SUSTAINING DECENTRALIZATION AND PROMOTING MUNICIPAL DEVELOPMENT UNDER AUSTERITY: A PROPOSED PROGRAMME FOR THE DEMOCRATIC AND GOVERNANCE DOMAIN

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CURRENCY AND EXCHANGE RATES

Currency Equivalents
(Exchange Rates as of May 20, 2013)
US$1.00 47.8 Macedonian Denar (MKD)
US$1.00 0.7791 Euro (EUR)

Government Fiscal Year (FY): January 1- December 31

ACRONYMNS AND ABBREVIATIONS

CDPR	Centres for the Development of the Planning Regions
CHF	Swiss Franc
CHU	Central Harmonization Unit
EC	European Commission
EU	European Union
MKD	Macedonian Denar
MoF	Ministry of Finance
FYR	Former Yugoslav Republic
GDP	Gross domestic product
GIZ	The Deutsche Gesellschaft für Internationale Zusammenarbeit- The German Society for International Cooperation
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession Assistance
IPSAS	Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
LSG	Local self-government
MLGA	Macedonian Local Government Activity
MoLSG	Ministry of local self-government
MSIP	Municipal Service Improvement Project
NGO	Non governmental organization
OSCE	Organization for Security and Co-operation in Europe
PEPBG	Public Expenditure Policy Based Guarantee
PEFA	Public Expenditure Framework of Accountability
PIFC	Public Internal Financial Control
SDC	Swiss Agency for Development and Cooperation
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value added tax
ZELS	Association of the units of local self government

EXECUTIVE SUMMARY

Macedonia is at an inflection point—high unemployment, weak fiscal management and constrained by a region that is still coping with a deep recession. The proposed theme of the programme in Democratic Governance and Decentralization is: *Sustaining Decentralization and Promoting Municipal Development under Austerity.* The theme and its strategy is both a recognition of the serious macroeconomic context and a realistic approach for helping municipalities cope with austerity and also move forward in development. The proposed SDC program which is significant in amount, duration and appropriate in its provision of grant funding, can have a significant impact at this juncture. The recent and impending departure of other bilateral assistance also elevates the profile of an SDC programme going forward.

The economic and fiscal challenges facing Macedonia are immense and could easily diffuse the impact of a foreign assistance programme if it is not properly focused. The proposed three-track program will promote coherence and focus while limiting risk. The focus of the programme is municipalities—fully establishing the basics of PFM (track 1); providing much needed grant funded operational and investment support targeted selectively between high and limited capacity municipalities (track 2); and building on its long advocacy work to promote deepening of decentralization—greater devolution—which is needed to better manage the resource scarcity of austerity (track 3).

Each of the three tracks on their own will have impact and together will provide synergy to better manage resources. Track 1, *Strengthening Public Financial Management of Municipalities,* will address the four areas needed to fully establish municipal capacity in financial management: procedures, training, organization, and data. Track 2, *Budget Support for Municipalities*, will provide a mix of budget support—operational and investment—based on the capacity of a municipality. Municipalities with high capacity (Type 1) will receive only investment budget support and will demonstrate how local development can successfully be planned and executed. Municipalities with limited capacity (Type 2) will receive operational support as an incentive to strengthen their PFM (track 1) as well as investment support. Track 3, *Advocacy for Devolution*, harnesses the long standing relationship SDC has had with ZELS to change the conversation between the central and municipal governments from one of resource entitlement to discretion over resources by municipalities.

Sustainable public financial management is about observing the hard budget constraint—government's living within their means. The key task of maintaining a sustainable budget is the management of fixed recurrent costs—the salaries, entitlements and interest payments. The deconcentrated structure of decentralization in Macedonia does not promote discretion to manage the fixed recurrent cost and unfunded mandates make the situation worse. For municipalities to cope with austerity, they need discretion to better manage their finances. The programme will promote better resource management by strengthening PFM, which in turn will promote discretion.

The new programme means a more active role for SDC--more doing and less advocacy. As a more active programme there are understandably more risks involved yet these are manageable. There is already considerable risk baked into the current financial environment and inaction is arguably more risky than prudent action. The relatively long time frame of the new programme (5 years), the independence of the three tracks, and the potential to partner with other donors, who plan further initiatives in PFM, can mitigate risks. While risks need to be considered, the upside gain must not be forgotten and it would be significant for this programme.

SECTION 1

CONTEXT

1.0 In designing a programme for the democratic and governance domain, four contexts need to be considered: (1) the macroeconomic environment, (2) the status of public financial management (PFM) especially in municipalities, (3) initiatives to promote municipal economic development, and (4) the advocacy of decentralization for municipalities. The four contexts are of course closely interrelated but the order in which they are listed above is a hierarchy that shapes and informs a programme in this domain. The macroeconomic environment places constraints on the resources available and defines what is an appropriate and sustainable programme. The quality of PFM in turn constrains and determines how well the municipalities can manage the challenging economic environment and in turn will be able to manage a programme's budget support for local economic development. The effectiveness of budget support will require adequate municipal PFM and the selection of an appropriate option—content and delivery. Finally, while the dialog on decentralization is the fourth on the list and derivative of the preceding three contexts, it can potentially support both the central government and municipalities in effectively managing the first three contexts.

1.1 Due to the absence of a comprehensive assessment of PFM in municipalities, the focus of this scoping exercise was on assessing the status of PFM. As part of the assessment of PFM, the exercise also reviewed macroeconomic management. Assessing the efforts to date in promoting municipal economic development and possible options for budget support as part of the programme were only briefly touched given the shortage of time. Finally, shortage of time also precluded a follow-on discussion with the stakeholders engaged in advocacy for municipalities (ZELS) and what options might be possible for improving and changing the dialog with this programme.

Context 1: Macroeconomics

1.2 In July 2007, two years after the start of the first phase of decentralization in Macedonia, the first group of 42 municipalities including the City of Skopje, entered into the second phase of decentralization. Less than a month later the global financial crisis began.[1] The crisis continues and while there are signs that the global economy is recovering, recovery is not uniform. The most recent IMF Article IV Consultation of Macedonia completed at the end of 2011 found that "the economic recovery is losing steam due to adverse external developments [but] nonetheless, that Macedonia is poised to achieve low but positive growth under the baseline scenario of a shallow recession in the euro area."[2] Unfortunately, the baseline scenario, of a shallow recession in the euro

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[1] Phase one of the global financial crisis began on 9 August 2007 with the seizure in the banking system precipitated by BNP Paribas announcing that it was ceasing activity in three hedge funds that specialised in US mortgage debt. This was the moment it became clear that there were tens of trillions of dollars worth of risky derivatives were worth a lot less than the bankers had previously imagined. The crisis came to head a year later in September 2008 with the bankruptcy of the Lehman Brothers investment bank.

[2] International Monetary Fund (2012:1). Note that the data of the Article IV was as of December 13, 2011.

area is not materializing—it is deeper and longer than envisioned as shown in figures released by the European Commission on May 15, 2013.

> The recession across the 17-nation euro zone has continued into a sixth quarter, figures show. The bloc's economy shrank by 0.2% between January and March, according to official figures. That left the region's economy 1% smaller for the period compared with a year ago. Individual data for member countries showed nine were in recession, although Germany recorded weak growth of 0.1% in the period. The figure marks the longest recession since the euro was launched in 1999. It was worse than the 0.1% fall expected by economists, although gross domestic product (GDP) numbers, like other economic statistics, are subject to revisions. The weak state of so many euro zone has led to rising unemployment. About 19 million people in the 340 million-strong euro zone population are without work, with unemployment in Greece and Spain running at 27% of the workforce.[3]

The small and open Macedonian economy depends on the euro zone for exports of its goods and crucially for the export of its labor, which cannot find employment in Macedonia. The greatest economic challenge facing Macedonia is its high unemployment estimated to be 31.6 percent, which is especially high amongst the youth and even higher for young women. Macedonia has one of the lowest employment rates in Europe at two-thirds the EU-27 average.[4] The prospects of growth in the euro zone, which can promote growth in Macedonia, and employment of its citizens are not promising.

1.3 The challenging macro economic environment is the defining context for Macedonia's economic development and its policy of decentralization. The resources available for public spending by the central government and municipalities will at best be what exists currently and there is the real possibility that resources will diminish. It is this context that recommends a strategy of decentralization going forward of: *Sustaining Decentralization and Promoting Local Development Under Austerity*. The resource reality facing the country at this time and over at least the short and possibly medium term does not support expanding public services regardless of the tier from which they are delivered. Further, decentralization is a significant expense and while it is essential for political peace, the current resource environment means that decentralization must achieve its promise of more effective and efficient service delivery. Austerity demands that both central and local government manage finances well and this assessment, albeit brief, finds there are significant deficiencies that need to be addressed.

1.4 Except for one striking discussion with a Macedonian financial expert who served as head of both the Ministry of Finance (henceforth the MoF) and the Central Bank, none of individuals interviewed raised the broader macroeconomic context and its implications

[3] "Eurozone recession continues into sixth quarter." Available at: www.bbc.co.uk/news/business-22536201.
[4] World Bank (2012b:4).

for decentralization.[5] While some of the recent literature on the country's decentralization states that the process has stalled and enumerates the various claw backs of the central government, which violate law, these studies do not locate decentralization in a context of austerity.[6] One study stated: "the general conclusion inferred in regard to fiscal decentralization monitored in the period 2008-2011 is that there is no progress, i.e. 2011 fiscal decentralization performance is on the same level recorded for the monitoring year 2008."[7] As our findings on fiscal management below will show, the situation has not plateaued but has deteriorated not just in numbers, but also of far greater concern, in transparency.

1.5 Decentralization should be a partnership based on trust and respect for the distinctive contributions different tiers of government can deliver which has long been discussed and proven in theory.[8] It was not the brief of this assessment to delve into the causes of current fiscal management in Macedonia which have been caused by external factors and quite possibly by recent domestic political factors—expansionary policies as a run up to the 2013 election. There are no simple solutions to austerity or reversing past excesses, but to achieve a sustainable way forward, a frank dialog is needed between the decentralization partners. Local government needs to understand the macroeconomic context and the need for the central government to have flexibility in redeployment and reduction in resources for all tiers of government. Central government needs to understand the virtues of discretion by local government to redeploy and reduce resources—the need for discretion is especially needed in the education sector specifically in the management of complement, which is the single largest expense of municipalities. The core task in securing sustainable public finances is the *management of fixed recurrent costs*—entitlements, payments of interest and principal of debt and typically complement. For the central government, decentralization with its legal provisions that specify levels of resource transfer (i.e. the VAT block grant, the earmarked grants for competences, the grant for local economic development) is in effect an entitlement—a fixed cost—and has to be managed. The recent claw backs by the central government of resource transfers to municipalities clearly demonstrate that the center is unable to meet the resource commitments to decentralization established in law. The claw backs include:

- ✓ Reduction in the monthly transfer of the VAT block grant.
  [In FY 2011 one monthly transfer was not released. In the first quarter of FY

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[5] The expert was Petar Goshav who has publically critiqued the central government's imprudent fiscal management and has privately presented to select multilateral foreign aid agencies their improper role in supporting these practices.

[6] Illustrative of the recent literature on the plateauing of decentralization can be seen in the titles of the Centre for Local Democracy Development 2012 reports: *Decentralization at Standstill; Local and Regional Development in the Republic of Macedonia: Neither Local Nor Regional; New Difficulties for "Incumbent Utilities" on Local Level.* See Centre for Local Democracy Development (2012a, 2012b).

[7] Centre for Local Democracy Development (2012a: 14).

[8] The economic functions of the different tiers of government and the rationale for decentralization was presented by Musgrave and Musgrave (1989).

2012, only a one-month transfer was made of the correct amount, the other two months were not according to formula].[9]

- ✓ Reduction in the share of personal income tax municipalities receive.[10]

- ✓ Reduction of the legally mandated 1% of GDP to be assigned to the Ministry of Local Government (MoLSG) for regional development to .02% in 2012.[11]

The most significant claw back was the reduction in the VAT block grant, which funds education, culture and social affairs and other projects. A sample of 12 municipalities found that the 2011 one month claw back meant they had to use local funds to cover the 11% gap in education costs.[12] Table 1 shows the impact of this claw back for Krushevo municipality—a 34.6% reduction. The reduction in the VAT block grant for 2011 was done even though VAT collections had not declined—further evidence of the central government's need to redirect funds from municipalities to central liabilities—the management of fixed recurrent costs nation-wide.

Table 1

Receipt of Transfers to Krushevo Municipality: FY 2009-2011

(MKD)

2009	2010	2011
29,685,543	34,433,190	22,528,511

Source: Association of Finance Officers of the Local Governments and Public Enterprises (2012a:8).

1.6 The financial amount of these claw backs is significant but equally if not more damaging has been the way in which they have been done. The claw back of the VAT block grant was done without any ex ante notice or ex post explanation and illustrates how the central government is managing the fixed cost of decentralization.[13] The lack of dialogue is damaging to decentralization for it undermines trust.[14] An orderly consolidation and if necessary, retrenchment in the provision of public services by municipalities would be far better than a disorderly process that disappoints current expectations and worse, dashes even higher expectations in the future. The principal

[9] Centre for Local Democracy Development (2012a: 24).
[10] Centre for Local Democracy Development (2012a: 22).
[11] The transfers from the central government for regional development have dropped in recent years from .15% of GDP in FY 2008, .006% in 2009, .02% in 2012. The MoLSG was hoping to negotiate an increase in FY 2013 for the regional development funds from 1.5 million euro in 2012 to 2.5 million euro in 2013.
[12] Centre for Local Democracy Development (2012a: 59).
[13] Non-payment of the VAT block grant continued into first quarter of FY 2012 as only one instalment was disbursed and the balance of the other two was not according to plan or methodology. See Centre for Local Democracy Development (2012a: 24).
[14] The lack of dialogue in the claw back of the FY 2011 VAT block grant can be seen in the MoF's explanation of the claw back: "this is the factual situation, i.e., the State's responsibility ends with the end of the fiscal year." Cited in Centre for Local Democracy Development (2012a: 24).

rationale for decentralization in Macedonia is that it promotes social peace yet if it raises expectations and then disappoints, decentralization may well undermine that very peace.[15]

1.7 Ironically, the adversity of austerity demands deepening of decentralization—evolving from deconcentration to devolution and delegation.[16] The recent literature on decentralization in the country is striking by the absence of a discussion of the three types of decentralization. Austerity is about shocks and who bears them. Local government is the most vulnerable to shocks because it has the least means to respond to them. The claw backs experienced in 2011 and 2012 demonstrate that municipal governments are taking the shocks of austerity. A key discussion going forward by the partners in decentralization is who bears the greatest burden of shocks and how a strategy of *Sustaining Decentralization Under Austerity* can be realized.

Context #2: Public Financial Management

1.8 Understanding the system of PFM at both levels of government and its performance proved to be a challenge for this assessment. The assessment team was unable to identify and obtain documents on the procedures of the core PFM systems (budget, accounts, disbursement, financial information system) though materials were available on internal audit. Discussions with finance officials at both levels of government found that there was confusion over fundamental procedures such as what was the basis of accounting. The absence of a recent and comprehensive assessment of the performance of PFM at either level of government meant that with only limited time available, our understanding of performance would not be informed by documents but gathered piecemeal by interviews. The last comprehensive assessment of PFM, which was limited to the central government, was the PEFA conducted by the World Bank in 2006/07 (see table 5, column 3 below).[17] But the principal constraint to understanding PFM and discussing a possible reform by SDC was the unwillingness of the key departments of the Ministry of Finance—budget, accounts, and treasury—to meet with the assessment team. Only in the second from the last day of the assessment, were we able to meet with the Central Harmonization Unit of the MoF, which is charged with overseeing the government's compliance with the financial requirements of PFIC (Public Internal Financial Control), which are needed for accession to the EU.[18]

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[15] The empirically proven "J curve" developed by Ted Gurr holds that social unrest is sparked not by social stasis or even conditions of absolute immiseration, but when rising expectations are not met. See Gurr (2011).

[16] The three types of decentralization are elaborated in Cohen and Peterson (1999).

[17] The Public Expenditure Accountability Framework (PEFA) is the acknowledged metric for assessing the performance of a country's public financial management. The PEFA conducted in 2006/07 was partial for 10 of the 28 indicators were not scored. See World Bank (2007: Appendix B). It should be noted that the PEFA did not in 2007 have a means of assessing fiscal decentralization and while efforts are being made to upgrade the metric to assess decentralized systems, it is primarily a tool for assessing one tier of government.

[18] For the elements of PIFC see EC (2008).

1.9 It is instructive to review the procedures and performance of any government's system of PFM in terms of two principles. The first and fundamental principal is sustainability—is there a *hard budget constraint*—does government live within its means? Is the budget, which is a one-year plan of revenue and expenditure executed? Only after the first principle of PFM is achieved is it possible to pursue the second principle, good financial management, which has three features: *contestability* (can policy and budget allocations be challenged), *discretion* (do spending agencies decide on deployment of resources) and *active reallocation* (can spending agencies shift resources from one sector to others). Our assessment found that the central government was not adhering to the hard budget constraint and the lack of transparency of financial statistics regarding municipal debt did not allow for a conclusion as to whether municipalities were adhering to this first principle. The current structure of decentralization means that on average, half or more of a municipality's budget is deconcentrated and thus non-discretionary and that the other half is also largely non-discretionary. In this situation, there is little room for contestability, discretion and active reallocation.

Public Financial Management by the Central Government

1.10 The central government is not prudently managing public finances. It is overspending the annual budget by not controlling commitments, it is incurring substantial arrears to suppliers which is limiting liquidity, and it is accumulating levels of debt that are not sustainable. Equally if not more seriously, it is not being transparent about the country's fiscal position.

1.11 *Lack of commitment control.* The first principal of sustainable public finance is observing the hard budget constraint and in systems of government where the legislature appropriates the budget—the executive should not spend without legal authorization. The central government is recently and currently not observing the hard budget constraint and incurring expenditure without legal authorization. The 2011 IMF consultation found the following:

> [Commitment control systems should be strengthened and budget laws and procedures should be strictly enforced to prevent budget users from making commitments that are not matched by budget appropriations. See IMF (2012:17).]
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> [**The authorities agreed on the need to improve public financial management systems.** In particular, they indicated that they would upgrade Treasury IT systems in line with recommendations by a recent Fund TA mission so that all budget users would be required to enter detailed information on annual and multiyear spending commitments into the Treasury information system. They believed that in addition to providing for better control over spending commitments, this would support the medium-term budget process by improving baseline-spending estimates. See IMF (2012:18)].

Whether the weakness of commitment control of the central government's budget is due to deficient Treasury computer system or its operation is worrisome but it is unlikely that incurring commitments is principally, if at all, a computer problem.[19]

1.12 *Arrears.* In recent years, the central government have been incurring arrears to suppliers and have also delayed VAT payments. The 2011 IMF consultation found the following:

> [**The deficit was somewhat larger on an accrual basis due to arrears.** The government failed to make payments totaling Euro 7.6 million due to an external supplier of medical equipment in the second half of 2011 and eventually reached agreement to make the overdue payments (plus interest in January 2012). It also reported Euro 8 million in arrears on VAT refunds. There are also widespread reports by businesses of late payments by the government to its suppliers, suggesting the actual amount of arrears may be higher. Moreover, the government renegotiated some contracts to extend payments to future years for goods and services received in 2011. See IMF (2012:9)].
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> [The government should also ensure that annual budgets provide funding for multi-year contracts signed in previous years. Progress in these areas will help to prevent government payment arrears such as those that arose in 2011. The government should make public the amount of any arrears and commit to reduce them over time. The practice of seeking to reschedule amounts due to private suppliers should be discontinued because suppliers may feel they have little choice if they want continued access to government contracts, and on grounds of transparency. See IMF (2012:17)].

Petar Goshav, the former Minister of Finance and Head of the Central Bank discussed arrears at length with the assessment team and indicated that it was far more serious than what was indicated in the 2011 IMF consultation report, and contends that it is contributing to a serious problems of liquidity. He personally knows of a case where a supplier faces bankruptcy due to the failure of the central government to pay over 20 million euro owed to his firm. The problem of delayed payments to suppliers was also confirmed by the Head of the Project Implementation Unit in the MoF, which is managing the World Bank's Municipal Service Improvement Project (MSIP). She indicated that procurement of the MISP was hampered because very few contractors were willing to supply services in part, to the risk of delayed payments and even when they are willing to supply services, they are unable to secure liquidity. The lack of liquidity and its impact on driving up the cost of procuring goods and services by municipalities was confirmed by the Center for Civil Communications which found that procurement costs varied up to 400% much of which could be attributed to the cost of risk for delayed or non-payment which suppliers passed on to the municipality.

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[19] German Filkov of the Center for Civil Communications confirmed that arrears were a serious problem and said it was made public by a journalist in the past year.

1.13 *Levels of public debt*. Public debt is estimated to be 32.3% of GDP for 2012, which is beyond the 30% level, which the IMF deems, is sustainable. Government statistics on debt do <u>not</u> include the liabilities of state corporations, or arrears and no mention is made of local government debt. The 2011 IMF consultation found the following:

> [**Government Finance Statistics:** data coverage on government below-the-line financing from National Bank deposits is inadequate…In addition, data on arrears, including those on public hospitals, as well as data on state enterprises, which are not part of central government are limited. See IMF (2012: Statistical Issues, pg. 2)].

> [The government debt ratio was 28.6 percent of GDP at end-2011, which is moderate and consistent with debt sustainability. Staff recommends reducing the fiscal deficit to below 1.5 percent of GDP over the medium term, with will be required to stabilize public debt at 30 percent of GDP. Low deficits would also provide space for counter-cyclical policies during future downturns. See IMF (2012:14)].

Petar Goshav has come out publically saying that public debt to GDP is 45% which is 39% above what the IMF lists in the Article IV for 2012 and which is 50% above the 30% sustainability threshold recommended by the IMF.

1.14 *Weak Budgeting.* The central government has not been prudent in budgeting for it has based expenditure on over optimistic revenue forecasts that have diminished the credibility of the budget. The 2011 IMF consultation found the following:

> [**Given the optimistic revenue forecasts in the 2012 budget, expenditures will need to be significantly below budgeted amounts to meet the deficit target.** The amount of needed adjustment relative to the budget is estimated at 2.5 percent of GDP. See IMF (2012: 24)].

The budget cut recommended by the IMF for the 2012 budget totals 11.75 billion MKD (a 7.7% cut in expenditure). If the fiscal position is far worse than the IMF figures indicate and experts such as Goshav contend, then the central government needs to make significantly larger budget cuts.

1.15 The findings presented above from the most recent IMF consultation and the opinion of a very credible local expert do support the real likelihood that public expenditure certainly in the short and quite possibly the medium term, will have to be significantly reduced—there will be more claw backs from municipalities going forward. It confirms that decentralization will be conducted under austerity.

Public Financial Management by Municipalities

1.16 One must be cautious about making generalization about the performance of municipalities in PFM because the variation is so immense. Indeed, the director of the Center for Civil Communications which is implementing a USAID funded project to expand the involvement of small and local enterprises to provide goods and services to municipalities, has argued that municipalities need to be considered in two tiers. Two statistics illustrate the great differences in municipalities. In terms of the amount of local revenue they raise as a percentage of central transfers and donations, Strumica raises 80% while Staro Nagoricane raises 20%.[20] From its study cohort of 12 municipalities, the Centre for Local Democracy Development found per capita annual capital investment in these municipalities varied from 10,040 to 553 MKD.[21] <u>It is clear that there are two types of municipalities—Type 1 that has good capacity and Type 2, which have limited capacity.</u>

1.17 *Commitment Control and Debt.* Neither the literature nor interviews during the assessment found that municipalities had problems of commitment control—overspending the budget authorized by the municipal council. As will be presented below, municipalities do have overoptimistic plans of revenue and expenditure in their budgets and the outturns (what was spent) and there is considerable under spending especially on capital. Whether municipalities have or are incurring debt is not clear but there is some evidence they are indebted. Since 2010 the MoF has removed the listing of municipal debt from its website thus indicating that municipalities were indebted as of that time. The principal reason for the delay of the last six municipalities graduating from first to second phase decentralization was their indebtedness.[22] The Organization for Security and Co-operation in Europe (OSCE) has repeatedly asked the MoF for data on municipal debt and has been told that it cannot be provided due to the constant changes in the amount. It would appear that municipalities do have debt.[23] That said, the two municipalities we were able to obtain financial statements from—Strumica and Krushevo—show no interest payments.

1.18 *Arrears.* None of the five municipalities we visited stated that they were incurring arrears. The recent report by the Centre for Local Democracy Development presents in

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[20] Centre for Local Democracy Development (2012a: 44).

[21] Centre for Local Democracy Development (2012a: 42). A dated study illustrative of the disparities between municipalities were the results of the Macedonia Municipal Capacity Index (MMCI) developed by Development Alternatives. Using the index which ranges from 25 highest capacity to 6 lowest capacity it scored six municipalities as follows: Strumica (25), Gostivar (21), Shuto Orizari (12), Shtip (11), Resen (11) and Kratovo (6). See Development Alternatives (2007: 8).

[22] Organization for Security and Co-operation in Europe (2011:20).

[23] While the statistics on municipal debt may be unclear, what is clear is that there is a lack of mechanisms at the municipal level for managing commitments and debt. The UNDP has found that integral monitoring of the indebtedness of the municipalities does not exist however municipalities are obliged to inform the MoF on the situation of arrears and blocked accounts due to arrears. What is missing is proper management of the commitments and planning of expenditures that shall prevent arrears and on time accurate reporting to the Mayor, the municipal Council and the MoF. Most of the municipalities haven't developed policy and strategy for debt management, as an instrument regarding servicing of debt.

detail the serious arrears that exist in Bitola municipality associated with the legal mandate that transportation be provided to students free of charge.[24] Given the recent requirement of mandatory secondary education which is provided by municipalities, the transport issue has been compounded. Without going into the details of the inadequacy of the education grant to cover the increasing costs of providing transport services to students, Bitola incurred over 1 million euros in arrears to 11 transport companies by the end of 2011. For four months these companies continued services without payment but ceased services at the end of March 2012. As of the publication of the Centre for Local Democracy Development report, these arrears have not been paid and how transport services are to be provided in the municipality has not been resolved. The report goes on to report that the response by the Ministry of Education was "the block grants to education have been disbursed."[25]

1.19 *Weak Budgeting.* In our assessment of the performance of two municipalities in budgeting several weaknesses were found. The variance in total outturn, what was spent by the end of the year to total approved budget, showed for Strumica a 20.2% variance (see table 2). The variance for the capital budget was striking at 39.6%. The reason for the variance in outturn to budget in FY 2012 for Strumica was the variance in revenue collection—under collection of local capital revenue (sales of land and intangible assets) by 41.8% and local revenue for operating expenses by 14.9% (see table 3). What is striking is that the budgeted transfer was fully received. Krushevo municipality also planned a massive increase 314% increase in capital spending for FY 2012 from FY 2011 (see table 4). This weakness in budgeting for 2012 may well be the result of governments in municipalities ramping up capital spending in advance of the 2013 election. The capital budget is the political budget because it is discretionary and visible to voters--a new school or road. Recurrent expenditures are not so visible—salaries and operating and maintenance of facilities—and don't garner votes. Despite the significant increases in budgeted capital expenses for both municipalities in 2012, the ratio of capital to total planned budget was 36.3% and 38.6% for Strumica and Krushevo. A rule of thumb commonly used by budget specialists is that capital expenditure should not exceed 30% of the budget if it is to be sustainable. Above 30%, there is insufficient headroom in the recurrent budget in following years to fund the operating costs of the new capital investment. The 30% is a rule of thumb and in the short term can be exceeded if the capital investments are productive so the proposed capital budgets of these two municipalities were not excessive. Given that municipal budgets are already underfunded, exceeding the 30% rule would be imprudent at this time even if the investment were compelling. The recurrent budget going forward is not adequate to support new capacity.

[24] Centre for Local Democracy Development (2012a: 25-28).
[25] Centre for Local Democracy Development (2012a: 28).

Table 2

Performance of the Strumica Budget for FY 2012

Variance of Outturn to Budget

	Budget (MKD)	Outturn (MKD)	Variance (percent)
Total	1, 120,209,441	894,273,500	20.2%
Operating	712,979,730	648,267,327	9.1
Capital	407,229,711	246,006,173	39.6

Source: Finance Department, Strumica Municipality.

Table 3

Performance of the Strumica Budget for FY 2012

Variance of Outturn to Budgeted Revenue

	Budgeted Revenue (MKD)	Outturn (MKD)	Variance (percent)
Total	1, 120,209,441	905,372,137	19.2%
Operating	883,263,730	751,748,785	14.9
Capital	236,945,711	153,623,352	41.8

Source: Finance Department, Strumica Municipality, 2013.

Table 4

Capital Budget as a Percentage of Total Budget for
Krushevo Municipality: FY 2010-2012

	2010 Outturn	2011 Outturn	2012 Budgeted
Total budget (MKD)	111,434,023	111,780,991	202,728,100
Capital budget (MKD)	16,133,625	18,912,703	78,251,500
Capital budget as % of total budget	14.5%	16.9%	38.6%
Increase of capital budget from previous year %		.3%	314.8%

Source: Association of Finance Officers of the Local Governments and Public Enterprises (2012a:11).

1.20 The central task of managing a budget is the management of fixed recurrent costs. In the short to medium term, complement costs (salaries and allowances) are a fixed recurrent cost and are by far the largest single expense of municipalities. Complement was 52.9 percent of the FY 2012 budget of Strumica and 59.4 percent of the FY 2011 budget of Krushevo. Good budgeting should begin with an accurate listing of staff but it is not clear that municipalities have such a list. Indeed, the annual budget of each municipality should have as part of the budget document, a detailed listing of staff by grade and cost. According to the UNDP, there is no data on local public servants and it is not possible to derive numbers from the budgets, which show aggregates for salary. Given that the central government still has to approve hiring and firing decisions for several categories of public servants particularly teachers, the absence of a current and accurate central register of staff is worrisome for it would appear that there is not data upon which the central government can make decisions on municipal complement.[26]

1.21 Petar Goshav singled out overstaffing as a key problem stating that government had in recent years added upwards of 60,000 new staff. While Goshav did not apportion this increase between central and municipal governments, it would be a significant change from the stated figure of 30,221 municipal employees (see table 5). Goshav also did not say if this increase principally happened in 2012--increasing public sector employment ahead of an election is a practice found in many countries. While we were unable to confirm the increase stated by Goshav, the lack of accurate data on this core budget expense is very worrisome. Accurate data is needed not only for budgeting, but also to ensure that there are no "ghosts' on the payroll.

Table 5
Staffing of Municipalities

Area	*No. of Staff*	*No. of Institutions*
Institutions in the area of culture	557	45
Primary schools	18,505	338
Secondary schools	6,655	81
Area units of the Ministry of Education and Science	11	-
Homes for elderly people	107	4
Kindergartens	3,236	51
Territorial fire fighting units	710	29
Urban planning	279	-
Financial management (Ministry of Finance)	69	-
Tax Administration (Public Revenues Office)	92	-
Total	30,221	548

Source: UNDP.

[26] According to the UNDP, the tracking of public servants in municipalities by the Ministry of Information Society and Administration which maintains a register of all public servants in the country is no longer comprehensive because of a decision of the Constitutional court to exclude from the register all employees in the institutions that belong to the health, education and culture sectors as well as in public communal enterprises not established by the government.

1.22 *Organization and Staffing of the Finance Function in Municipalities*. The finance function including internal audit has not been fully organized and staffed in all municipalities. According to the UNDP, only 38 municipalities, mainly urban have established finance units. The OSCE study of decentralization, which has data through July 2011 from the 74 municipalities that responded to their questionnaire, found that 24 had not appointed an authorized accountant; 16 had not established internal audit units or entered into an inter-municipality cooperation agreement to provide audit services (3 municipalities did not answer the question).[27] It is of course difficult to improve financial management if the organizations and staff responsible have not been created or appointed.

1.23 *Discretion.* One if not the principal argument for decentralization and the justification for its considerable overhead is better provision of public services for they can be tailored to local conditions. The literature and interviews of the assessment clearly confirmed that discretion is very limited. The 2012 Centre for Local Democracy Development found that on average for its survey cohort of 12 municipalities, recurrent expenditures were largely non-discretionary and comprised 85% of the budget leaving only 15% as non-discretionary—the capital budget. More serious, the report found that the trend was for less discretion by municipalities.

> [I]n the last four years [2008-2011] funds obtained as transfers for which municipalities can take independent expenditure decisions were marked by a continuous decrease, i.e., de facto increasing amounts of funds received as central government transfers became "earmarked" grants although, de jure, most of them were block grants.[28]

Another review of local finances confirms the limited discretion of municipalities over finances and service delivery: "local governments are rather passive managers of the institutions they now run, and that in many cases, money is simply passing through their budgets to institutions that are more or less running on autopilot."[29] Our meetings with the finance staff of Gostivar confirmed the limited and diminishing discretion of municipalities. Of particular concern is the lack of discretion over the principal cost for most municipalities—teacher salaries. Municipalities are not allowed to fire or retire staff without the approval of the Ministry of Education. Gostivar faces declining enrollments which in the past few years are approximately 2% per annum yet it is unable to rationalize its staffing of the sector.

1.24 *Adequacy of financial procedures.* The assessment team was unable to obtain manuals for budget and accounts procedures much less training materials related to these

[27] Organization for Security and Co-operation in Europe (2011:24, 27). Authorized accountants in municipalities are responsible for ensuring that the COSO principles of internal control are adhered to: the environment, communication, risk assessment and management, controlled activities and monitoring.
[28] Centre for Local Democracy Development (2012a: 39).
[29] Levitas (2011: 23).

procedures.[30] The lack of availability speaks volumes about how well financial management is documented and sustained. Of particular concern was the confusion found over basic financial procedures, specifically what is the basis of accounting for government accounting. Not only were the municipalities confused, so was the State Auditor's Office. Of the five municipalities visited, one head of finance stated they were doing accrual accounting, two heads of finance stated they were doing cash accounting and two heads did not answer the question. The six officials of the State Auditors Office stated that government accounting was cash basis with notes to the financial statement using an accrual basis. The government is not doing cash basis accounting it is doing modified cash accounting.

1.25 Illustrative of the incompleteness of financial procedures and the lack of sustaining previous technical assistance efforts in PFM is the status of the financial information system (FIS) used by municipalities to manage their budgets and accounts. The final report of the USAID funded Macedonia Local Government Activity (MLGA) states that by its close in 2011 all 84 municipalities were using an FIS developed by the project.[31] Upon the project's closure in 2011, this FIS was placed on the ZELS website for use by municipalities. The assessment team asked the heads of finance of all five municipalities about the status of this system and only the finance head of Strumica responded and indicated that the FIS developed by the MLGA had been out of date for several years. The initial software had both a budget and accounting module but due to changes in the law, the budgeting software became obsolete. She indicated that new software for budgeting was developed and data is entered into that software and then reentered again manually into the legacy MLGA system in order to use the accounting module of the legacy system.[32] Assuming this view by one municipal official is correct, the MLGA FIS either needs to be upgraded so that both the budget and accounting modules are current or new software needs to be acquired. Given the limited manpower and turnover of finance staff, having a user friendly and current FIS is essential to good financial management in municipalities. As the assessment team was unable to meet with the Treasury department of the MoF, which manages the central government's FIS, the shortcomings of the municipal FIS could not be verified from their perspective. It should be noted here that the recent IMF Article 4 consultation found deficiencies in the central government's FIS in terms of its capacity to record commitments and the government agreed to upgrade the system based on a recent IMF technical assistance mission.[33]

Summary of the Performance of Public Financial Management

1.26 <u>Perhaps the most telling statement about PFM in Macedonia is the refusal by the MoF for a PEFA to be conducted</u>.[34] As with all metrics, the PEFA has its limitations but

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[30] The assessment team requested budget and accounts procedure manuals and their training manuals from the following organizations: the Central Harmonization Unit of the Ministry of Finance, the State Auditor's Office, the five municipalities visited, the Association of Finance Officers of the Local Governments and Public Enterprises, and ZELS.
[31] Tetra Tech ARD (2011: 4-5).
[32] The firm of ADISOFT provided the new software.
[33] International Monetary Fund (2012:18)
[34] The government's refusal to allow a PEFA assessment was confirmed by officials of the EC.

it is recognized as the international standard for assessing the performance of a country's PFM. One can speculate as to the government's reasons for refusal but clearly such an assessment would have presented a picture of weak PFM in the central government and worse—shown that deterioration since the 2006/07 PEFA. If PEFAs were conducted for a set of municipalities, serious deficiencies as presented above, would also be uncovered.

1.27 The last PEFA conducted in Macedonia was in 2006/07, which focused only on the central government.[35] There are many limitations of the PEFA metric especially its lack of indicators for fiscal decentralization yet it is instructive here for some of the deficiencies found six years ago persist in the central government and can also be seen in municipal financial management. Column (3) of Table 6 presents the scores for the central government from the 2006/07 PEFA and columns (4) and (5) provide an estimated score of select indicators for both the central and municipal governments based on this assessment. The 2006/07 PEFA was very incomplete with 10 indicators not scored.

- Budget credibility
    - PI-1 (aggregate expenditure outturn compared to original approved budget). 2006/07: the highest rating (A); 2013 for Municipalities (C).[36]
    - PI-4 (stock and monitoring of payment arrears). 2006/07 the highest rating (A); 2013 for Central government would be a (C) or (D).

- Predictability and Control in Budget Execution
    - PI-8 (transparency of inter-governmental fiscal relations). 2006/07: was not scored; 2013 for Central government would be a (C) or (D).
    - PI-10 (public access to key fiscal information). 2006/07: was not scored; 2013 for Central government would be (C) or (D).
    - PI-16 (predictability in the availability of funds for commitment of expenditures). 2006/07: scored (B+); 2013 for Central government would be (C) or (D); 2013 for Municipalities would be (C) or (D).
    - PI-17 (recording and management of cash balances, debt and guarantees). 2006/07 scored (A). 2013 for Central government would be (C) or (D).
    - PI-19 (competition, value for money and controls in procurement): the central government received a very low score in (D+). 2013 for Municipalities (C) or (D).
    - PI-20 (effectiveness of internal controls): 2006/07 scored (B). 2013 for Central government would be (C) or (D); 2013 for Municipalities would

[35] World Bank (2007).
[36] The PEFA metric uses a grading system from A to D.

be (C) or (D). This indicator specifically addresses the effectiveness of expenditure commitment controls. The assessment has not yet been able to ascertain if commitment control is a problem in municipalities. The recent OSCE assessment of decentralization examined the performance of municipalities in terms of external control using the criteria of whether they had appointed an authorized accountant.[37] As of July 2011, 32% of municipalities had not appointed an authorized accountant.

- PI-21 (effectiveness of internal audit): 2006/07 scored (C). 2013 for Central government (C) or (D); 2013 for Municipalities (C) or (D). The OSCE assessment report as well as our discussion with OSCE staff flagged internal audit as a serious problem for municipalities (see paragraph 1.20 above).

[37] Organization for Security and Co-operation in Europe (2011:27).

Table 6

Summary of the PEFA Indicators for 2006/2007 and
Estimated Scores for Central Government and Municipalities Based on this Assessment

		Central Gov't 2006/7 PEFA	**Central Gov't 2013 Est**	**Local Gov't 2013 Est**
(1)	(2)	(3)	(4)	(5)
	INDICATOR			
	A. Credibility of the Budget			
PI-1	Aggregate expenditure out-turn compared to original approved budget	A		C
PI-2	Composition of expenditure out-turn compared to original approved budget	A		
PI-3	Aggregate revenue out-turn compared to original approved budget	A		C
PI-4	Stock and monitoring of expenditure payment arrears	A	C or D	?
	B. Comprehensiveness and Transparency			
PI-5	Classification of the budget	A		A
PI-6	Comprehensiveness of information included in budget documentation	Not scored		
PI-7	Extent of unreported government operations	Not scored		
PI-8	Transparency of inter-governmental fiscal relations:	Not scored	C or D	
PI-9	Oversight of aggregate fiscal risk from other public sector entities	Not scored		
PI-10	Public Access to key fiscal information	Not scored	C or D	
	C (i) Policy-Based Budgeting			
PI-11	Orderliness and participation in the annual budget process	Not scored		
PI-12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	Not scored		
	C (ii) Predictability and Control in Budget Execution			
PI-13	Transparency of taxpayer obligations and liabilities	Not scored		
PI-14	Effectiveness of measures for taxpayer registration and tax assessment	Not scored		
PI-15	Effectiveness in collection of tax payment	Not scored		
PI-16	Predictability in the availability of funds for commitment of expenditures	B+	C or D	C or D
PI-17	Recording and management of cash balances, debt and guarantees	A	C or D	?
PI-18	Effectiveness of payroll controls	C+		
PI-19	Competition, value for money and controls in procurement	D+	?	C or D
PI-20	Effectiveness of internal controls for non-salary expenditure	B	?	?
PI-21	Effectiveness of internal audit	C	C or D	C or D
	C (iii) Accounting, Recording and Reporting			
PI-22	Timeliness and regularity of accounts reconciliation	A		
PI-23	Availability of information on resources received by service delivery units	C		
PI-24	Quality and timeliness of in-year budget reports	C+		
PI-25	Quality and timeliness of annual financial statements	C+		
	C (iv) External Scrutiny and Audit			
PI-26	Scope, nature and follow-up of external audit	B		
PI-27	Legislative scrutiny of the annual budget law	B+		
PI-28	Legislative scrutiny of external audit reports	C		
	D. Donor Practices			
D-1	Predictability of Direct Budget Support	D		
D-2	Financial info provided by donors for budget, reporting on project, programme aid	C		
D-3	Proportion of aid that is managed by use of national procedures	D		

Sources: Column (3) from World Bank (2007); Columns (4) and (5) from Assessment.

Context #3: Municipal Economic Development

1.28 The third context, the status of municipal economic development, directly informs how budget support could be used under this programme. As indicated above, there was insufficient time to adequately examine this context. Table 7 presents the six types of funding that are currently used or are proposed to be used to fund municipal development.[38]

Table 7
Current Types of Funding for the Economic Development of Municipalities

	Type of funding	*Pros*	*Cons*	*Experience*
	Revenue			
1	Municipal revenue	-sustainable -better stewardship? -contextual	-inter-municipal imbalances	-select municipalities have failed to raise the revenue earmarked for capital investment (e.g. Strumica)
	Grants			
2	MoLSG	-a more coordinated nation-wide development programme	-not contextual	-lack of funding -little capacity -limited experience
3	Regional Development Bureaus	-a more coordinated regional development programme -provision of technical assistance -possible twinning of muncipalities	-administrative overhead nter-regional imbalances	-lack of funding -little capacity -limited experience
	Debt			
4	Municipal Bonds	-expansion of capacity that promotes growth	-fiscal sustainability -quality of investment plans to repay bondholders	-select municipalities have not been granted approval by the MoF to issue bonds (e.g. Strumica)
5	Bank Borrowing	-expansion of capacity that promotes growth	-fiscal sustainability -quality of investment plans to repay loans	-growing but a very small proportion of municipal funding
6	World Bank Infrastructure Project	-concessionary rates	-cumbersome procurement	-poor quality of requests -uncompetitive contracting environment

1.29 The experience of all six types is limited so it is difficult to evaluate the respective performance. The results to date, however, are not encouraging. Promoting municipal development, especially the development of municipalities that are not well endowed nor have adequate administrative capacity--the Type 2 municipalities--faces serious disabling factors. First, there is a lack of capacity at the municipal level to not just plan a local development project, but more important, to execute a project. Related to execution is a second disabler--the lack of a competitive contracting environment, which would promote quality bids and execution. This problem is particularly found in the construction sector, which is dominated by a few firms. A third disabler discussed under the macroeconomic context is the public sector's--both central government and municipal governments-- accumulation of arrears, which threatens the viability of firms servicing

[38] The assessment did not determine whether municipalities have issued bonds—type 4 financing.

the public sector. Concomitant with arrears is the lack of liquidity for contractors. In short, there are pros and cons of all six types of financing municipal development but unless the execution of local development projects is improved, the type of financing is moot. Improving the execution of municipal development is as we have seen is greatly constrained by the challenging macroeconomic environment, which are beyond the means of a technical assistance programme focused on municipal development to ameliorate.

1.30 We briefly here examine the experience of select types of financing municipal development. Type 1, municipal revenue, promotes imbalanced inter-municipal development for the better off regions have access to revenue for investment. In one of the five municipalities visited, Strumica, the municipality under collected by 42% the revenue it planned to use for investment which resulted in an under spend of 40% of the capital budget (see tables 2 and 3 above). Granted this is a case of one but if the planning and execution of the revenue/budget nexus is so unpredictable in a Type 1 municipality, it will be especially difficult to effectively plan and execute development in Type 2 municipalities.

1.31 The experience of Type 2 and 3 funding—grants through the MoLSG and the Regional Development Bureau--is very concerning. Indeed perhaps the most shocking claw back by the central government has been its gutting the funding for regional/local development. The central government was mandated to allocate 1% of GDP to this activity and has never come close to respecting this mandate. The transfers from the central government for regional development in recent years have been less than .2% of GDP: .15% of GDP in FY 2008, .006% in 2009, and .02% in 2012. The Minister of the MoLSG is hoping to negotiate an increase in FY 2013 for the regional development funds from 1.5 million euro in 2012 to 2.5 million euro in 2013. These are paltry sums.

1.32 The experience of Type 5 funding, bank loans shows that it is a miniscule amount of municipal funding. In 2010 Bank loans comprised only .49% of select municipalities total finance, which increased to 1.82% in 2011.[39] What is not clear from this aggregate figure is the profile of the select municipalities taking bank loans—presumably they are the better off, Type 1 municipalities. These statistics do indicate that the MoF is being cautious in its approval of bank lending by municipalities.

1.33 The experience of Type 6 funding, accessing the World Bank's infrastructure loan program, is also not encouraging. Disbursements have not met plans for this project because of the poor quality of bids.

1.34 To conclude our discussion of the challenges facing funding of municipal development I draw on the 2012 case study of Krushevo municipality. This municipality received financial assistance from the UNDP and technical assistance from the Association of Finance Officers of Local Governments to prepare a local development plan. While recognizing the limits of a single case, a few insights are possible. First, and again, without knowing the full context, did the agency providing technical assistance—

[39] UNDP.

the Association of Finance Officers—have the requisite expertise in local economic development? This raises an issue not just for Krushevo but for crafting a broader program of budget support for municipal economic development—is there expertise in Macedonia in this specialized area? A second observation from the case is the lack of capacity, indeed organizational confusion, in the municipality to not only plan but also execute projects. The case study found:

> In local self-government there are departments for local economic development and departments for urban planning and spatial planning. In general, the problem in the local administration is the overload with administrative competences, so one department at the same time covers competencies of more departments and within the department one person is presented in more sectors, which are not defined according to competences.[40]

The case provides a third observation—that the weakness of civil society and local business means—limits these sector's participation in municipal development. Interestingly, the study raises, but does not expand on, the need for a "cluster" approach to local development.

> The fragmentation and poor capacity of the citizen's sector and the economic sphere we consider there is a poor basis for the establishment of functional networks of the economic entities, as in a cluster sense, as well as in concession and establishment of social and public-private partnerships.[41]

The report concludes on why the municipality's plans have not been executed:

> The existing strategic plans and programs partly have adopted action activities, but very little of the planned has been realized. The basic reasons are lack of economic activity and stronger economic entities in the municipality, insufficient support by the investment funds, as well as disinterest of the population and poor inventiveness of the few economic entities, in relation of long term implementation of these efforts.[42]

In short, the ground is not fertile for promoting municipal development using local agents—CSOs and business. There are serious headwinds challenging economic development especially in Type 2 municipalities.

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[40] Association of Finance Officers of the Local Government and Public Enterprises (2012c:9).
[41] Association of Finance Officers of the Local Government and Public Enterprises (2012c:11).
[42] Association of Finance Officers of the Local Government and Public Enterprises (2012c:7).

Context #4: Decentralization Advocacy

1.35 The fourth and final context is how decentralization and the promotion of a better balance between the central government and municipal governments is advocated. This task has largely fallen to ZELs and the conversation understandably has focused on protecting the entitlements that recent claw backs have infringed upon. Again, for the central government, decentralization is a fixed cost that must be managed. While the dialogue between center and locale has focused on entitlements, little attention has been given to a discussion on increasing the discretion of municipalities so that scarce and diminishing resources--the claw backs--can be better managed. In sum, deepening decentralization from deconcentration to devolution to better utilize scarce resources. As with the context of funding municipal development, the assessment had only brief discussions—a few hours at the start of the assessment—to understand the advocacy process.

Summary

1.36 The four contexts can be summarized as follows:

Macroeconomic context

- ✓ Imprudent fiscal management: weak commitment control, accumulation of arrears, and unsustainable levels of debt.
- ✓ Lack of transparency by the central government about financial data of both the central government and municipalities.
- ✓ Significant claw backs of resources to municipalities in violation of the law.
- ✓ Expansion of unfunded mandates to municipalities (e.g. mandatory secondary education and school transport).
- ✓ Violating the law by sending capital grants to schools directly.

PFM context

- ✓ Current decentralization and its trend are de jure and more important, de facto deconcentration with little discretion.
- ✓ Significant variation between municipalities in terms of scale, capacity and local revenue sources.
- ✓ Organization and staffing of the finance function including internal audit is not complete in some municipalities.
- ✓ Weak budgeting with over optimistic forecasts of revenue and expenditure.
- ✓ Weak financial procedures in terms of documents, training and information systems.

Municipal economic development

- ✓ Limited experience of successful planning and execution.
- ✓ New organizations for implementing municipal economic development (regional organizations).
- ✓ Weakness of the MoLSG.
- ✓ Modest amounts of bank loans to total municipal finances.

Advocacy of decentralization context

- ✓ Focus on protecting municipal entitlements.
- ✓ Lack of focus on deepening decentralization through devolution.

SECTION 2

NEW DEMOCRATIC GOVERNANCE AND DECENTRALIZATION PROGRAMME: MAIN PRIORITY AREAS AND OPTIONS RECOMMENDED FOR THE PERIOD 2014 TO 2018

Strategy

2.0 The theme of SDC's initiative for a finance component of its Democratic Governance and Decentralization domain should be: **Sustaining Decentralization and Promoting Municipal Development under Austerity.** Austerity is clearly upon Macedonia as it is in virtually all of Europe and many parts of the world. It is better to manage it than ignore it. The finance project under the SDC domain of democratic governance and decentralization will assist municipal governments to better cope with austerity but also move forward with development. The programme's strategy would have three tracks:

- Track 1: *Strengthening Public Financial Management of Municipalities*. This would ensure that the basics of PFM are in place specifically--procedures, organization, staffing, training and data.

- Track 2: *Budget Support for Municipalities*. Grant financing of local municipal development would compensate for the virtual elimination of funding of this activity by the central government and the limited access to bank loans. Grant financing unlike loans would not be a burden on recurrent budgets of municipalities which are already strained to meet unfunded mandates and are not in a position to take on additional fixed costs—principal and interest payments.

- Track 3: *Advocacy for Devolution.* Austerity demands that all partners do more with less, which requires better management and thus greater discretion by municipalities of resources.

Austerity is painful and difficult to accept but there is a silver lining if it promotes better management through greater discretion thus deepening decentralization with greater devolution and delegation and less deconcentration.

2.1 Table 8 below presents the three tracks and the specific activities within each track. The tracks are independent and would on their own have a significant impact. The independence of the tracks limits the risk of the proposed programme. To the extent all three tracks are realized there would be considerable synergy and greater impact. For example, if track 2 (budget support for regional development) proceeds, municipalities would be better able to manage this new investment if their financial management was in good order (track 1).

Table 8

The SDC Strategy for Sustaining Decentralization Under Austerity:
Three Tracks and their Activities

Track/ Activity	Description	Partner Organization
1	**Strengthening Public Financial Management of Municipalities**	
	Procedures	MoF
1.1	Development of Procedure Manuals for Budgeting, Accounting, Treasury for Municipalities	
1.2	Introducing modified cash accounting	
1.3	Development, implementation, and maintenance of a Municipal Financial Information System (FIS) covering budgeting, accounting	
	Training	MoF
1.4	Development of training materials using the updated procedure manuals	
1.5	Establishment of a training unit in the Ministry of Finance	
1.6	Delivery of training to finance staff of municipalities	
1.7	Delivery of training to mayors	
1.8	Delivery of training to municipal assemblies	
	Organization	MoF, MoLSG, Municipalities
1.9	Financial units established in all municipalities	
1.10	Authorized accountant hired	
1.11	Internal auditor hired	
	Data	MoLSG/Municipalities
1.12	A performance assessment of a representative sample of municipalities	
1.13	Disclosure of municipal debts and arrears	
1.14	Establishment of a staffing database by municipalities	
1.15	Salary census by municipalities	
1.16	Preparation of an infrastructure deficit index of municipalities	
1.17	Preparation of a list of deferred maintenance by municipalities	
1.18	Development of costing techniques for key municipal services	
2	**Budget Support for Municipalities**	TBD
2.1	Capacity building of municipalities in local economic development	
2.2	Capacity building in the preparation and execution of municipal development projects	
3	**Advocacy for Devolution**	ZELS
3.1	Presentation and discussion of the municipal finance performance assessment	
3.2	Presentation of municipal liabilities	
3.3	Presentation and monitoring of the impact of claw backs on municipal budgets and services	
3.4	Policy dialogue between central government and municipalities on discretion in staffing and financial resources	

2.2 *Rationale.* For municipalities the rationale for this programme is clear especially the need for track 2. The following observations by two mayors highlight the level and nature of the demand, which an SDC programme would be responding to.

"An empty house needs everything."[43]

> "One mayor went so far as to say that SDC had made itself marginal to the real issues of decentralization by concentrating entirely on the national level (ZELS) and on participation. He recommended a more active role for SDC that would directly impact the functioning of municipal governments."[44]

These observations show the opportunity and challenge facing an SDC programme in the governance and decentralization domain. There is much need especially for budget support that could fill significant gaps caused by claw backs and unfunded mandates. It is recommended that the SDC programme <u>not</u> provide budget support to supplement the recurrent budget of municipalities but instead provide budget support for grant financing of local development projects that will have a long-term impact. Recurrent expenditures should be sustainable and they should be met by domestic not foreign sources. The second observation above by a municipal mayor goes to the heart of the rationale of this programme and all three tracks—the need for SDC to have a direct impact on the functioning of municipalities.

2.3 The proposed programme, especially tracks 1 and 2 would have a direct impact on the functioning of municipalities but requires a significant departure by SDC from its previous programmes--it involves working with a new partner (the MoF), deepening its engagement with an existing partner (the MoLSG) and realigning its role with existing partners (ZELS and Community Budget Forums). In brief, the proposed SDC strategy is less about advocacy and more about doing. Doing is far more risky than advocacy yet austerity demands it. The current needs of municipalities, which will continue in the foreseeable future, have never been greater. The SDC also needs to be more active because bilateral support to the country has been declining in recent years and with GIZ's imminent exit, SDC will be the only bilateral left.[45]

2.4 *Risks.* While the proposed programme involves greater risks than previous SDC programmes that focused on advocacy, the potential upside gains are significant and well worth the greater risk. The three tracks would help government at both tiers manage austerity and deepen decentralization. While the proposed programme does have risks, there are several means of its mitigation. First, the five-year time frame of this programme is sufficiently long to build the needed capacity of tracks 1 and 2. Second, risk can be managed by partnering with other development agencies, specifically the UNDP which is planning further engagement in PFM.

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[43] Mayor, Mavro-Rostusha, May 2013.
[44] Mohmand and Acosta (2012: 12).
[45] This is according to the study by Mohmand and Acosta (2012: 12)

Details of the Strategy: the Three Programme Tracks

Track 1: Strengthening Public Financial Management of Municipalities

2.5 Despite limited time and the absence of a recent comprehensive inventory and assessment of the financial performance of municipalities, this assessment found evidence that the basics of financial management—procedures, organization, staffing, training, and data--are not fully established in municipalities—track 1 would do so.

2.6 The findings of this assessment on the performance of PFM at both the center and especially the municipal level means that the initial design of the PFM needs to be reconsidered. The initial design was deepen PFM at the municipal level by introducing more advanced budgeting techniques related to costing (e.g. cost drivers by sector, the development of unit costs) which would bring policy more directly into the budget process. Once budgeting at the municipal tier was improved, the initial design envisioned introducing performance techniques that would use the costing techniques—performance agreements signed by municipalities in advance of the receipt of their block grants that could be based on cost drivers (e.g. pupil teacher ratios). Introducing more advanced techniques of budgeting and adding performance to the fiscal transfer is premature given that the basics of PFM are not yet fully established in all municipalities. Track 1 can therefore be viewed as having two phases. The first phase is to get the basics in--procedures, organization, staffing, training, and data—followed by a phase two when budgeting is enhanced with costing and performance techniques. What makes the sequencing of these phases complicated is that great variation in the capability of municipalities. For some, phase 1 could be completed relatively quickly while for others which face severe capacity constraints; phase 2 may take several years. One of the first activities of Track 1 would be to conduct a PFM assessment of municipalities and this could be followed up with a second assessment to determine if a municipality was ready to adopt phase two reforms.

2.7 *Procedures.* There are three procedural weaknesses: apparent lack of manuals for budgeting, accounting and treasury; the lack of clear guidelines for modified cash accounting; and an inadequate financial information system (FIS) for municipalities. Procedure manuals are essential for several reasons: documenting the existing system so that future reforms depart from what exists; providing users with a reference; for the design of training materials; and, the design of an FIS that meets government specifications. Good procedure manuals are the foundation of good training. Procedure manuals ideally should clearly present the principles that underpin the activity (e.g. the materiality principle in accounting), the specific tasks and forms needed to perform the activity, and the legal basis of the activity (the relevant current laws that regulate the activity).

2.8 A striking finding of this assessment, which some might consider arcane and of minor consequence, was the confusion the assessment team found over the basis of accounting. Some finance staff in municipalities simply did not understand the concept of the basis of accounting while others including staff of the State Auditors Office stated the basis was cash. This is incorrect based on answers by officials to a simple test of how a transaction might be handled. Perhaps one reason why the central government does not accept that the country is running modified cash is because there is no international standard for modified cash or modified accrual. Given the government's *process* rather than *results* view of financial management which assumes that laws and regulations are all that is needed to establish PFM, it is not surprising that the absence of an international standard means the government will not adopt publically a system of accounts even though it is done in practice.[46] There are four basis of accounting starting with the simplest—cash followed by modified cash followed by modified accrual followed by full accrual. A cash basis only presents on current asset—cash and the system simply show the movement of cash—inflow and outflow. The modified cash and accrual basis show a variety of entities beyond simply cash of current nature (e.g. payables to suppliers, receivables, etc) and provides a more complete picture of an organization's activities. Full accrual presents the same entities as modified cash and accrual but shows them as current and non-current and provides a comprehensive view of the financial position of an organization. There is a fierce and ongoing debate in the PFM as to whether governments should adopt full accrual accounting, which we need not go into here. According to the staff of the State Auditor Office the IMF has recommended that Macedonia adopt full accrual accounting and one of the officials stated her support for such a reform.

2.9 There are several reasons why Macedonia should adopt modified cash accounting and why it is part of getting the basics of PFM established. First and most obvious they should adopt it because they are doing it. Not being clear about this procedure is a source of confusion, which the assessment found. Second, modified cash would make simpler and facilitate the execution of the budget. Under modified cash there is an agency period, typically one month after the close of the fiscal year—January in the case of Macedonia. This agency period allows time for suppliers and government to settle their transactions that were incurred during the fiscal year just ended in December. While the government does have provision for a revote, that is unused portions of the budget can be carried forward to the next fiscal year so that transactions can be settled in principal under the new budget, revotes are about the paper of the budget, not the cash that support them. The precarious cash situation of municipalities especially with claw backs means that government liabilities should be settled as quickly as possible. There is a serious problem of arrears to contractors, which has knock on effects of drying up liquidity. Establishing an agency period would allow for the prompt settlement with contractors and restore trust in government procurement. The third and very significant reason for adopting modified accounting is that it would make public finances more transparent—current liabilities

[46] The International Public Sector Accounting Standards Board (IPSASB) is the source for International Public Sector Accounting Standards (IPSASs) and to date has only issued a standard for the cash and full accrual basis of accounting. Activity (a.5 in Table 10 above) of the EC IPA project (improving the Public Sector Accounting and reporting system to be aligned with international standards and EU requirements, full application of ESA 95/2010) raises a question. What basis of accounting is the EC proposing that needs alignment with international standards? From the meeting with the State Auditors Office our assessment team was informed that the IMF is recommending that the government adopt accrual accounting. It should be noted that the PIFC does not require accrual accounting.

would be in public accounts for all to see. Transparency of liabilities certainly in the central government and quite possibly in municipalities is a major deficiency in PFM. The fourth and final reason for adopting modified cash is it provides the basis for much better financial management at both tiers of government as public managers have a far more comprehensive picture of the current financial position.

2.10 One finding of the assessment is that the financial information system (FIS) developed under the USAID MLGA project has not been maintained and is no longer adequate. It needs to be replaced. What is recommended is an FIS for municipalities that at this point is separate from but may in future be linked to the MoF's Treasury FIS. This component needs to be carefully done because FIS systems can be quickly over specified and take years to develop and cost multiples of the original budgets. The World Bank PEPBG project has as one of its components (b.3) the upgrade of the Treasury's FIS so that commitments can be entered (see table 10). The EC IPA 2 Project seems to be duplicating what the World Bank is doing with its activity (a.3) and what is not clear is whether the EC is doing and upgrade or a wholesale replacement of the central government treasury FIS.[47] The SDC municipal FIS should steer clear of the activities by the EC and the WB to upgrade the central treasury system. What is needed is a simple system that can be rapidly implemented and maintained in Macedonia at minimal cost. One option might be to use a "low end" commercial off the shelf (COTS) software like FreeBalance, which is relatively inexpensive. Another option would be to examine the partial upgrade that was done to the MLGA legacy system. According to the Head of the Finance Unit in Strumica, the local firm of ADISOFT did an upgrade. In any case, the system running in Strumica should be reviewed to determine what options make sense. Down the road and after the municipal FIS is properly running in all municipalities it may make sense for the Treasury Department of the MoF to think about how the municipal and central government systems could work together. While it would be preferable to develop a municipal FIS through the MoF Treasury department, if they want to over complicate matters and demand that the system be part of the Treasury upgrade or a new Treasury system, then serious thought should be given to developing a system through ZELS so to get a functioning FIS implemented quickly and cheaply—SDC could better control costs through ZELS.

2.11 *Training.* There is no unit in the MoF responsible for in-service training. Effective training begins with authoritative procedure manuals from which authoritative training materials are based. Our assessment was unable to obtain procedure manuals or training materials for PFM. The past efforts of training have been one-off and of very short duration—two to three days. Training in budgeting and accounting for municipal staff needs to be adequate and experience from other countries shows, requires intensive training over several weeks. The law specifies that the heads of finance departments have a first degree in economics but such preparation may not involve any study of budgeting, accounting or auditing. Our brief assessment of five municipalities found that heads of finance units had not been trained in PFM. Another reason why a thorough and frequently scheduled training programme needs to be provided is that municipalities have

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[47] The EC IPA 2 project has activity (a.3) that will upgrade of the Treasury System by introduction of Treasury Integrated Information System for efficient management of public finances. See table 10.

turnover of finance staff and replacement staff need to be trained. Finally, given that decentralization in Macedonia is largely deconcentration, the central government and thus the MoF should be responsible for the training of finance staff in municipalities. Training is needed not only of the finance staff in the municipalities, but also of mayors and councils to improve their awareness and oversight of the finance function.

2.12 *Organization.* The SDC programme would work with the MoF, MoLSG and municipalities to ensure that the organization and staffing, which is missing in some locales, is established. A conditionality of a municipality receiving support under track 2 (budget support for regional development) would be their establishment and adequate staffing of a finance unit.

2.13 *Data.* As indicated in section 1 of this report, there has never been a systematic assessment of the PFM performance of municipalities along the lines of a PEFA. The 2006/07 PEFA was focused only on the central government. The government's refusal to allow donors to conduct another PEFA of the central government is extremely concerning for it raises questions about the government's commitment to transparency of fiscal matters. Activity 1.12 (a performance assessment of a representative sample of municipalities) is needed. The assessment team discussed with UNDP the need for a "PEFA Light" of municipalities and they agreed to its importance and have suggested doing such an activity under activity (a.1) of their IPA 2012 project (see table 9 below). (This assessment need not be expensive and could be done by local staff, possibly college students or graduates as long as they were properly supervised). What is not being recommended here is that donors conduct a full fledge PEFA no that it cover the central government. In any case, the central government has made it clear it would not accept a full-fledged PEFA. This assessment should be done early in the programme for it will provide input into several of the activities of track 1 as well as provide a benchmark of the readiness of a municipality to receive budget support for regional development (track 2). Another sensitive issue would be the requirement of municipalities to disclose their debts and arrear activity (1.13) as a condition to receive budget support under track 2. The recurrent budget in municipalities will also be better managed if staffing and operating and maintenance (o&m) are clearly understood. Staff is the principal fixed cost of municipal budgets and adequate data is needed (activity 1.14) and it would be prudent to conduct a salary census to ensure that the payroll is accurate and includes no ghosts (activity 1.15). Operating and maintenance tends in many countries to be ignored while paying salaries and making capital investments take higher priority. Given the lack of central grants for facilities that municipalities have no tenure over, there is a need to prepare a list of deferred maintenance and rank needs (activity 1.17). Turning to the capital budget, an infrastructure deficit index needs to be developed (activity 1.16) which will assist in both planning local development programmes and be part of future discussions with the central government on equalization. Pulling all of this data together and making better decisions about resource allocation, municipalities need to know how to do proper costing of their budgets in terms of the cost drivers and unit costs of their key sectors (activity 1.18)

2.14 *Donor Activities in the track 1 space.* Given the need for coherence and the scarcity of donor resources to the country it is essential that the programme not duplicate and where possible, complement current and planned donor initiatives in PFM. Given recent and planned departures of select bilateral aid agencies from Macedonia, the SDC will have a unique niche as one of the few and certainly the most significant, bilateral agency. Three other donors are currently involved in PFM and or planning to work in this space: UNDP, World Bank and the European Commission. The UNDP is planning through EC financing a new programme to support decentralization, which includes four components of PFM (see table 9). This programme, which is planned to begin in the autumn of 2013, is scheduled to run for two years and has a proposed budget of 2.3 million euro.[48] UNDP is currently in the process of preparing the detailed activities and there may be overlap with some of the activities of track 1. The recently contracted World Bank Public Expenditure Policy Based Guarantee (PEPBG) project has a PFM component and the EC is proposing an IPA 2 project. The activities of these projects in PFM are presented in tables 10 and 11 respectively. As can be seen from these tables, while there is some overlap with other donors, most of track 1 is not being addressed. The World Bank and the EC are focused on the central government not municipal governments.[49] UNDP has the most overlap in terms of track 1 though is taking a very different approach to track 2 by building capacity of municipalities to use debt for local development. One virtue of SDC's involvement in track 2 is that it would provide grant not debt financing of local development.

[48] The proposed budget of 2.3 million euro of the UNDP IPA Decentralization covers other activities beyond the PFM activities presented in table 9.

[49] Assuming the central government follows through, the PFM components of the World Bank's PEPBG project should promote transparency in debt, liabilities and improve commitment control. The PEPBG project matrix does not however mention municipalities but does refer to the Law of Budgets, which presumably covers municipalities.

Table 9

Proposed IPA Decentralization Project to be implemented by UNDP

UNDP Activity (1)	**Possible overlap with proposed Track 1 activities** (2)	**Description** (3)
A		
a.1	1.12	Assessment of municipal performance indicators
a.2		Upgrade and replication in all municipalities and city of Skopje
a.3		Reinforcement with interventions in primary and secondary legislation
B		
b.1		Establishment of Monitoring and Evaluation Units in representative municipalities
b.2		Strengthening the M&E units with effective reporting mechanisms
C		
c.1		Introduction of relevant ISO and CAF standards
c.2		Obtaining international credit rating for select municipalities
D		
d.1		Preparation and delivery of a comprehensive capacity development programme for efficient collection of local tax revenues
d.2	Potential overlap with all of Track 1	Stable financial management and internal financial control to all municipalities and the city of Skopje. The focus will be on local debt and contracts management (commitments, arrears as well as on financial monitoring, evaluation/internal control and reporting.

Source: UNDP.

Table 10

The PFM Components of the World Bank PEPBG Project

PEPBG Activity (1)	**Possible overlap with proposed Track 1 activities** (2)	**Description** (3)
A		The borrower has established an inventory of its (i) payment arrears and (ii) VAT refund arrears, and has agreed to a timeline and plan to clear the stock starting in October 2012.
B		The borrower's MoF has taken the following measures to improve the management of fiscal commitments:
b.1		Amendments to the Manual of Treasury Operations (Official Gazette No. 118/12) to (i) set forth how multi-year liabilities will be recorded, reported and validated, and (ii) prohibit the Treasury Department from approving payment requests if liabilities are not properly registered
b.2		The Amendments to the Manual of Treasury Operations have been circulated to all budget users with a confirmation that the statutory penalties provisioned in the Law of Budgets will be applied for failure to meet the requirements of (i) reporting commitments and (ii) meeting expenditures with the available budget without incurring arrears
b.3		Establishment of a Working Group with the MoF (Decision number 04-27553/1) to (i) prepare changes to the Treasury Information System to incorporate entry and monitoring of multi-year liabilities; and (ii) adopt a plan of activities; and (iii) commence implementation of such plan.

Source: World Bank (2012:31).

Table 11

The PFM Components of the Proposed EC IPA 2 Project

IPA 2 Activity (1)	**Possible overlap with proposed Track 1 activities** (2)	**Description** (3)
A		Sound Public Financial Management, support for the core functions of the MoF
a.1		Strengthening the medium-term fiscal programming, development of reliable medium-term projections improving the analytical capacities for fiscal impact and fiscal risk assessment
a.2		Improving the framework for medium-term budget planning (central and local) and implementation, establishing medium-term expenditure framework, strengthen strategic planning and budgeting; debt management
a.3		Upgrade of the Treasury System by introduction of Treasury Integrated Information System for efficient management of public finances
a.4		Full implementation of the PIFC concept, decentralized financial management for further delegation of financial authority and responsibilities; managerial accountability
a.5	1.2	Improving the Public Sector Accounting and reporting system to be aligned with international standards and EU requirements, full application of ESA 95/2010
a.6		Alignment of relevant legislations and its implementation with the acquis of the sector

Source: EC.

2.15 *Risk.* Track 1 involves risk because it requires the MoF to deliver *procedures* and *training* and take the lead in concert with the MoLSG and municipalities to complete the *organization/staffing* of the finance function of municipalities. The MoF has proven to be a difficult client for other donors. The recent experience of the EU with its twinning project in the MoF is not encouraging. This project was to improve internal financial control and support the MoF's capacity to implement the PIFC financial requirements needed for accession to the EC. The project was meant to cover 25 organizations in the central government and 40 municipalities but had to drop coverage of the later to focus on the central government. The assessment of this latest project to build capacity in the MoF by the EC task manager is sobering: the project made little progress and the organization established in the MoF to implement the PIFC (the Central Harmonization Unit) is marginal and ignored by the relevant departments of the ministry (budget, financial control, treasury) that need to adopt PIFC procedures.[50] Even more sobering is the EC task manager's conclusion that the MoF will not take accession related PFM reforms seriously until accession talks begin. For track 1 to have impact and more

[50] For the experience of the recent EC twinning project see European Commission (2013b).

important, for it to be sustainable, it must be located in the MoF. Previous efforts by development agencies and NGOs to introduce PFM reform outside of the MoF have not lead to systematic and sustainable reform. The USAID funded MLGA project developed an FIS system that was passed on to ZELS but was not sustained and is no longer fully functional. The Association of Finance Officers of the Local Governments and Public Enterprises has conducted episodic PFM training but appears to have no comprehensive training materials that are based on government procedure manuals for budgets and accounts (which may in any case not exist). The MoF must take the lead in PFM reform and experience has shown that attempts to circumvent the MoF have led to unsatisfactory outcomes. PFM in Macedonia must be coherent and that can only be achieved if one organization, the authoritative organization of PFM, drives reform—the MoF. The question for SDC is whether the MoF would accept implementing track 1? There are several reasons to believe the Ministry would be receptive if the SDC approach was appropriately couched. Track 1 should have no stated link to PIFC and accession issues. A separate brief would be needed to go into the details of why PIFC is at least technically difficult for MoF and thus why the EC twinning project has faced such difficulties. In sum, the SDC approach to track 1 should be couched in strengthening the existing financial administration of municipalities so that they can better carry out the mandates of decentralization. Unlike many of the features of PIFC, which require a major sea change in financial management, track 1 is about improving what exists. Indeed, while track 1, activity 1.2 (introduction of a modified basis of accounting), would appear to be a major reform, it is simply recognizing what is going on in practice—improving what exists. The logic of working with MoF to strengthen municipal finance is compelling—one hopes it is accepted and effectively implemented by the MoF.

Track 2: Budget Support for Municipalities

2.16 The limited schedule and the focus on the status of PFM at both levels of government precluded a detailed design of the content but especially the agents which the SDC programme might partner with to deliver budget support to municipalities. Despite the limitations of time, table 7 above shows that there is limited experience with municipal development. Put more starkly, while there has been progress in strengthening the planning process of municipal development, execution at that level remains problematic. Indeed, do we know what to do to promote municipal development and how to do it? The context of this track is challenging—the contracting environment is not competitive, the skill set of municipal planners and managers is limited, the organization within municipalities for these activities is inadequate, grant funding from central government has been virtually withdrawn and there is institutional innovation that has yet to be fully established and tested—the Centers for the Development of the Planning Regions (CDPR).

2.17 In crafting the track 2 strategy two decisions need to be made—differentiating the needs of Type 1 and 2 municipalities and the mix of support appropriate for the type of municipality (tables 12 and 13 below).

Table 12

Budget Support Options for Municipalities under Track 2

	Pros	Cons
Option 1: Operational Support	-municipal budgets are severely underfunded -limited transaction costs for delivery -rapid disbursement -large disbursements -could be tailored to Type 2 municipalities	-not prudent to fund operational expenditures with foreign aid -gets the central government off the hook in terms of unfunded mandates -weakens the leverage for greater devolution -fiduciary risk due to weak municipal PFM
Option 2: Investment Support	-investment expenditures are an appropriate use of foreign aid -funding—debt and grant--is extremely scarce -grant funding would not pose a short-term burden on already burdened municipal operational budgets -could promote more balanced development by targeting Type 2 municipalities	-many disablers (see context 3) -no clear agencies to work through -significant transaction costs for delivery -slow disbursement -small disbursements -fiduciary risk due to weak municipal PFM

Table 13

Strategy for Budget Support

	Operational Support	Investment Support
Type 1 municipalities		x
Type 2 municipalities	x	x

2.18 Clearly a decision needs to be made as to relative priority to be accorded Type 1 and 2 municipalities. There are many potential scenarios and one can see the tradeoffs in Scenario 1 as follows:

Scenario 1

- Funding both types of municipalities
- Rationale for funding Type 1 municipalities
    - Only investment support provided
    - Investment support would provide an incentive for improving the basics of PFM (track 1) but also introducing policy based PFM

    - With robust PFM in place, investment support could start soon into the programme demonstrating what to do and how to do it—relatively quick wins
    - Possibility of "twinning" with nearby Type 2 municipalities to strengthen their PFM (track 1) and their use of investment support (track 2)

- Rationale for Funding Type 2 municipalities
    - Operational and investment support would be provided
    - Operational support compensates in part the local resource endowment
    - Operational support would be an incentive for strengthening the basics of PFM (track 1)
    - Operational support would limit the diversion of investment support for operational needs
    - Operational support would precede the provision of investment support in part to see how well the municipality manages funds
    - Investment support would start relatively late in the programme and be of judicious amounts appropriate to the small scale of investment opportunities

2.19 There are many virtues to scenario 1. The Type 1 municipalities would have an incentive to rapidly improve the basics of PFM and also adopt more advanced PFM techniques—policy based budgeting. Type 1 municipalities could thus demonstrate what are the basics of municipal PFM and what is appropriate beyond the basics. Second, they could early on provide lessons in how to successfully plan and execute municipal development projects, which could be replicated in other Type 1 and hopefully Type 2 municipalities, and might also inform national policy—promoting a robust contractor environment. This scenario also would provide an opportunity to further test the innovative 'micro-region' approach developed by UNDP in its MDG Based Planning project, which paired three more developed municipalities (Type 1) with smaller rural municipalities (Type 2).[51] From the standpoint of the need for the SDC programme to plan and achieve adequate disbursement rates, scenario 1 will ensure a budget support mix during its five-year life that should ensure strong disbursement rates especially in the earlier years with operational support for Type 2 municipalities.

2.20 *Donor Activities in the track 2 space.* Table 7 above presents the 6 types of financing for municipal economic development and the organizations, which provide this funding. The central government through the MoLSG and the new tier of government—Centers for Development of the Planning Regions are providing grant funding (type 2 and 3 in table 7). The World Bank through its infrastructure project is providing loan funding (type 6 in table 7). The IPA Decentralization project proposed by UNDP is still being designed but will continue its work in providing technical assistance to the planning and execution of municipal development projects.

[51] UNDP (2010:5).

2.21 Arguably one of the most compelling reasons for SDC to provide budget support for municipal investments is the dearth of funding. Government funding that was promised has not been forthcoming. The central government was mandated to allocate 1% of GDP to this activity and has never come close to respecting this mandate. The transfers from the central government for regional development in recent years have been less than .2% of GDP: .15% of GDP in FY 2008, .006% in 2009, and .02% in 2012. The Minister of the MoLSG is hoping to negotiate an increase in FY 2013 for the regional development funds from 1.5 million euro in 2012 to 2.5 million euro in 2013. These are paltry sums.

2.22 The SDC programme would not only provide much needed funding for municipal development; its grant character is especially valuable given the state of public finances in Macedonia. Grant financing also accords with Law of Financing of Municipalities, which stipulates a diversified portfolio of instruments—not just loans. There has been much discussion in recent years that municipalities should embrace debt driven development either through borrowing or issuing bonds. ZELS is even considering the creation of bank from which municipalities can borrow. The MLGA project stated that one of its best achievements was to bring Moody's in to do a credit rating for municipalities and a Moody's certificate hangs prominently in the mayor's office of Strumica. The 2012 study of fiscal decentralization in Macedonia by academics from Georgia State University goes on at great length about the theoretical and economic wisdom of local governments incurring debt for capital investments.[52] Track 2 is based on a very different view of how municipal development should be financed under austerity—<u>it should be grant not loan financed</u>. It is imprudent to burden the recurrent budget at this time when its funding is not stable (claw backs), when it must cope with unfunded mandates with large fixed recurrent costs that are not being met (i.e. mandatory secondary education, free transportation for students), and when it is carrying liabilities (arrears and debt). The argument that taking debt is a sign of autonomy and deepening of decentralization is academic if municipalities simply are not in a position to assume the risk of more liabilities. Yes, debt can promote development but it also is a risk to sustainability. Further, debt funded projects need to be properly planned and well executed so the expected benefits payback the interest and principle—are there such municipal projects in Macedonia? It would be helpful to have such cases to prove that the reality supports the theory of debt led development.

2.23 Track 2 would be a godsend to municipalities for it would be grant financed and should have as part of the investment package, provision for two to three years of grant financing of the installation recurrent costs of maintaining the investment—operating support for Type 2 municipalities. The virtue of this provision is that if gives "breathing room" to the recurrent budget so that it does not have to support the new investment in the short term. Given the significant claw back by the central government in funding local development, now 1.5 million euro, the SDC programme could be the major player in this activity and following the recommendation of the mayor quoted above—the SDC would play a more active role that would directly impact the functioning of municipal governments. Track 2 is clearly part if not coterminous with the SDC's strategic domain

[52] Republic of Macedonia, Ministry of Finance (2012b: 88-122).

2—economic development. Indeed, the SDC might want to rethink how domain 2 fits with track 2.

2.24 *Risk.* Track 2 does have risk the most significant being that that little is done over the life of the programme. Of particular concern is the array of actors involved (e.g. MoLSG, CDPRs) and the lack of their track record in assisting municipalities in the design and execution of development programs. As the discussion of the municipal development context shows, there is much inertia and little proven success in the area of municipal development. While there is a downside, there is enormous upside to track 2. Arguably the most pressing problem in the country is unemployment, which is particularly high in the Type 2 municipalities. Track 2 is not a panacea but it is a start and given the relatively long 5-year duration of the programme, results can be achieved and built on by other programmes. With a 32 percent unemployment rate, which is even higher amongst the youth and even higher amongst young women, municipal development is urgent.

Track 3: Advocacy for Devolution

2.25 As with municipal development, the schedule for the design exercise did not allow for in depth consultation with stakeholders involved in the advocacy of decentralization. We did have a two-hour meeting with senior officials of ZELS at the start of the exercise. The conversation between municipalities and the central government often conducted through the intermediary of ZELS has been focused on resources and their inadequacy—the claw back of entitlements. Austerity requires that this conversation also include not just issues of resources but equally if not more important, discretion over the management of resources. It is clear that the central government does not have the resources to meet the decentralization mandates already in place—the claw backs. As section 1 of this report shows, this situation is not likely to change any time soon. The conversation on resources has now shifted to how municipalities can obtain more resources through incurring debt—a strategy that at this juncture should be used modestly at best for it is imprudent given the fragile resource environment and the lack of stability of municipal recurrent budgets. Resources are not the answer, they never are and what is needed is to make decentralization promote better resource management is to give municipalities greater discretion over resources generated locally and received from the center. The promise of decentralization is precisely better management of resources because they are tailored to local needs and conditions. What is striking about the recent literature on decentralization in Macedonia is the absence of the distinction between the three types of decentralization—deconcentration, devolution, delegation. It is clear that decentralization currently is for the most part deconcentration, which circumscribes local discretion. Even those areas which are not deconcentrated involve non-discretionary expenditures so there is very little discretion. There is no magic bullet to managing finances in the best of circumstances and there is certainly no magic bullet to do so under austerity. But management is needed and management is about discretion. The SDC has had a long and productive relationship with ZELS and track 3 builds on that relationship. Changing the conversation with the central government from resources to discretion is less threatening to the central government because they can always continue the practice of clawing back resources—and given the macroeconomic context they probably will continue to do so. Indeed, by giving municipalities discretion they could if need be, argue that claw backs were needed because of mismanagement—an argument the central government has already made in the dispute with Bitola municipality regarding free transportation of students.[53] Through ZELS municipalities should push for greater discretion especially over the key cost drivers of services—teacher and health care worker salaries.

2.26 In addition to promoting devolution by dialogue with the center, track 3 could promote decentralization between municipalities as suggested by the innovative twinning approach of 'micro regions' discussed above for promoting municipal economic development as well as introducing and sustaining municipal PFM reform.

2.27 Track 3 would require a serious policy dialogue between SDC and ZELS for it is a very different approach to what ZELS has done in the past and is proposing to do in the future. Track 3 would involve three changes between SDC and ZELS.

- First, ZELS would be shifting the emphasis of its advocacy from keeping the status quo deconcentration (with more resources) to that of expanding the discretion of municipalities. ZELS is well placed to understand the policy issues for the center and the municipalities to realize devolution. Taking this first step would require an intense engagement by SDC and ZELS. As part of this process, ZELS could monitor the performance of municipalities in achieving the two phases of track 1: phase 1 (establishing the basics of PFM) and phase 2 (going beyond the basics to policy budgeting).

- Second, fiscal management under austerity means that ZELS needs to better understand the respective expenditures and financing of recurrent and capital budgets. Recurrent budgets have to be stabilized in terms of expenditure (unfunded mandates—e.g. free transport of students) and their sources of funding. Capital budgets should not impose a burden on overburdened recurrent budgets—ZELS needs to reconsider its advocacy of debt financed local development. Its vision of becoming a bank for municipalities in an era of high indebtedness of certainly the central government and quite possibly select municipalities seems out of step.

- Third, the design of track 1 means that ZELS would be out of the role of PFM capacity building of municipalities—this would be done by government.

2.28 To make a compelling argument for greater discretion by municipalities over its finances, the municipalities need track 1 as a foundation and track 2 in turn, which would demonstrate the virtues of discretion in practice. The three tracks on their own will have impact but together have a common synergy—deepening devolution.

[53] The central government argued that Bitola municipality mismanaged the contracts with the transport companies. See Centre for Local Democracy Development (2012a: 27).

2.29 *Donor Activities in the track 3 space.* Again, the assessment of track 3 was limited by time but it would appear that few if any donors are involved in this space. The SDC's long and productive relationship with ZELS should continue.

2.30 *Risk.* Track 3 does require that ZELS change its message and also get out of the capacity building business. The argument for the latter hopefully would be accepted for its rationale is so compelling—sustainability requires government manage the support of PFM. The loss of resources to ZELS from its exit from providing capacity building may be compensated by the use of ZELS in promoting municipal twinning to support tracks 1 and 2.

Going Forward

2.31 This assessment provides a framework for the design of the upcoming SDC programme in the democratic and governance domain. Going forward what is needed is a critical discussion of the framework by stakeholders as to content and especially execution.

ANNEX 1

Individuals Interviewed

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The following individuals/organizations were contacted but did not confirm an appointment or cancelled the appointment.

1. Vukica Savovska, Department of Municipal Budgets, MoF.
2. Nikola Popovski, expert (former Minister of Finance)
3. Abdulmenaf Bexheti, expert, professor at University of Southeast Europe (former Minister of Finance)
4. Ivo Ivanovski, Minister, Ministry of Information Society and Administration (MISA)
5. Budget Department of the Ministry of Finance (contact: Kristina Jordanovska Minister’s secretary).

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