues, the Government would need to increase tax rates, presently capped by central government regulations at extremely low levels (even relative to regional comparators). As the central government defines the formula for allocating funding to municipalities for education, any increase in such funding for education would require a central government decision to do so.

(2) Are disparities in per capita revenues among municipalities sufficiently addressed?
Although disparities exist among municipalities with respect to the level of funding for infrastructure services, the existing equalization transfer—based on the VAT—does a reasonable job of supplementing the own-source revenues of the poorest municipalities without excessive costs to the central government.

The current system for financing education, ostensibly based on enrollment, is equalizing and favors poorer, rural jurisdictions. This is largely because the allocation of funding is subject to ‘buffers’ that have prevented any substantial decrease in funding for schools with low and declining student populations. In principle, eliminating these buffers would force municipalities to close schools, freeing up resources for other purposes. But experience elsewhere suggests that the Government would have to accompany this reform with a concerted effort to assist local governments in the rationalization process.

(3) What should be done to forestall reoccurrence of municipal arrears?
The aggregate level of municipal arrears has generated Government concern. The arrears do not, however, result from systemic or widespread problems in municipal finance (e.g., a systematic underfunding, or unfunded mandates); rather, they result from historic behavior by a small number of “bad apples,” some of whom seem to have worked out a modus vivendi with their creditors in anticipation of a central government bailout. In October of 2018, the Government announced plans to provide grants totaling MKD 3.02 billion to help municipalities pay off their arrears, conditional upon municipalities reaching debt-reduction agreements with their creditors. Many creditors declined to write down the arrears owed to them, however, and the stock of arrears declined by only about twelve percent between September 2018 and March 2019.

The practice of repeated bailouts creates a moral hazard. If mayors know that a future bail out is highly likely, they have an incentive to continue making expenditure commitments that their municipalities cannot afford. And if suppliers and contractors know that their invoices will eventually be paid, they will be happy to go along. To reduce municipalities’ incentive to run up arrears, future debt relief could require a quid pro quo, in the form of a Government-imposed financial recovery plan, incorporating mandatory increases in local tax rates, staffing reductions, and cuts in capital spending. Such a solution is already authorized in the municipal finance law, but apparently has never been implemented.

(4) What can be done to improve performance of communal service enterprises?
In North Macedonia, water supply, sewerage, and solid waste management are generally provided by municipally-owned companies, most of which are organized as communal service enterprises (CSEs). While tariff levels are sufficient to cover actual operating costs, they are not sufficient to cover an adequate level of maintenance or to finance upgrades or new capital investments. One solution would be to increase tariffs. However, raising tariffs would not address well-known, widespread issues of operational inefficiency. In the most inefficient CSEs, there is room to reduce costs by reducing excess staffing, improving leak detection (to reduce technical losses), cracking down on illegal connections, and improving collection enforcement. This would allow CSEs to generate additional resources for maintenance and investment without significantly increasing tariffs.
(5) How can municipal capital investment planning be improved?
Capital spending accounted for about 20% of total municipal spending in 2017. Anecdotal evidence suggests that the efficacy of local capital investment planning is deficient, heavily influenced by the thematic focus and timing of funds from donors and central government ministries. There are several potential ways to improve capital investment planning, including consolidation of central government sectoral transfers, enhancement of the functionality of the existing Regional Development Fund (RDF), and the establishment of a municipal development fund. But such approaches would not solve the underlying challenge, which is that two thirds of municipal investments are financed from municipal own source revenues – which means that municipalities need to increase their own resources and technical capacity to plan and prioritize capital works.

(6) Do municipalities have sufficient resources to prepare for and mitigate against risks of natural disasters?
North Macedonia is vulnerable to natural disasters: more than 80% of urban (and 18% of rural) residential dwellings are exposed to seismic risk. Summer fires occur regularly, and flood risk is higher in North Macedonia than any other country in the Europe and Central Asia region. A recent World Bank disaster risk management (DRM) sector assessment1 for North Macedonia found that, compared to other countries in the region, North Macedonia has relatively low resilience - when considering factors such as potential asset losses, access to warnings, and protection from the financial shock associated with disasters.2 A major flood or earthquake disaster would derail economic growth, affect critical infrastructure, and disrupt livelihoods.3 With climate change, the annual damage to critical infrastructure from climate-related hazards is expected to double by 20206 and by 2080 could be more than five-times higher7.

Municipalities play a major role in natural disaster management. Municipalities are required to undertake risk assessments, monitor their own preparedness, and adopt an annual program for protection and rescue in line with the National Strategy for Rescue and Protection. In addition, responsibility for fire and rescue services has been decentralized to the municipal level.

While the legal framework for disaster management is largely in place, vulnerabilities from climate and disaster risks are exacerbated by national and municipal policy, institutional and resource

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1 UNISDR has also undertaken a review of civil protection mechanisms and legislation, https://www.unisdr.org/files/9346_Europe.pdf pg 114.
2 Hallegatte et al. (2016).
3 In North Macedonia, 82% urban (and 18% rural) residential dwellings are exposed to seismic risk, for example. Also, flood risk is higher in North Macedonia than all other countries in the Europe and Central Asia region, and by 2080, the impact of floods on GDP is expected to quadruple (source: World Bank (2016a).) The most recent major floods in 2015 occurred in 43 of 80 municipalities, affecting 170,000 people, resulting in a damage bill of €35.7 million. Flood risk is particularly high in Skopje. The most recent floods happened in January and February 2015 with estimated damages and losses in amount of EUR 35.7 million (EU estimate). With climate change, the annual damage to critical infrastructure from climate-related hazards is expected to double by 2020 (source: https://www.sciencedirect.com/science/article/pii/S0959378017304077) and by 2080 could be more than five-times higher (source: 2016 (WB) Country Risk Profiles for Floods and Earthquakes in Europe and Central Asia). A major flood or earthquake disaster would derail economic growth, affect critical infrastructure, and disrupt livelihoods.
4 World Bank (2016a).
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7 2016 (WB) Country Risk Profiles for Floods and Earthquakes in Europe and Central Asia
limitations. There is a general lack of compliance with resilience measures (e.g., building codes, disaster- and climate-informed land use plans); a significant amount of aging building stock; and limited institutional and financial planning to deal with disasters. Further, disaster risk management infrastructure (including, for example, fire stations and fire trucks) are not upgraded nor adequately maintained, and the number of disaster risk management staff (including, for example, firefighters) are low in some areas.

Funding for municipal implementation of disaster risk management responsibilities, in particular, remains insufficient. Additional funding is needed for:

(1) municipal or city level disaster risk assessments where this has not been achieved or the assessment inputs are outdated – including, for example, where erosion of the land has exacerbated flood risk;

(2) risk reduction investments (e.g., drainage channels that would reduce the risk of flooding; funding for firefighters and volunteers to undertake risk reduction and preparedness activities; engineering evaluation of public buildings that are deemed to be “earthquake prone”; upgrades to firefighting equipment that is ageing), and

(3) additional fire and rescue staff that could potentially be shared among adjacent municipalities in times of disaster.
Organization and Functions of Local Governments in North Macedonia

1. The current organization and functional responsibilities of North Macedonia’s 81 local governments are the product of series of reforms dating from 1995. After independence, North Macedonia chose a centralized path of state organization. The Republic centralized most local government competencies dating from former Yugoslav times, except for communal services such as water supply and waste water, solid waste management, street cleaning, cemetery management, and maintenance of local roads. Such competencies were taken from all 30 of the local governments that existed at the time.

2. A tentative move toward decentralization occurred in 1995, when the country adopted the Law on Local Self-Government and Law on Territorial Organization. Although the law on local self government listed a plethora of local government powers, in practice, most of those powers were severely circumscribed due to an “in accordance to the law” phrase attached to the list. The law on territorial organization increased the number of local governments from 30 to 124.  

3. The period 2002-2005 brought a more profound set of reforms. In 2002, North Macedonia adopted a second Law on Local Self-government. The new law greatly expanded local government responsibilities, particularly in education, and created a two-phased process for the decentralization of these functions. In the first phase, local governments were made the owners of primary and secondary schools, old-age homes, local cultural institutions, sports facilities and fire protection units. They were given earmarked grants to pay for the costs of maintaining these facilities. Under the second phase, local governments that met specific conditions became responsible for maintaining these facilities as well as for paying the wages of the people who worked within them. At that point, earmarked grants were transformed into sectoral block grants. Local governments were not, however, given complete autonomy over management of these functions. Sectoral laws define the roles and responsibilities of both central and local government in the management of social services. As of 2016, all but one of the 81 local governments had entered the second phase of decentralization.

4. According to 2017 data, social services—and education in particular—now comprise the majority of local government expenditures. As shown in Chart 1, education alone accounted for nearly 45 percent of the total. Social protection, consisting largely of spending on preschools, accounted for another seven percent.

5. Infrastructure services, including road construction and maintenance, water supply, sewerage, and solid waste management accounted for 21 percent. Of this, approximately half consisted of spending on road construction and maintenance. It is unclear how much of this expenditure includes risk reduction investments.

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Subsequently, the number of local governments was reduced from 124 to the current 81. The Skopje metropolitan area is governed by 10 separate municipalities and a metropolitan municipality which is responsible for such functions as secondary education and public transport within the metro area.
6. **Municipal budget data understates total municipal spending on infrastructure services.** As described below, most infrastructure services, including water supply, sewerage, and solid waste management, are provided by municipally owned CSEs. The operating costs of these enterprises are largely financed from tariffs and therefore do not appear in municipalities’ financial statements. The amounts can be significant. For example, in 2016 the expenditures of the water company serving metropolitan Skopje totaled MKD 1.3 billion, equal to 12% of the budgetary expenditures of the municipalities serving the metropolitan area.
Revenues

7. **Local 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, identified in Chart 2:

- Block grants from the central government to finance specific services
- Unconditional grants and shared taxes
- Locally administered taxes and fees
- Revenues from the sale or development of land
- Other sources

![Chart 2: Sources of Municipal Receipts](chart2)

**Block grants**

8. **The largest single source of local revenues consists of block grants.** As shown in Chart 2, these comprised for nearly half of municipal revenues in 2017. The largest of these is a block grant for education. As shown in Chart 3, the block grant for education accounted for nearly 90 percent of total block grants in 2017.

![Chart 3: Total Block Grants to Municipalities](chart3)

9. **Education** The education block grant is intended to finance the majority of the operating costs of primary and secondary schools, including salaries, utilities and routine maintenance, as well as the costs of transporting primary school students to schools. (This last is a significant expense for municipalities that must transport students from remote villages.) The education block grant has three components: one

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9 The law on local government finance specifies that block grants shall be provided for the functions specified in Article 22, items 5, 7, 8, and 9 in the local government law. In the original local government law (2002) these refer to culture, social protection (preschools), education and health. The current budget classification system, however, does not refer to a block grant for health. Instead it refers to a grant for fire fighting.
for primary education, one for secondary education, and a third to finance the transport of primary school students.

10. **In principle, the block grant for primary schools is capitation-based.** The amount transferred to each municipality is based on the number of students in its schools, multiplied by a standard amount per pupil, a figure set each year. In calculating enrollment, additional weight is given to students in low density municipalities. The formula also includes a ‘basic amount per municipality’ which goes to each municipality regardless of enrollment, and adjustment factors to reflect variations in the proportion of students attending lower primary schools and the number of pupils with disabilities. The formula for secondary education, similarly, is based on enrollment in secondary schools, with an adjustment for the number of those pupils enrolled in vocational schools and a basic amount per municipality. The block grant for transporting primary school children is based on the number of students requiring transport and the routes’ length.

11. Despite the per capita formulas, the amounts of block grants to municipalities for education are affected by additional factors other than simply enrollment. The initial shift to a capitation-based formula would have implied a sharp drop in funding for municipalities with large numbers of sparsely-enrolled classes. To address this problem, the original legislation specified that the amounts to be transferred in the first years of implementation were to be based on the amount the central government was spending on education in each jurisdiction in the year prior to the decentralization of the function. Thereafter, the capitation-based formula was to be phased in, but with buffers, i.e., limits on the extent of year-to-year changes in funding, and these buffers were to be phased out over time.

12. **Buffers for secondary education were eliminated in 2008;** buffers for primary education, however, have not yet been fully eliminated. If the formula for a given municipality would result in a reduction in funding greater than a specified percentage, then the allocation to that municipality is based on that municipality’s allocation in the previous year, multiplied by the maximum percentage reduction (the buffer). In effect, this is a “hold harmless” clause that prevents sudden reductions in the amount of each municipality’s allocation. (There is also an ‘upper buffer’ that limits increases in allocations above a set percentage.) As a result, per student allocations to some municipalities are higher than the formula itself would dictate.

13. **The decree governing the allocation formula does not specify the numerical values of the main parameters of the formula:** the lump sum, the per student standard, and the upper and lower buffer. Nor does it explain the methodology for determining the limits of the buffers. There is evidence that the formula allocations are affected by staffing levels, rather than by enrollment. At present, the central government is legally obligated to ensure that all approved teaching positions are funded. As a result, the process appears to work backwards. The Ministry of Education estimates the salary costs of teachers for each municipality for the coming budget year, negotiates the total pool of funds with the Ministry of Finance and then sets the two financial parameters of the formula (lump sum, per student standard) and two buffers (upper, lower) with the goal of ensuring that, for all municipalities, the block grant covers, at minimum, each municipality’s salary.

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10 If a municipality has a density of less than 20 inhabitants per square kilometer, each student is given an additional weight of 1.4; for municipalities with densities of 20 to 35 inhabitants per square km, the additional weight is 0.8. For those with densities between 35 and 70 inhabitants per square km, the weight is 0.6. Thus if a municipality has a population density of only 30 inhabitants per square km, the weighted number of students is equal to the number of students multiplied by 1.8.

11 Pre-university education consists four years of lower primary education, four years of upper primary education and four years of secondary education, either in academic schools (gimnazija) or vocational schools.
costs. As discussed later in Box 3, this weakens local governments’ incentive to rationalize their school networks.

14. **Social services**: Roughly 10 percent of block grants are allocated to social services. There are two block grants in this category: one for pre-schools and another for homes for the elderly. The block grant for pre-schools is capitalization based: the amount allocated to each municipality is based on the number of children enrolled in its preschools multiplied by a standard amount. The formula also includes an adjustment coefficient to reflect the extent to which facilities are fully utilized and a so-called municipal coefficient. The ‘municipal coefficient’ is intended to ensure that the allocation for each municipality meets the salary requirements of each of its preschool, regardless of enrollment. The coefficient is set by the Ministry of Labor and Social Protection on a case by case, year by year basis. The block grant for old-age homes is based on the number of persons residing in such homes, multiplied by a standard amount, and adjusted for the number of staff working in such institutions. Unlike the case of primary (and, recently, secondary) education, local governments are not obligated to provide pre-school to all children in the relevant age brackets—municipalities are free to turn down applicants if no facilities are available.

15. **Cultural institutions**. Transfers for culture (e.g., the operation of museums) are distributed based on the estimated operating costs of existing facilities. For 2018, the formula takes into account the number of employees in local cultural institutions and other costs associated with activities in the fields of music and museums.

16. **Firefighters**. The Ministry of Interior distributes the fire-fighting-related grant to municipalities according to the number of Government-approved employees in local firefighting units. As the Government is reluctant to approve new employees, even to replace retirees, municipalities must pay the salaries of new hires. As a result, the number of firefighters has dropped since from 2005.

**Transfers and Shared Taxes**

17. **The VAT transfer**. In addition to sector-specific block grants, local governments also receive an unconditional grant. Article 8 (1) of the current municipal finance law specifies that the total amount of the grant should be 4.5 percent of VAT revenues in the previous year. The law also states that at least 50 percent of the grant is to be distributed on a per capita basis. The specific allocation formula is determined annually by the Ministry of Finance after consultation with the Committee for Monitoring the Development of the Local Government Finance System, a body that includes both representatives of the national government and (through the Macedonian Municipal Association--ZELS) local governments.

18. At present the VAT transfer consists of two parts: The first is a fixed amount of 3 million denars (approximately US$ 60,000), distributed to each jurisdiction. The remaining funds are divided into two pools: 12% for the Skopje municipalities and the City of Skopje, and 88% to other

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12 The municipal finance law--Article 12 (3)--includes a hold-harmless provision: the amount of the block grant may not be less than the amount of spent by the Government on education in each jurisdiction in the year prior to decentralization. (This applies not only to education but to the other block grants as well.) Because inflation over the last decade has been fairly low, this hold-harmless provision may still be binding, ensuring that the level of block grant funding will not decline even in municipalities with under-enrolled classes and declining enrollment.

13 Skopje City is funding some firefighting needs across other municipalities even though it is not their responsibility to support others. 385 firefighters should be in Skopje to cover the population count but there are only 187 currently that cover 17 municipalities. The firefighting brigade does not cover Skopje proper. In terms of a flood response, the City note they have enough equipment but there is not enough people to meet a flooding event.
municipalities. The 12% for Skopje, in turn, divided into two parts: 40% percent is allocated to the City of Skopje; and 60% is allocated to the ten Skopje municipalities proportionate to their respective populations. The remaining 88% (for the non-Skopje municipalities) is divided into three parts: 65% to municipalities proportionate to their population; 27% to municipalities proportionate to their surface area; and 8% to municipalities proportionate to the number of settlements. Because Skopje accounts for one-quarter of North Macedonia’s population but receives only twelve percent of the VAT transfer, the formula favors jurisdictions outside of the Skopje metropolitan area.

19. **Shared PIT.** Article 5 of the municipal finance law grants local governments a fixed share of the centrally-administered personal income tax (PIT). This is distributed among municipalities on the basis of origin. The PIT is a significant source of central government revenues. In 2017, it generated MKD 15.3 billion, equivalent to about 15 percent of total central government tax revenues. Similar to the VAT transfer, municipalities’ share of the PIT is quite small: 3%. As a result, the contribution of PIT to municipal revenues is only 1% of the total.

**Local taxes and fees**

20. **The current municipal finance law allows municipalities to administer a wide range of taxes and fees on their own.** Two sources—a recurrent property tax and a tax on property transfers—account for the majority of locally administered tax revenues.

21. **Recurrent Property Tax** The recurrent property tax is levied on immovable property, including urban and rural land and buildings (except for land and buildings used for agricultural production). Liability rests with the owners or occupier.\(^\text{14}\)

22. **In principle, discovery—the administrative process of identifying all taxable properties and bringing them onto the tax rolls—relies on self-declarations.** By law, owners or occupiers of taxable properties are required to declare their properties to the local tax authorities, and this process is supplemented by local fiscal cadasters. According to the Law on Property Taxes (Article 39), each municipality is required to keep its own register of immovable properties for tax purposes. The register (in accordance with the Law on the General Administrative Procedure) should contain the name and address of the taxpayer, the total area of the land and buildings, the value of the property, the applicable tax rates and the status of outstanding payments. Municipalities are required to harmonize their property registers with that of the Agency for Real Estate Cadaster (AREC)\(^\text{15}\) and submit the contents of their property registers to the Central Register of the Republic of North Macedonia and to the Public Revenue Office.

23. **Individual property values are to be self-assessed by property owners and reported in owners’ annual tax returns.** These valuations are supplemented municipal assessments in

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14 If a legal owner cannot be determined, usufruct is sufficient.

15 Under the Law on the Real Estate Cadaster (2004), the Agency for Real Estate Cadaster (AREC), is responsible for maintaining a comprehensive central registrar of property rights. According to the IMF, coverage reached 98% in 2010.
according with the Law on Methodology for Assessing the Market Value issued in 2010 (as amended in 2012) by the Ministry of Transport and Communications. The methodology lays out a very detailed list of property characteristics that should be included in the assessment, including location, type of construction, age, sanitary facilities, etc. Each of these variables is assigned a specific number of “unit cost points” per square meter, then combined in a formula to produce the appraised value. Taxpayers are obliged to submit a tax return by January 31st of the relevant tax year. The property tax law prescribes severe penalties for those who fail to pay on time, beginning with the seizure of personal property and extending to the garnishing of wages. Delinquent taxpayers are also required to bear the costs of these procedures.

24. While the 2018 IMF report on property taxes found North Macedonia’s coverage and overall system to be good, particularly relative to regional comparators, the report was somewhat critical of the quality of local property administration. It notes that while significant progress has been made in expanding the coverage of property registration, smaller municipalities in rural areas have significant difficulties in keeping their registers updated. Further, although the report finds the valuations based on the official methodology to be generally accurate, it notes that some significant discrepancies exist. The IMF report is also critical of collection administration. While accurate data on municipal collection ratios is not available, the IMF report concludes that ratios are ‘lower than 100 percent—in some cases significantly so’. Noting that the property tax law provides local governments with extensive enforcement powers, the IMF report concludes that the problem largely lies with insufficient staffing. Experience elsewhere suggests that a contributing factor may also be reluctance of mayors to tax important constituents or to aggressively pursue indigent ones.

25. But the key constraint on property tax yields lies in the low tax rate. The property tax law (as of 2017) restricts the property tax rate to an extremely low 0.10 to 0.20 percent of assessed value. (As a point of contrast, in Serbia, the rate on residential buildings is progressive: 0.4 percent on the first RSD 10 million of value, 0.6 percent of the value (if any) between RSD 10 million to RSD 25 million, one percent on the value between RSD 25 million and RSD 50 million, and two percent on any value over RSD 50 million.) The IMF reports that the majority of the 81 municipalities opt for the lowest rate. Owner occupied residential property is taxed at an even lower rate: 0.05 percent. As a result of both low rates and administrative problems, the yield of the property tax is very low: In 2017, revenues totaled MKD 1.2 million or about €11 per capita. In Serbia, in contrast, the yield of the property tax in 2017 was €28 per capita; in Croatia, €54 per capita.

26. Property Transfer Tax. The municipal finance law also permits municipalities to impose a tax on property transfers. As defined in the Property Tax Law, the base of the tax is the market value of the property at the time of sale. This value may be determined by the municipality according to the Law on Methodology for Assessing the Market Value (see above). Alternatively, the taxpayer may request a valuation by an authorized appraiser. In the latter case, however, if the municipality determines that the market value has not been properly calculated by the authorized appraiser, it may submit a request for audit of the appraisal by the Chamber of

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16 IMF. Fiscal Affairs Department. 2018. FYR Macedonia: Property Taxes
17 The Ministry of Justice, the Chamber of Appraisers and the Ministry of Transport and Communication are reportedly working on a proposal to change the methodology for property valuation. This would be based on data on all property transactions, as reported by authorized appraisers. It was not clear to the IMF mission whether the proposal would remove the appraisal function from individual municipalities.
18 The law allows higher rates on certain types of the property, including a specific provision allowing the rate on ‘agricultural land not used for agricultural production’ to be three to five times the standard rate. At the same time, the law exempts property belonging to the central and local governments, religious instructions, and agricultural land and facilities used for agricultural production.
Appraisers. The decision of the municipality (presumably based on that audit\(^{19}\)) is binding. The rates of the property transfer tax are decided by individual municipal councils but must be within the range of 2-4 percent. Certain transactions are exempt from the transfer tax, including first-time sales of new residential buildings and inheritance of property by close relatives who provided lifelong support to the decedent.

27. As shown in the chart above, the yields of the property transfer tax in 2017 were about 25 percent higher than those of the recurrent property tax—a fact presumably explained by the difference in tax rates. Although far more properties are subject to the recurrent property tax than the property transfer tax, the permissible rate on the recurrent tax is 1/20\(^{th}\) of the permissible rate of the transfer tax. Somewhat surprisingly, yields of the property transfer tax have been relatively stable in recent years. One might expect that the volume of property sales would vary from year to year, resulting in fluctuations in transfer tax revenues. But this has not been the case. The coefficient of variation in transfer tax revenues was only 0.08 over the period 2010-2017, less than half that of the recurrent property tax. The IMF report nevertheless recommends the eventual abolition of the property transfer tax, as it discourages property sales or drives them underground.

28. Fees The municipal finance law authorizes local government to impose a long list of fees for so-called communal and administrative and other services. As a group, communal fees are the largest contributor to own-source municipal revenues, accounting for about 15% of the total. The most important of these, in terms of revenue generation, is the public lighting fee. This accounted for about five percent of municipal revenues in 2017. Municipalities also generate not-entirely-insignificant revenues from charges for pre-schools. Fees for the exploitation of minerals contribute about 1.5 percent of municipal revenues, although revenues from this source are concentrated in a few, smaller municipalities. Five municipalities, none with more than 30,000 inhabitants, account for roughly 70 of revenues from this source.

29. Earmarked revenue for supporting DRM services are not substantial or consistent. Local Government revenue for DRM comes from two sources: 2 percent of insurance premiums from motor vehicles, and fees from providing firefighting security at, for example, sports events or concerts.

30. Land development charges. Local governments are permitted to impose charges for the costs incurred in preparing vacant land for development. Such costs include site clearing and grading and the extension of water and sewerage lines, roads, and storm drainage. The level of such charges is governed by a 'rulebook on the level of arrangement of the construction land with objects of communal infrastructure and the manner of determining the amount of costs for the arrangement depending on the level of arrangement'.\(^{20}\) The rulebook sets out three standards of infrastructure services—basic, higher and lower.\(^{21}\) In principle, land development charges are to be based on the actual cost of providing the specified infrastructure services. The rulebook establishes a more mechanical basis for setting the charges, setting out a series of coefficients and surcharges that are to be applied to a basic charge per square meter of building area. For instance, the charge for 'high

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\(^{19}\) See Article 38-e. The law does not explicitly state that the municipality must accept the result of the audit by the Chamber of Appraisers

\(^{20}\) See Official Gazette of the Republic of North Macedonia No. 38/11 and 93/11). According to the law on construction, an investor may provide the required infrastructure at his own expense, in which case the charge is not applied.

\(^{21}\) The basic standard requires access from a public road, connections to the municipal water, sewerage and drainage networks, street lighting and underground electrical supply. The lower standard requires only access from a 'non-categorized' road, on site water and sewerage (e.g., a well and a septic tank); on site drainage and overhead electrical supply. The higher standard requires (in addition to services required under the basic standard), connection to district heating and gas networks, and on site waste water treatment.
standard' infrastructure may be up to 20 percent above the charge for the basic level of infrastructure. In residential buildings, the charge for lofts and rooms with low ceilings (<2.5 meters) is 20 percent of the standard amount for residential buildings.

31. While the rulebook sets out the parameters of the land development charge, each municipality is responsible for setting its own rates. According to the ordinance proposed by the mayor of Strumica, the charge for developing land for single family houses in the urbanized part of Strumica (as opposed to outlying parts of the municipality) is MKD 1700 per square meter. For multi-family buildings, the fee may range from MKD 3500/m² to MKD 4500/m², depending on location (zone.) For business and public facilities, the fee is MKD 3.800/m². In Gazi Baba, the land development fee for residential buildings ranges from €83/m² to €120/m² depending on zone. The fee for industrial and office (working) space ranges from €E87/m² to €140/m². It is not clear whether these charges cover the actual costs of providing the required infrastructure.

**Capital receipts**

32. **Land revenues.** Receipts from the sale of land are a significant source of capital receipts in some municipalities. Municipalities are permitted to acquire state-owned land located within their borders free of charge and sell it to private individuals, subject to central government approval. (If the land is classified as agricultural, for example, the Ministry of Agriculture must agree to have it reclassified as ‘construction land.’) According to the Law on Construction Land, the land must be sold at auction (with some exceptions), with 20 percent of the proceeds going to the central government and 80 percent going to the relevant municipality.  

33. Receipts from the sale of construction land do not make a significant contribution to municipal budgets because, except in Skopje, market demand for developable land is weak and therefore land prices are low. Since local governments must also provide basic infrastructure (charging only the land development fee) the acquisition and sale of formerly state-owned land can be a money-losing proposition for local governments. In 2017, gross receipts from the sale of land generated nearly MKD 2 billion, or about half of total capital receipts. But the figure for net receipts (gross receipts less costs of infrastructure provision) is not available.

34. **Capital grants from the central government account for about 30 percent municipal capital receipts.** Roughly 80 percent of grant receipts take the form of discrete grants from central government ministries, including the Youth and Sports Agency, the Ministry of Environment, the Ministry of Agriculture, Ministry of Local Self-Government, and The Protection and Rescue Directorate. According to one recent EU report, municipalities can apply for capital transfers

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22 Proceeds from the sale of land for technological development zones are divided between the central government (20 percent) and the Directorate for Technological Industrial Development Zones (80 percent). Proceeds from the sale of land in tourism development zones are divided according to the law on tourism development zones.
through 18 different programs. The allocation of central government grants is said to be highly politicized. It is also fragmented: grants are authorized for a single year, even for projects that may take several years to complete.

35. To provide a more orderly channel for local capital investment financing, the Government has established a regional development fund (RDF). According to its authorizing legislation, the RDF is to disburse an amount equal to one percent of GDP. This would have equaled MKD 6.2 billion in 2017; however, that year, the RDF disbursed only MKD 150 million. (Its budget for 2018 was about MKD 300 million.) The process for allocating RDF funding begins with a formula-based allocation among North Macedonia’s eight regions. The mayors in each region are then called upon to agree on a few projects for funding in the current year. (Because the total amount is so small, only two or three projects can be funded each year in each region.) Although the mayors come from different parties, the meeting is reportedly congenial. The proposed projects are then evaluated by an inter-ministerial group according to specific guidelines (‘a ‘rulebook’) and then submitted to a high level committee, chaired by the deputy prime minister.

36. Loans and grants from donors to municipalities accounted for, on average, 30 percent of capital receipts in 2017. The largest single donor in that year was the EU, accounting for 70 percent of the total. (Note that receipts from this source are volatile. Receipts in 2017 were nearly twice the level in 2016.)

37. Loans from domestic banks account for the remainder of municipalities’ capital receipts. As shown in Chart 5, loans from domestic banks account for about one-quarter of total capital receipts. Data for 2016 suggests that long term borrowing is largely confined to Skopje and a few other large cities and does not make a major contribution to local receipts as a whole. According to the recent Public Finance Review, the outstanding stock of municipal debt equals only 0.1 percent of GDP.

38. Current legislation permits municipalities to borrow from domestic and foreign creditors and from the Treasury, with the consent of the Ministry of Finance. Municipal borrowing is regulated by the Law on Financing of the Units of Local Self Government, which prescribes two limits on municipal long-term borrowing: First, the total stock of long term debt cannot exceed 100 percent of the previous year’s operating revenues; second, debt service cannot exceed thirty percent of the previous year’s operating revenues. Although these ceilings are liberal by international standards, the World Bank’s recent Public Finance Review (PFR) reports that the Government has never been called upon to bailout a contractual loan. As noted above, the same cannot be said about municipal arrears.

Issues

1. Are municipalities underfunded?

39. It has been argued that municipalities lack sufficient resources to perform the functions assigned to them. This argument comes from several different directions. Some people point to the poor quality of municipal infrastructure services—road maintenance, drainage, sewage treatment and disaster risk management—and say that a scarcity of resources is to blame. Some point at the current fiscal difficulties facing local government (see below) and say that increased

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24 Figure for loans from domestic banks excludes short term loans.
funding would be the solution. Others complain about the decentralization process, saying that block grants are insufficient to finance the costs of functions that have been decentralized.

40. **This argument is difficult to answer, if based solely on analyses of municipalities’ financial statements.** There have been efforts to answer the question by defining physical norms for each of the services local governments provide and calculating the cost of achieving them. But this approach is fraught with difficulties. What constitutes an acceptable standard? Should every municipality have 100% coverage of sewage treatment—regardless of the cost? Inevitably, public sector spending decisions involve tradeoffs. More funding for local governments implies either less funding for the central government (if the increase is financed through transfers) or less money in the pockets of North Macedonia’s taxpayers (if the increase is funded through local taxes and fees). But the central government is facing its own fiscal constraints as are North Macedonia’s taxpayers. The argument for increasing local funding must be evaluated carefully.

41. **There are several ways to do this.** One way is to rely on international comparisons—to see how much money North Macedonia’s local governments have available to spend compared to other countries. Chart 6 compares the level of local government spending in North Macedonia with the levels in other central and eastern European countries, measured as a percent of GDP. In terms of aggregate spending, North Macedonia ranks near the bottom. Based on 2016 data, local spending in North Macedonia was about five percent of GDP, above the level in Greece (3.5 percent) and below the levels in all the other comparator countries.

42. **Of course, the level of local government spending would be expected to vary according to the functions assigned to local governments in each country.** In countries where local governments pay for teachers’ salaries, health care costs, or social assistance, the level of local spending would be expected to be higher than in countries where the central government bears these fiscal burdens. To account for variations in local expenditure assignments, Chart 6 disaggregates the level of local spending in each country by sector. Even after excluding spending on health, education and social protection, North Macedonia still ranks near the bottom. Spending on infrastructure services—classified as economic affairs, environment, and housing and community services—is only 64 percent of the regional average.

43. **These figures must be interpreted carefully, however.** First, the performance of other countries does not necessarily represent an ideal; rather, it represents a comparative reality. Second, the figures themselves are not strictly comparable due, inter alia, to the different treatment of expenditures by locally-owned CSEs. The data for comparator countries shown in Chart 6 is (with the exception of Serbia) from Eurostat. In the Eurostat data, spending on water supply, sewerage, solid waste management and similar functions is included in government expenditure. The data for North Macedonia excludes spending on these functions, to the extent they are financed from tariffs.

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26 Source of data (except for North Macedonia and Serbia) is Eurostat.
retained by communal service enterprises. If these expenditures were included, North Macedonia’s rank would be higher.

44. **Chart 7 illustrates the variations in funding for two slightly more comparable jurisdictions:** metropolitan Skopje (including the ten component municipalities) and Belgrade, Serbia. In both cases, the tariff financed expenditures of CSEs are excluded from the municipal budget figures. (Because teachers’ salaries are directly funded by the central government in Serbia, funding for education is excluded from the figures to maintain comparability.) As shown, per capita funding for Belgrade in 2017 was about twice the level in metropolitan Skopje. Much of the difference was exhausted on subsidies to public transport.

45. **Yet another approach is to look at trends in subnational fiscal performance within North Macedonia.** A sharp drop in revenues, with no corresponding drop in expenditure responsibilities, for example, might indicate that subnational governments are under-funded relative to some preferable situation in the past. Growing deficits and arrears might indicate the same.

46. **Chart 8 illustrates recent trends in municipal revenues.** The upper (red) line expresses municipal revenues as a percent of GDP. The lower (blue) line expresses municipal revenues as a percent of central government revenues. Both lines show that municipal revenues peaked in 2012. In that year, municipal revenues were equal to 6.3 percent of GDP, and 21 percent of central government revenues. Both ratios have since declined. Municipal revenues in 2017 were equal to five percent of GDP, about the same level as in 2009. They were equal to 17 percent of central government revenues, midway between the levels of 2009 and 2010. In real terms, municipal revenues have remained roughly constant since the peak, increasing by only 1.5 percent over the period. Considered together, this evidence suggests that the current level of municipal revenues does not represent a systematic decline in revenue in recent years, but rather a return to the status quo ante-2012. By this reasoning, municipalities do not appear underfunded.

47. **Arguably, another indicator of underfunding would be a municipality’s financial performance.** Persistent deficits could indicate underfunding (although as discussed below, they could also indicate poor budgeting practices). Because municipalities record their revenues and expenditure on a cash (rather than accrual) basis, data from annual budget execution reports is not very useful in this regard; municipalities disburse whatever money they have, regardless of whether these amounts are sufficient to cover all their expenditure obligations. (In 2017, cash receipts were equal to 99 percent of cash expenditures, and only two percent of receipts were borrowed.) Data on
arrears, on the other hand, are a more reliable signal of fiscal distress. But it is not clear whether these arrears are indicators of a fundamental underfunding of the municipalities—or something else. Detailed analysis suggests the latter. The arrears issue is discussed in detail in the next section.

48. **Are the decentralized functions underfunded?** As described earlier, the 2005 decentralization vastly increased the functional responsibilities of local governments. While provisions were made for financing these functions, some argue that the level of financing is insufficient—that local government have been forced to finance these functions from their own revenues.

49. **The current transfers from central to local governments for primary and secondary education, the largest decentralized function, appears to be sufficient.** Local governments are now responsible for paying the recurrent costs of primary and secondary education, including teacher’ salaries, utilities, and routine maintenance and student transportation. But the education block grant is specifically tailored to ensure that funding is sufficient to pay the salaries of all existing teachers (a line item that comprises the vast majority of education spending.) Moreover, an analysis of municipal spending by source of financing indicates that the primary education block grant covered 97 percent of municipal spending on primary education in 2017. The grant for secondary education covered 94 percent of spending on secondary education. The grant for preschools covered 72 percent of spending in the sector. (As noted earlier, municipalities charge a fee for preschool attendance, which covers much of the remainder.) The only sectors that are not largely funded by grants are culture and housing for the elderly, neither of which makes a significant claim on overall municipal budgets. While the amount of the transfer may or may not be sufficient to finance an **adequate** level of spending on the decentralized functions, it appears to be sufficient to cover the amounts that municipalities are actually spending on them.

50. **Overall, the results of this analysis are ambiguous.** North Macedonia’s municipalities appear to be under-funded by the standards of other European countries, even after accounting for differences in local functional responsibilities among different countries. But they do not appear underfunded on the basis of financial performance. (As discussed below, the current stock of arrears is large, but it is largely confined to a few bad apples.) And funding for recently decentralized functions appears to be adequate to cover local expenditures on those functions.

51. **Perhaps a more pragmatic question to ask is: if the Government wished to increase local government revenues, what would be the best way to go about it?** In examining options, there is a strong case for focusing on revenue sources that are stable.

52. **At present, the particular nature of the revenues assigned to municipalities results in a high degree of local financial instability.** Chart 9 illustrates the trends, over time, in the principal sources of municipal revenue. As shown, revenues from the PIT, the VAT transfer, and the property tax all grew at a fairly uniform rate over the period 2010-2017. Revenues from the property transfer tax, land sales, and ad hoc grants did not. The instability of local revenues is particularly evident in the fiscal performance on individual jurisdictions. Chart 10 illustrates the fluctuations in the revenues of North Macedonia’s largest municipality, Kumanovo.27 As shown, revenues from land sales were particularly volatile over this period. This is not surprising. The PIT, the VAT and the recurrent property tax are all derived from broad-based tax bases which would be expected to grow at roughly the same rate as the economy as a whole. Revenues from the property transfer tax, on the other hand, would be expected to fluctuate with the volume of real estate transactions, as would revenues from land sales. Revenues from ad hoc transfers would be expected to fluctuate with the

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27 As noted earlier, metropolitan Skopje, by far the most populous urban area in North Macedonia, is divided into ten individual municipalities.
financial situation of the central government and the priorities of individual sectoral ministries. Because the current yield of the stable revenue sources is relatively small, these unstable sources have a large influence on year-to-year changes in total revenues.

53. **If the Government chooses to increase local resources while at the same time improving stability, three options readily present themselves:** (1) an increase in the local share of the VAT; (2) an increase in the local share of the PIT; and (3) an increase in the property tax rate. Table 1, below, illustrates the scale of the changes that would be required to achieve a substantial (20 percent) increase in municipal discretionary revenues under each of these three options. (Discretionary revenues are defined as total recurrent municipal revenues, excluding block grants. They are discretionary in the sense that they can be used for any purpose, as opposed to block grants which must be spent on the functions they specifically support.) As shown, the 20% increase could be achieved by: increasing the municipal share of the VAT from 4.5 percent to ten percent; increasing the local share of the PIT from 3 percent to 24 percent; or increasing the prevailing rate of the recurrent property tax from 0.1 percent to 0.3 percent. 28

54. **From the central government’s perspective, the option of increasing the property tax rate would presumably be the preferable one,** as it would not require an increase in central transfers. But the political obstacles to increasing the property tax rate should not be underestimated. From a political perspective, it might be easier to increase the local share of the VAT or the PIT to fund an increase in local revenues; the impact of such measures on the budget of the central government would be fairly modest, however. In 2017, central tax revenues (excluding social security contributions) totaled MKD 104.6 billion. An increase in the local share of the VAT or the PIT sufficient to increase municipal revenues by twenty percent would reduce net central tax revenues by only two percent.

55. **Each of the above discussed options to increase local resources, of course, has different implications for specific municipalities.** Because the VAT transfer is distributed (largely) on the basis of population and land area, an increase in the VAT share would benefit poorer, more rural jurisdictions relative to other options. An increase in the PIT share or an increase

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28 In calculating the increase in the property tax rate that would be required to increase total municipal discretionary revenues by 20 percent, it is assumed that the current prevailing rate is 0.1 percent of assessed value—i.e., the lower end of the range of rates permitted by law. It is also assumed that the current reduction for owner occupied residential property would remain intact. Thus the rate on such property would be 0.1 percent of assessed value.
in the property tax rate would benefit the richer, urban jurisdictions. The case for and against greater revenue equalization is discussed below.

<table>
<thead>
<tr>
<th>Increase the:</th>
<th>From current share/rate</th>
<th>To required share/rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT share</td>
<td>4.5%</td>
<td>10%</td>
</tr>
<tr>
<td>PIT share</td>
<td>3%</td>
<td>24%</td>
</tr>
<tr>
<td>Recurrent property tax rate</td>
<td>0.1%</td>
<td>0.3%</td>
</tr>
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</table>

**Table 1: Options for Increasing Discretionary Municipal Revenues by 20 Percent**

Disparities in Discretionary Revenues

56. **As in most countries, municipalities in North Macedonia vary significantly with respect to per capita revenue.** Chart 10 illustrates these variations, ranking the 81 municipalities in order of recurrent revenues per capita in 2017. As shown, with the exception of four sparsely populated jurisdictions, revenues per capita range from about MKD 6,600 to MKD 21,000. Roughly three-quarters of municipalities fall within a range of MKD 10,000-MKD 20,000. Metropolitan Skopje (including the ten municipalities and the metropolitan government) ranks sixth.

57. **Much of this variation is due to differences in local discretionary revenues.** As shown in Chart 11, differences in per capita block grants are fairly modest (standard deviation: MKD

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29 Novaci (population: 3,105); Makedonska Kamenica (7,492), Makedonska Brod (6,137) and Kabinci (3,959)
But the standard deviation in discretionary revenues is MKD 4,044, about 2.5 times larger.

58. This variation, in turn, reflects variations in the revenues from the wide array of taxes, fees and charges for public services that municipalities are permitted to impose, as well as variations in revenues from land sales. One might expect that much of the variation would be explained by differences in the yields of local taxes—i.e., the property tax and the property transfer tax—and the local share of the PIT, all of which (one would expect) would be higher in per capita terms in Skopje. And in fact, the per capita revenues from these sources are considerably higher in Skopje than elsewhere. But the yield of these revenue sources is so small that they have little impact on variations in total discretionary revenues per capita.

59. One might also think that the VAT transfer would offset the relatively high yields of property taxes and PIT revenues in Skopje, since it is distributed largely on the basis of population plus a flat MKD 3 million per municipality. But this is not entirely the case. It is true that VAT revenues are the mainstay of smaller, poorer municipalities. And that VAT revenues per capita are inversely correlated with per capita revenues from the property taxes and the PIT. But the relationship is not strong.

60. Instead, much of the variation is explained by unpredictable “windfalls” that boost the revenues of certain municipalities in individual years but do not represent stable sources of revenue over time. The largest such source consists of revenues from the sale of former state lands: (standard deviation: MKD 2,276). The second largest consists of ad hoc transfers (as opposed to the formula-driven VAT

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30 Even this much variation reflects the fact that small municipalities do not have their own secondary schools, and thus do not receive block grants for this purpose.
transfer and block grants): (standard deviation: MKD 1,673.) 31 Chart 12A, below, illustrates the variations in all categories of revenues of each municipality, with metropolitan Skopje treated as a single jurisdiction. Chart 12B illustrates variations in per capita revenues, excluding non-formula transfers and land sales. As shown, once the unstable sources of revenue are removed, variations in per capita discretionary revenues are fairly modest.

<table>
<thead>
<tr>
<th>Chart 12: Sources of Variation in Discretionary Revenues per Capita</th>
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<tbody>
<tr>
<td><strong>B: Variations in Per Capita Discretionary Revenues, Stable Sources</strong></td>
</tr>
<tr>
<td>MAKEDONSKI BROD</td>
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<tr>
<td>OHRID</td>
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<tr>
<td>ILINDEN</td>
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<tr>
<td>GEVGELIJA</td>
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<tr>
<td>RESEN</td>
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<tr>
<td>CESINOV O I OBLESEVO</td>
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<td>PETROVEC</td>
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<td>STIP</td>
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<tr>
<td>VENCANI</td>
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<td>BERVO</td>
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<td>SVETI NIKOLE</td>
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<tr>
<td>VALANDOVO</td>
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<tr>
<td>NEGOTINO</td>
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<tr>
<td>VELES</td>
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<tr>
<td>TETOVO</td>
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<tr>
<td>KRIVA PALANKA</td>
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<tr>
<td>KRIVOGRADSKI</td>
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<tr>
<td>NOVO SELO</td>
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<tr>
<td>DEBAR</td>
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<tr>
<td>VASILEVO</td>
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<tr>
<td>PLASNICA</td>
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<tr>
<td>VRAPCISTE</td>
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<tr>
<td>ZELINO</td>
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<td>ARACINOVO</td>
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<tr>
<td>ARACINOVO</td>
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</tbody>
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61. **Is there a case for more equalization?** In principle, North Macedonia could adopt a transfer formula that achieves more equalization in discretionary revenues. The equalization transfer in neighboring Serbia, for example, specifically targets municipalities with low revenues from the personal income tax. See Box 2. But the Government would have to substantially increase the local share of the PIT if such an approach were to have a significant impact in North Macedonia.

62. It is not clear that further equalization is desirable. If discretionary revenues were required to finance expenditures with significant distributional implications, then there might be a cause for concern. Every child in North Macedonia deserves a minimum level of education, regardless of the strength of the tax base of the jurisdiction where he or she lives. But expenditures on education and preschool—the two municipal functions with distributional implications—are largely financed from block grants. Discretionary revenues are instead going to finance the construction and maintenance of roads and works constructed by municipal communal services enterprises, including types of works that do not exist at all in smaller rural jurisdictions. There is a strong argument for concentrating those resources in the few parts of the country that have good economic

31 These, in turn consist largely of capital transfers, ‘other current transfers’ (excluding block grants and the VAT transfer) and balances carried forward from previous years (which the accounts classify as transfers). Each of these contributes about 30 percent of the total.
prospects. The existing formula for distributing the VAT transfer therefore has much to recommend it, in the sense that it provides a minimum lifeline to smaller, more rural municipalities while also supporting municipalities where growth—both economic and demographic—is likely to be concentrated.

**Box 2 Revenue Equalization in Serbia**

In Serbia, the shared PIT is by far the largest source of municipal revenues, accounting for about half of the total. In its original form, the transfer formula was explicitly designed to bring the per capita PIT revenues of poorer jurisdictions up to 90 percent of the national average. (The four largest cities were excluded from the calculation). Since then, the transfer system has been subjected to many modifications. At present, for example, the shares of municipalities classified as ‘more developed” are reduced by half.

In some respects, the Serbian approach could serve as a model for North Macedonia, as it explicitly targets the poorest municipalities, rather than dispersing funds to all municipalities on the basis of population. But it is not immediately applicable to North Macedonia. The Serbian approach works because it equalizes revenues from a tax that is administered by the central government. Because the PIT is centrally administered, the Government knows precisely how much is collected in each jurisdiction. But the shared PIT in North Macedonia generates so little revenue that equalizing it would have little impact. And if the government attempted to equalize the broader set of own-source revenues, it would create a perverse incentive: municipalities would be tempted to decrease their own source revenues in order to increase their revenues from the equalization transfer.
Reforming the Block Grants

63. **Should the block grant formulas be changed?** The current formula for funding primary education is clearly failing to encourage network rationalization. Due to the generous use of buffers, municipalities with sparsely populated classes continue to receive sufficient funds to pay teaching costs and other operational expenses as if classes were full.

**Box 3: Rationalizing the School Network**

Like most Eastern European countries, North Macedonia has witnessed a reduction in the number of students, particularly at the primary level. However, despite the decline in student population, a corresponding reduction in the number of classes and teachers has not yet occurred. As a result, teacher to pupil ratios are high, particularly in rural areas. The average number of students per teacher in primary and lower secondary schools is 11 (as of the 2017/18 school year). In upper secondary schools, the average is ten. Rationalizing the school network—reducing the number of teachers and classes such that teacher to pupil ratios reach efficient levels (e.g., 25 students per class)—could result in significant savings.

Due to the continuing existence of buffers, the current transfer formula does not create sufficient incentive for mayors to close under-enrolled classes or schools. In addition, the central government is statutorily obligated to ensure that all authorized teaching positions are fully funded. As a result, pupil teacher ratios have remained roughly constant since at least the 2013/14 school year.

Experience in the region suggests that, even if the capitation formula were scrupulously followed, relying solely on the financing mechanism to force network rationalization rarely succeeds on its own, due to opposition from parents (who are reluctant to send young children on long bus rides) and teachers (who fear for their jobs). Central governments need to take a lead role in network rationalization, identifying classes to be combined and schools to be closed, reassigning teachers, promoting early retirement, and ensuring that redundant positions are eliminated once their current occupants retire.

Fortunately, the central government in North Macedonia is in a good position to do so. It is the central government, not the municipalities, that must approve all teaching positions. It must also ‘reapprove’ the positions to be occupied by new teachers hired to replace those who retire. While individual teachers cannot be fired (except for cause) the central government could use these powers to gradually reduce the number of authorized positions in schools with sparse enrollments. Actual teaching staff could be reduced through attrition; i.e., declining to approve new staff to fill positions that have been vacated by retirement. In addition, the introduction of compulsory higher secondary education and the Government’s efforts to expand preschooling have created potential new job opportunities for downsized primary school teachers, provided they are qualified. The expansion of pre-schooling also offers opportunities to re-purpose former primary schools.

64. **One option is to phase out the buffers over a defined period of time.** This would leave the basic formula intact: funding would be allocated on a per pupil basis, with a higher level of
funding (per pupil) in low density jurisdictions. If the level of funding per student remains as it is, it could also result in considerable savings to the Government. However, experience in other Eastern European countries suggests that shifting to capitation funding alone is unlikely to result in network rationalization. Political resistance can be strong, as villages are reluctant to see their only school close, parents are reluctant to see their children bussed to distant facilities and teachers are reluctant to lose their jobs. As such, a concerted effort will likely be required by the central government—to identify classes to be combined and schools to be closed, to reassign teachers, and/or encourage early retirement, etc.

3. Arrears

65. The issue of whether and how best to address municipal arrears has been a subject of significant policy discussion in recent months. As of September 2018, municipal arrears totaled MKD 8.2 billion, an amount equal to 27 percent of total municipal revenues in 2017. As shown in Table 2, about 60 percent of the arrears were owed directly by municipalities. Another 28 percent were owed by municipally-owned communal service enterprises. Ten percent was owed by schools and the remainder by preschools and cultural institutions.

66. Although twenty municipalities currently have their accounts blocked (see Box 4), the bulk of arrears are concentrated in a small number of municipalities. Half the arrears are owed by just five municipalities (including Grad Skopje) and 27% of them are owed by just two: Ohrid and Tetovo. This concentration of arrears has important implications. It strongly suggests that the arrears are not the result of a systematic underfunding that affects all municipalities. Instead, it appears to be the result of factors peculiar to a few. This conclusion is reinforced by the analysis shown in Chart 13. The chart illustrates the relationship between the level of arrears in each municipality and its level of income. (To control for variations in population, both variables are expressed in per capita terms.) As shown, there is little correlation between the per capita revenues of given municipality and its level of arrears (per capita). (r=.178.) In fact, wealthier municipalities tend to have a higher level of arrears, per capita, than poorer ones.

<table>
<thead>
<tr>
<th>Table 2: Municipal Arrears (September 2018)</th>
<th>MKD Mns.</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal budget</td>
<td>4998.3</td>
<td>61%</td>
</tr>
<tr>
<td>CSEs</td>
<td>2273.0</td>
<td>28%</td>
</tr>
<tr>
<td>schools</td>
<td>893.1</td>
<td>11%</td>
</tr>
<tr>
<td>preschools</td>
<td>41.4</td>
<td>1%</td>
</tr>
<tr>
<td>cultural inst.</td>
<td>4.0</td>
<td>0%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>8209.8</td>
<td>100%</td>
</tr>
</tbody>
</table>

67. The propensity of municipalities to run up arrears appears to be largely the result of poor budgeting practices and strategic behavior, prevalent in some municipalities and not in others. As noted in the decentralization chapter of the recent PFR, and was confirmed by the eight municipalities interviewed for this report, municipalities tend to overestimate future revenues when they prepare their budgets. These interviews suggested that unrealistic budgeting is deliberate, rather than a result of technical incapacity.

32 Note that the scale of the adjustments for low density municipalities should be reconsidered. It may be that the adjustment level is too small (or too large) to account for the additional costs of providing primary education in rural areas.

68. **There are political benefits to over-estimating revenues during the budget preparation process:** it allows for mayors to apply the most optimistic scenarios and increase the expenditure side of the budget. And this in turn allows mayors and councilors to include politically attractive projects in the budget—even if the projects are unaffordable. Over the course of budget execution, unrealistic budgets also increase the mayor’s power over the disbursement of funds. A realistic budget can be executed as planned: there is enough revenue to pay for the expenditures specified in the budget. But an unrealistic budget includes expenditures that cannot be paid; giving the mayor the power to determine which bills get paid and which do not.

69. **Some speculate that this strategic behavior has a longer-term objective: a bailout.** Both mayors and creditors are said to be hoping that the arrears will become so large that the central government will be forced to take them over. They have had good reason to hope. A major bailout occurred in 2005. In late 2018, the Government initiated a second one. The Government has now allocated MKD 3.02 billion to help municipalities pay off their arrears. This amount is intended to enable each municipality to pay off 51 percent of its arrears. Municipalities are expected to pay off the remainder using their own resources. However, the municipalities’ arrears clearance program is conditioned on the municipalities agreeing with suppliers to take a ‘hair-cut’. Many of them declined to do so, and the stock of arrears declined by only about twelve percent between September 2018 and March 2019.

70. **The repeated pattern of bailout clearly creates a moral hazard.** If mayors know that they will eventually be bailed out, they have an incentive to continue making expenditure commitments that the municipalities cannot afford. And if suppliers and contractors know that their invoices will eventually be paid (with interest) they will be happy to go along. The current rules for distributing bailout funds are particularly problematic, as the largest share of the funds will go

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**Box 4 Why do creditors continue to tolerate municipal arrears?**

At present, the arrears are mostly owed to suppliers and construction firms. One might expect that creditors would eventually cease to do business with local governments that failed to pay on time. But this is not the case. These creditors eventually go to court for relief. The court then reviews the municipality's finances and decides on a minimum amount that is needed to keep the municipality operating. This typically includes the wage bill, which the Treasury pays directly to employees. The remainder is then garnished (‘blocked’ in the parlance of the municipal finance law) to pay the creditors, on a first-come, first-served basis. In the mean time, the creditors are due interest on the amount outstanding. At this time, twenty municipalities have their accounts blocked in response to lawsuits arising from arrears, and another twenty are approaching that condition.
to municipalities that have run up the largest arrears.

71. **To forestall future arrears, the Government has established a ceiling on municipal revenue projections.** An amendment to the municipal law, enacted in 2018, prohibits municipalities from forecasting an increase in revenues of over 10%, compared to the average of the previous three years. In theory, this would prevent a municipality from budgeting more expenditures than it can afford. But this may not be enough.

72. **There is a strong case for imposing some form of quid-pro-quo, in addition to the ceiling on municipal revenue projections, as a condition of central government assistance.** This could, for example, take the form of a Government-imposed financial recovery plan, incorporating mandatory increases in local tax rates (e.g., raising the property tax rate to the maximum permitted by law), dismissal of contractual and temporary staff, and sharp cuts in capital spending. Such a solution is already authorized in the municipal finance law (see Box 5). But it has never been implemented. Since the law requires the mayor to initiate the process, this is not surprising. Parliament could, however, amend the law to permit the Government to take the initiative and impose a plan of its own.

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**Box 5 Municipal Bankruptcy**

The municipal finance law sets out a procedure for dealing with municipal insolvency, (termed ‘financial instability’ in Macedonian parlance). According to the law (Article 39) a municipality is in a state of financial instability if its accounts have been blocked for more than six months, or its accounts payable have exceeded 80 percent of its revenues (in the previous year) for six continuous months. Under either of these conditions, the mayor is required to proclaim a state of financial instability and inform the municipal council, the Ministry of Finance (MOF) and the Ministry of Local Self Government. The MOF is then required to convene a ‘coordinating body (consisting of the president, representatives of the ministry of education and ministry of local self government and two representatives of ZELS). The mayor then has 15 days to prepare a draft plan of recovery measures and submit it to the coordinating body. Once the plan is approved, it is submitted to the municipal council. Once the council approves, the mayor is obliged to propose a revised budget reflecting the agreed plan of measures. The plan, including the revised budget, remains in effect until the condition that led to declaration of financial instability no longer exists. In the meantime, the municipality is forbidden (inter alia) to undertake new capital projects, hire new staff or promote existing ones. The penalty section of the law encourages mayors to initiate the process. A mayor is personally liable for a fine of between euros 5,000 and E 10,000 if he has not issued a declaration of financial instability as soon as the defining criteria are met. But, as noted in the main text, these provisions in the law have never been implemented.

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4. **Improving Performance of CSEs**

73. **Water supply and sewerage services are carried out by municipally-owned single-purpose water companies or communal services enterprises (CSEs).** (The latter also manage solid waste and maintain parks and cemeteries.) According to the World Bank’s FYR Macedonia Country Note on the water sector\(^\text{34}\), one single purpose water company serves metropolitan Skopje.

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\(^{34}\) World Bank Danube Water Program. FYR Macedonia Country Note. 2015
and seven water companies serve other municipalities. Together, they cover about 40 percent of all consumers. Sixty smaller multi-purpose CSEs cover another 45 percent of consumers. The remaining consumers rely on self-supply.

74. **In terms of coverage, CSEs’ performance appears to be fairly good.** Nine-three percent of all households have access to piped water and 89 percent have flush toilets. Service is generally available 24 hours a day.

75. **However, good coverage and decent performance obscure serious, underlying problems with quality, inefficiency and financial sustainability.** According to the FYR Macedonia Country Note, CSEs have suffered in the last decade and a half from delayed maintenance, insufficient tariff levels, and poor financial management, leading to a vicious cycle of deteriorating assets and lack of funding for new investments. Most water and sewerage infrastructure was installed more than 50 years ago and is now in dire need of capital upgrades. The average number of pipe breaks is over 4 per km annually, compared to the standard benchmark of less than 0.5, and there are around 5.5 sewerage blockages per km annually compared to the standard benchmark of less than 0.1 blockages. Nonrevenue water is high, at about 61 percent. With an average staffing of 8.2 per 1,000 connections, the sector is much less productive than international best practices of 1 to 2, although it is not out of line with the regional average. Most notably, sewage is largely untreated. Although there are nine wastewater treatment plants, these cover only 13 percent of the population. According to the FYR Macedonia Country Note, over €500 million euros (€20/capita/year) in investments are needed to comply with the EU acquis.

76. **Although current tariffs are sufficient to cover the majority of day-to-day actual operations and maintenance expenditures, they are insufficient to finance an adequate level of maintenance, let alone contribute to the cost of capital investments.** An obvious solution to the financial difficulties of the CSEs to increase tariffs. As described in Box 6, the power to set tariffs was recently taken away from municipalities and given to a central regulatory body, which

<table>
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<th>Box 6 Will Water Tariff Reforms Help?</th>
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<td>Until recently, local governments were free to set tariffs for water supply and sanitation. These tended to be set at a level barely sufficient to cover the costs of personnel, energy and supplies. Funding for maintenance was minimal. Funding for major capital works—such as water mains and sewage treatment was provided by donors, if at all. In 2016, the power to set tariffs was transferred to a central regulatory body, which is instructed to set water tariffs to cost recovery levels. The ‘costs’ to be recovered in this case include current running costs (personnel, supplies, energy) as well as maintenance and funding for major capital investments. Advocates of this reform argue that it will force an improvement in the efficiency of CSEs. Two conflicting theories seem to exist about how this is supposed to work. The first assumes that the regulatory body will mandate a decrease in tariffs which will then force CSEs to lay off redundant staff. The second assumes that the regulatory body will mandate an increase in tariffs, which will generate enough revenues to finance needed investments. It is also conceivable, of course, that the regulatory body will succumb to political influences and leave things as they are.</td>
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35 IBNet 2017.  
36 NRW is the difference between the amount of bulk water flowing into the system and the amount that is ultimately billed to consumers.  
37 IBNet 2017.
is charged with setting tariffs sufficient to cover current running costs (personnel, supplies, energy) as well as maintenance and funding for capital investments.

77. **The problem with the approach of raising tariffs is that it does not address underlying operating inefficiencies.** There is evidence that there is room—at least in the most inefficient CSEs—to reduce costs as well. This could be accomplished, for example, by reducing excess staffing, improving leak detection (to reduce technical losses), cracking down on illegal connections, and improving collection enforcement. Such an approach would allow the companies to generate additional resources for maintenance and investment.

78. But finance is not the only constraint on CSE performance. Efficacy of management is also lacking. According to a 2014 report by the Swiss Agency for Development and Cooperation, many CSE managers do not take asset management seriously enough. Managers interviewed for the Swiss report made remarks such as ‘we already do some of the activities, but not in a formal program’, ‘we are more interested in putting out a fire now’, and ‘there are not sufficient resources to implement formal asset management systems’. While municipal councils are legally required to adopt three-year strategic plans for the provision of communal services, the report found that these strategic plans, with few exceptions, do not specify the concrete actions necessary to achieve the desired objectives and required levels of service.

79. The present report did not have the opportunity to examine the financial and managerial problems in CSEs in detail. Nevertheless, available evidence suggests that the problems cited in the Swiss-sponsored reports remain. Further work would be required to define opportunities for reform in the current environment, including through supporting of such type of analysis from the technical assistance available under the World Bank financed projects and with support of other donors or Government funded programs.

5. Capital investment planning

80. **Capital spending accounted for about 20% of total municipal spending in 2017.** Roughly half of this amount was spent on roads (see Chart 14). Another seven percent was spent on water and sewerage works. (The category ‘other construction’ accounted for about thirty percent of the total. No more detailed breakdown of this category is available.) Budget execution data for 2017 suggests that only about one-third of this was financed from external sources (central government capital grants, donors, domestic borrowing) and one-time proceeds from the sale of public land. The remainder is evidently financed from current revenue.

81. **Anecdotal evidence suggests that the quality of local capital investment planning is deficient.** According to the recent Municipal Development Policy Note (MDPN), while the municipalities have formally completed a mandated strategic planning process and refer to these strategies when justifying their investment priorities, most rely on project readiness (e.g., availability of technical documentation and building permits) in deciding which projects to propose for government or donor funding or to undertake with their own resources. (The MDPN finds fault with the strategies themselves, noting that ‘not all are based on sound analysis of the socioeconomic development context at the municipal level, including identification and appraisal of more complex strategic interventions, potential partnership projects, or major investments, that would provide for

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greater impact and sustainable management, and often lack well-formulated and measurable monitoring and evaluation indicators.’

82. **Local investment planning is hampered by uncertainties surrounding the availability of financing from external sources.** According to the recent PFR, ‘funding awards suffer from a lack of clear guidelines and transparency. This fragmentation of policy instruments leads to ineffectiveness and significant administrative costs for municipalities and end users. In particular, the fragmentation of capital grants among different agencies and sectors is likely to impede the appropriate prioritization of projects.’

83. **To address this problem, the MDPN proposes the creation of a mechanism for more predictable capital funding**, by consolidating and reorganizing current capital transfers from different ministries to local self-governments.’ But sectoral ministries would be highly unlikely to give up control over the allocation of grants in their respective sectors. Nor would this solution affect the majority of capital investment financing. As noted above, central grants account for only one-third of municipal capital receipts, and capital receipts finance only one third of capital investments. Thus, a consolidated capital grant program would affect slightly less than ten percent of municipal capital spending.

84. A second approach would be to **enhance the capabilities of the RDF.** As noted above, current funding for the RDF is far below the amount originally contemplated. This approach would presumably require considerable changes in the way the RDF operates. The RDF’s approach for allocating funds among regions would have to be revisited, as the current informal and congenial method for making such decisions will presumably break down once significant amounts of money are at stake.

85. **A third approach would be to create a municipal development fund (MDF), which would provide project investment loans across a variety of sectors to municipalities on the basis of strict project selection and municipal creditworthiness criteria.** In theory, this vehicle could draw on donor financing as well as domestic sources of financing (i.e., domestic banks). The World Bank has a long history of supporting MDFs, with varying degrees of success. (In general, MDFs tend to thrive where they are closely supervised by donors and have no competition from government grant programs and rival donors offering more generous terms.) The latter conditions do not now exist in North Macedonia.

86. **All of these approaches bear further investigation.** When North Macedonia joins the EU, the need for an objective and transparent mechanism for allocating capital investment funding will become more critical, as the volume of EU funds is likely to be substantial.

87. **At the same time, municipalities will have to enhance their own capacity to plan and prioritize capital works.** As noted above, the majority of municipal investments are financed from municipal own source revenues. This will presumably continue to be the case. Municipalities need to put themselves in a position to determine their own investment priorities and only then figure out how to finance them. To this end, municipalities should consider employing qualified engineers.
and other technical experts who are capable of identifying asset management priorities in each infrastructure sector (i.e., maintenance, rehabilitation, new construction), assessing the economic merits of specific investments and assessing tradeoffs among expenditures in different sectors.

6. Disaster Risk Management

88. In North Macedonia, 82% of urban (and 18% of rural) residential dwellings are exposed to seismic risk. Summer fires occur regularly, and flood risk is higher in North Macedonia than all other countries in the Europe and Central Asia region, with the impact of floods on GDP expected to quadruple by 2080. With climate change, the annual damage to critical infrastructure from climate-related hazards is expected to double by 2020 and by 2080 could be more than five-times higher. A major flood or earthquake disaster would derail economic growth, affect critical infrastructure, and disrupt livelihoods.

89. A recent World Bank disaster risk management (DRM) sector assessment for North Macedonia found that, compared to other countries in the region, North Macedonia has relatively low resilience. While the legal framework for disaster management is largely in place, vulnerabilities from climate and disaster risks are exacerbated by national and municipal policy, institutional and resource limitations. There is a general lack of compliance with resilience measures (e.g., building codes, disaster- and climate-informed land use plans); a significant amount of aging building stock; and limited institutional and financial planning to deal with disasters. Further, disaster risk management infrastructure (including, for example, fire stations and fire trucks) are not upgraded nor adequately maintained, and the number of disaster risk management staff (including, for example, firefighters) are low in some areas. Finally, there are practices which are exacerbating these hazards, for example, not regulating riverbeds which result in blocked channels, so water doesn’t flow; and illegal woodcutting which result in erosion.

90. The legislative framework for disaster risk management consists of the Law on Crisis Management, the Law on Protection and Rescue, and a large number of laws and bylaws that contain provisions that directly regulate disaster management at the national and local levels. The Law on Crisis Management sets out the organization and functioning of the crisis management system and policies on decision-making, resource utilization, communication, coordination, planning and financing. The Law on Protection and Rescue (TLPR) establishes the system for protection and rescue of people and material goods against natural and technological disasters in peacetime, state of emergency or war, describing an interlinked system of planning, financing, coordination, mitigation of consequences, preparedness and response to natural and technological disasters. The TLPR indicates how responsibilities are divided between the participants in protection and rescue activities, including the state, local authorities, private companies, and public enterprises, facilities and services.

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39 In terms of relative GDP potentially affected by flooding
40 World Bank (2016a).
41 The most recent major floods in 2015 occurred in 43 of 80 municipalities, affecting 170,000 people, resulting in a damage bill of €35.7 million. Flood risk is particularly high in Skopje. The most recent floods happened in January and February 2015 with estimated damages and losses in amount of EUR 35.7 million [EU estimate].
43 2016 (WB) Country Risk Profiles for Floods and Earthquakes in Europe and Central Asia
44 UNISDR has also undertaken a review of civil protection mechanisms and legislation, https://www.unisdr.org/files/9346_Europe.pdf pg 114
45 For example, Law on Firefighting; Law on Spatial and Urban Planning; Law on Construction; North Macedonia Constitution; Law on Local Self-Government; Law on Macedonian Mountain Rescue Service etc.
46 The Official Gazette of R.M no.36/04,49/04,86/08,18/11.
91. **Within the public sector, responsibility for disaster risk management is dispersed among central and local entities.** Broadly speaking, the central government is responsible for overall strategy. The TLPR, for example, calls for the central government to prepare and revise a national strategy for rescue and protection (NSRP) and adopt a National Risk Assessment and a National Plan for Rescue and Protection. But much of the responsibility for implementing disaster management has been transferred to the municipal level. As noted earlier, responsibility for fire protection and rescue has been largely decentralized to the municipalities, (although the central government continues to pay the salaries of certain staff.) Responsibility for detailed disaster risk planning has also been decentralized. By law, municipalities are required to undertake risk assessments, monitor their own preparedness, and adopt an annual program for protection and rescue in line with the National Strategy for Rescue and Protection. Some municipalities have taken on this function more aggressively than others. For example, a five-year strategy is being prepared for disaster risk management in Skopje. Three million dinars are being allocated for this task and the City is looking to solicit UNDP to support this task. Much of the responsibility for the construction and maintenance of disaster risk reduction (DRR) facilities also rests with municipalities. The hierarchy of North Macedonia’s DRM entities can thus be visualized as follows:

![Diagram]

92. **At the municipal level, responsibilities are further divided between the council and the mayor.** The table below demonstrates the division of responsibilities for protection and rescue within each municipality.
### Party | Responsibilities
--- | ---
**Council** | 1. Determines the obligations of local public enterprises, institutions and services in:  
   a. Extinguishing of fires and rescuing of people and property in cases of car accidents, technical-technological and other disasters;  
   b. Clearance of local roads, streets and other infrastructural facilities from snow, frost and soil caused by heavy snowfalls, rockslides, landslides etc.;  
   c. Giving first aid in cases of increased number of diseased and injured, and, prevention of expanding of contagious diseases;  
   d. Protection of animals and plants in cases of occurrence of diseases, pests and natural disasters.  
2. Monitors the preparedness of local self-government protection and rescue unit.  
3. Decides on the amount of financial assets in the local self-government unit budget necessary for protection and rescue.  
4. Decides on the amount of financial assets from the local self-government unit necessary for paying damages for harm caused by natural disasters and other disasters.  
5. Decides on the distribution of humanitarian aid intended for stricken population in the local self-government units.  
**Mayor** | 1. Proposes the Plan for Protection and Rescue;  
2. Monitors the status of realization of decisions passed by the local self-government unit council related to prevention and mitigation of consequences caused by natural disasters and other disasters;  
3. Is responsible for the preparedness of protection and rescue forces established by the local self-government unit;  
4. Decides on engagement of protection and rescue forces established by the local self-government unit;  
5. Monitors the realization of activities for clearance of local roads, streets and other infrastructural facilities in cases of natural disasters and other disasters in the local self-government unit area;  
6. Requests assistance for engagement of protection and rescue forces established by the legal entities in the area of the local self-government unit;  
7. In cases when the protection and rescue forces cannot eliminate the consequences caused by natural disasters and other disasters requests engagement of the protection and rescue forces of the Republic.

93. **Given the potential costs of natural disasters in North Macedonia and shortcomings of existing prevention and recovery arrangements, several priorities present themselves.** First, municipalities --in partnership with central Crisis Management Center (CMC), the Protection and Rescue Directorate (PRD) other stakeholders-- should collect disaster and climate risk data that would enable them to understand their vulnerability and quantify exposure to natural hazards and the annual damage and loss from natural disasters. This data should be informed by the knowledge and expertise of the Regional Resilience Forum, and be fed into the National Risk Assessment. This is particularly important for those municipalities where a comprehensive risk assessment has not been achieved or the assessment inputs are outdated – including, for example, where new erosion of the land has exacerbated flood risk.

94. **Second, the municipalities, in conjunction with the central government, will need to invest in disaster risk reduction (DRR) measures,** choosing which aspects of DRR to invest in, when, and in what sequence. At present, it appears that a special budget for DRR is not planned at any level of organization. DRR measures could include, for example, drainage channels that would reduce the risk of flooding; funding for firefighters and volunteers to undertake risk reduction and preparedness activities; engineering evaluation of public buildings that are deemed to be “earthquake prone”; upgrades to firefighting equipment that is ageing.
95. Third, the municipalities (again in conjunction with the central government) will need to revisit the current arrangements for financing staff involved in disaster management, especially fire and rescue services. The decentralization of responsibility for these services is particularly burdensome to poorer jurisdictions, so that while some specialized capacities are maintained, basic capacities require additional funding. In an emergency, PRD normally does not provide financial assistance until the municipal budget has been exhausted. There could also be an opportunity where investments in additional fire and rescue staff could potentially be based on shared resources with other countries at the regional level in times of disaster.

7. Recommendations

96. The analyses presented in this report suggests several possible areas for improvements in the financing of municipalities in North Macedonia, including:

97. Increasing local government revenues. The case for increasing local government revenues must be weighed against competing claims on the resources of the central government and the taxpayers. But if the Government concludes that local governments do require more resources, there are three promising ways to accomplish this: increasing the local share of the PIT, increasing the local share of the VAT, and/or increasing the rate of the property tax. The first two of these are policy measures that could be adopted by the central government and would not require fundamental changes in administrative procedures. The last of these is also a policy measure but would require policy changes at both the central and local levels: the central government would have to raise the ceiling on the property tax rate and local governments would then have to raise their individual rates to something approaching the new ceiling. 47

98. Each of these options has a different implication for the distribution of resources among individual municipalities. Increasing the local share of the personal income tax or raising the rate of the property tax would favor jurisdictions with strong tax bases. Increasing the local share of the VAT—under the existing transfer distribution formula—would tend to favor municipalities that are not part of metropolitan Skopje and, among those, jurisdictions that are more rural. Before undertaking any of the measures to increase local revenues, the Government will need to consider their implications for different types of municipalities.

99. Reforming the equalization transfer system. The existing equalization transfer—based on the VAT—has much to recommend it. It is stable, transparent, and based on readily measurable indicators. Due to its small scale and its allocation formula, the VAT transfer is not strongly equalizing, however. The Government could consider improving the equalizing impact of the VAT transfer, particularly if it chooses to increase the overall level of local revenues by increasing the local share of the personal income tax or increasing the rates of the property tax. But the Government should avoid approaches that are too complex or depend upon municipalities accurately reporting their own financial performance. Overall, reforming the VAT transfer system is not recommended to be a priority.

100. Reforming the sectoral block grants. The most serious problem in the transfer system involves the block grants—specifically the block grant for primary education. As described earlier, the existing system of buffers is, in effect, forcing the Government to subsidize the costs of under-enrolled classes and schools. Phasing out the buffers would encourage municipalities to rationalize their school networks, particularly at the elementary level. But the Government would

47 The IMF study recommends improvements in the administration of the property tax as well. But the Government should not undertake such efforts until it has some reason to expect that subsequent tax rates would be high enough to generate revenues sufficient to justify the costs of doing so.
have to accompany this reform with a concerted effort to assist local governments in network rationalization.

101. **Addressing municipal arrears.** To forestall future municipal arrears, the Government should enforce the ceiling on revenue projections, limiting the growth in revenues that municipalities are permitted to incorporate in their budgets. But the Government’s current bailout program creates a moral hazard that such regulations may not be sufficient to neutralize. The Government may want to take a more aggressive approach, imposing some form of quid-pro-quo as a condition of central government assistance. This could, for example, take the form of a Government-imposed financial recovery plan, incorporating mandatory increases in local tax rates (e.g., raising the property tax rate to the maximum permitted by law), dismissal of contractual and temporary staff, and sharp cuts in capital spending. As noted earlier, such a solution is already authorized in the municipal finance law, although the law currently requires mayors to initiate the process. This provision of the law could be amended to allow the central government to take the initiative.

102. **Improving the performance of CSEs.** This report does not examine the performance of CSEs in detail. The available data nevertheless suggests that raising tariffs (e.g., water and sewerage fees) alone is not an optimal solution. There appears to be room to reduce costs instead, by reducing excess staffing, improving leak detection, cracking down on illegal connections, and improving collection enforcement.

103. **Capital investment planning.** This report also does not examine the current system for planning and financing capital investment—at least not in sufficient detail to provide specific recommendations. The available evidence nevertheless suggests that there is a problem: municipal investment choices are overly influenced by the priorities of funding agencies; i.e., Government sectoral ministries and external donors. Local governments’ ability to prioritize the capital investments they finance from their own revenues is weak. To address these problems, the Government could begin by evaluating the various options for reform, including the consolidation of central government grants, ramping up the RDF, or creating a municipal development fund.

104. **Disaster Risk Management.** While much of the responsibility for addressing natural disaster risks rests with the municipalities, the Government could assist them in assessing disaster risks, financing mitigation investments and ensuring adequate funding for fire fighters and rescue workers.

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