

## The Future of Fiscal Decentralization in Southeast Europe: What is on the Horizon?

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**ABSTRACT** Although the current post-decentralization decade offers much more tranquility for practitioners of the fiscal decentralization, decentralization scholars should not fall asleep. Some of the awakening questions are: where is the decentralizing limit? What is the likelihood of fiscal decentralization reconstructing the intergovernmental relations in a way that leads to federalization of unitary countries in Southeast Europe? Even though we focus on the Macedonian experience, the main findings largely hold for the entire region. The study aims to provide new, interdisciplinary understanding of the implications and perspectives of decentralization, overcoming the limitations when adopting a purely legal, economic or political perspective.

**KEYWORDS:** • fiscal decentralization • local revenue • local expenditure • federalism • intergovernmental relations • Southeast Europe • Macedonia

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DOI 10.4335/11.3.325-343(2013)

ISSN 1581-5374 Print/1855-363X Online © 2013 Lex localis (Maribor, Graz, Trieste, Split)  
Available online at <http://journal.lex-localis.info>.

## 1 Introduction

A large body of theoretical and empirical literature is highlighting the advantages and disadvantages of decentralization, both for unitary and federally structured states. The main corollary from the cross-country experience is that fiscal decentralization can produce sustainable net benefits for the developing and transition countries. Scientific research underscores that subnational governments in the South Eastern European (hereinafter: SEE) region ten years ago required much more real taxing power than they actually had. In terms of the geographical context of the investigation, the study focuses on the following SEE countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Macedonia, Montenegro, Serbia, and Slovenia. After extended studies and policy proposals, numerous solutions have been offered for their local fiscal systems, all inclining to a common denominator – a higher degree of fiscal decentralization.

As a result, these countries have established diverse but not so dissimilar models of subnational government financial systems, up to the “new” wave of decentralization that occurred worldwide in the previous decade. In that period, SEE countries have been strengthening subnational (local and regional) governments’ capacities as a high-priority item on their development policy agenda, along their European Union integration. A lot of work has been accomplished in the region, an issue that will be more extensively elaborated later in this paper.

In the year of 2013 we consider the region walking through the post-decentralization decade. The key issues of decentralization – from a public finance, political, social and legal perspective – have been solved, major questions have been answered or the answers are just behind the corner. Therefore, the decentralization steam is decreasing. It is a reaction of the kick off pressure on the start of transferring responsibilities in many areas that have never been exposed to such degree of decentralization before.

The region is now standing in front of the new “wave” with several possibilities: enjoying the fruits of decentralization; surfing on the decentralization waves continuously; strengthening local fiscal autonomy; negotiating and struggling with the central authorities for additional assignment of responsibilities and following local fiscal powers; creating more tiers of local governments versus the idea of decreasing the subnational tiers; remodeling territorial division; implementing asymmetric fiscal rules in order of keeping the state’s fiscal sovereignty? A lot of issues compromise the decision while standing at the crossroads. But the main concern is: which is the next direction of decentralization? Are there one-size-fits-all solutions suitable for the SEE countries?

A common way to shed light on the main challenges and perspectives is to look at the voluminous literature and worldwide conferences' conclusions that suggest a lot of priorities for the next period: rethinking the local taxes (Canavire-Bacarreza and Martinez-Vazquez 2012; Ponce-Rodríguez et al. 2012), remodeling intergovernmental relations, mostly in fiscal terms (e.g., Feruglio, Martinez-Vazquez and Timofeev 2012), and strengthening infrastructure services at local level (e.g., Feruglio, Martinez-Vazquez and Timofeev 2012). Each of them deserves a special research attention. But, being on the side of the decentralization, one issue has constantly been producing an ache to the policymakers at the SEE region. The question of decentralization limitations, particularly the question: is further decentralization leading to federalization of unitary structured states in SEE region?

The main research objectives of this paper are therefore: (1) to critically examine the results of the decentralization in SEE countries, particularly the fiscal decentralization benefits that had been experienced in the last ten years, and (2) to forecast the direction of decentralization and the possible policy options on the way forward.

The paper is organized as follows. The next section explains why intergovernmental fiscal relations do matter in unitary states in SEE region, whereas the case of Republic of Macedonia is taking a major part of the study. The third section examines the directions for further fiscal decentralization. Special attention is given to the nexus between fiscal decentralization and federalization as a possible option in some SEE states. Conclusions follow.

## **2 Why intergovernmental Fiscal Relations do Matter in the Unitary States in South Eastern Europe?**

### **2.1 The Benefits of fiscal Decentralization in the SEE Region**

The most important benefit from decentralization is the increased efficiency (and consequent welfare gain) that comes from moving governance closer to the people. True believers in fiscal decentralization argue that - if successfully implemented - it is not only improving welfare directly but also contributing to addressing key problems, such as economic development, revenue mobilization, innovation in public service delivery, accountability of elected officials, capacity development at the local government level, and grassroots participation in governance. What more can one ask for?

Therefore, this paper does not aim to examine the dilemma of "decentralizing or not" the small and unitary states. That has already been done by many scholars (Lockwood 2004; Inman 2007; Oates 2008). The same economic and non-economic benefits apply to the unitary as to any other state - that is a member of

federation or confederation. We are thinking in a way of reconsidering the idea of limits of decentralization in a unitary state, in order to predict if it is going to produce: a) more efficient results in terms of economy development or quality public service, or, b) lead to federalization.

The main goal is to assess the direction of the ongoing decentralization. Why does federalization or fragmentation make such a political noise or a hesitation and how that comes up to an academic query? The answer can be found in the political atmosphere all over the SEE region over the past 20 years. At every local election the policymakers and general public addresses this question. Federalization, separation, or fragmentation have been qualified as inappropriate and considered as a constant fear of unitary states' politicians in the SEE region. This paper neither has ambitions to re-assure the majority of policymakers, nor to settle down the wide public. Furthermore, being on a scholar's side, we accept that federally or unitary structured state does not mean that you have better or worse constitutional arrangement or intergovernmental relation. Both types of states have constitutional rules and legal procedures, explicit or implicit, for being at the side of the decentralization and making authority or spending powers to lower levels of government.

From today's point of view it is very important to summarize the decentralization benefits in SEE unitary state. In particular, the political benefits from decentralization have been associated with:

- Providing incentives for a politically more correct behavior by the central and local government (Croatia, Macedonia, Serbia);
- Strengthening the fragmented territories of the newly established post-socialist states (Albania, Bosnia, Macedonia);
- Ensuring civil rights to local government (in all SEE region);
- Relaxing fiscal powers of the central authorities (Hungary and Slovenia) (e.g., Brezovnik and Oplotnik, 2012);
- Enabling continuity in the tradition of devolution of many responsibilities (Slovenia, Hungary, Macedonia);
- Stabilizing the intergovernmental relations (Hungary, Croatia, Bulgaria, and Slovenia);
- Embracing new values of democracy, that is considered as guiding important spirit of the decentralization (Macedonia, Albania, Kosovo, and Serbia);
- Establishing accountability and transparency at local level (all over the SEE region);
- Pursuing local government's values (all over the SEE region);
- Stabilizing of the states (all over the SEE region), and
- Accomplishing the European Union integration process requirements, etc.

The economic benefits were recognized in achievement of efficiency in the local governance, higher quality services in education, social care, culture and mostly in communal services. For example, the preschool and elementary school had been decentralized and revenues were assigned to all municipal governments. Communal activities have been decentralized which led to higher quality in communal local services (Maksimovska and Pendovska 2009). Social care and responsibilities in the field of culture have been generally shared or decentralized between subnational governments. The results occurred promptly after few local projects in these areas. Broadly speaking, the decentralization, especially fiscal decentralization results has pushed the local government into new roles, as partners of the state in macroeconomic development, and created better place for living in accord the local citizen's needs. Therefore, the policy recommendations for SEE states have been justified on the economic grounds too. Furthermore, newly established municipalities have become macroeconomic partners of the central state in achieving positive economic results in the field of creating new employment, attracting foreign investors, bettering the infrastructure in terms of roads, water supply, energy etc.

The administrative benefits were recognized in moving the governance towards closer level to individuals, facilitating the work of the central government, building new local capacities, strengthening administrative infrastructure in terms of elementary schools and day care centres. Also, many of the previous central state's regional centres were replaced by new subnational or local centres (for example, in terms of administering and collection of taxes).

The legal benefits were recognized by strengthening the rule of law, at least as a respect of constitutional provisions and making use of ratified international agreements. One of the most important international local governance acts is the European Charter of Local-Self Government that requires many decentralization tools and sets new legal rules in decentralization laws in the countries that had ratified it (especially in the field of fiscal decentralization as stipulated in Articles 8 and 9). Therefore, the acquisition of these European Chapter's rules in the national legislation of these countries was found to be beneficial for the European integration agenda of the SEE region. Also the SEE states implemented the Recommendations of the Congress of Local and Regional Authorities of Europe in terms of broader legal document and acts to verify the local government capacity, provisions for local fiscal accountability and transparency in local budgeting, etc (AFWLG, 2007).

## **2.2 The Fear of and Reasons for Fiscal Decentralization in the Unitary States of the former Yugoslav Federation**

In terms of the models of fiscal decentralization in the SEE region, we narrow the research scope of the study and focus primarily on the ex-Yugoslav republics.<sup>1</sup>

Having in mind the history of ex-federation of Yugoslavia and the previous extreme system of fiscal decentralization with unique intergovernmental fiscal relations (during the 1974-90 period), we can disentangle some common characteristics for the newly established fiscally decentralized systems in the states. The main remembrance they have is that fiscal decentralization has not always led to better communication and intergovernmental relations (Maksimovska 2010). In other terms, the extreme fiscal decentralization in the ex-federation is thought to have brought dissolution of the state at the end.

After the break-up of the federation, the choice of fiscal decentralization model in the newly established states caused a number of dilemmas:

- the competences that should be decentralized;
- the degree of local fiscal autonomy that should be obtained;
- the principle of symmetry and equality between different local units;
- the principle of asymmetry in fiscal decentralization;
- the phase approach in transferring competences and assignment of responsibilities, and
- the type of local fiscal accountability that should be obtained.

The newly established independent states focused on nation building and institutional capacity building on one side, but also suffered from the fears of decentralizing authority powers to lower level of authority (subnational) at the beginning. On the other side, the democracy, the economic development, the processes for integration in the global market and into European Union, could not be accomplished without implementation of the quality system of local governance accompanied by adequate local fiscal powers (Brezovnik and Oplotnik, 2012). From, today's point of view it is clear that all ex federation states were cautious in choosing and implementing fiscal decentralization at the beginning years of their independency.

It might come as a surprise, but the decentralization in this region was pushed faster than expected and faster than South Africa, India, Philippines or other developing countries. This was mainly because of some specific reasons that could be explained with the need for resolving different ethnical tensions in fragmented societies. In this context, states had to respect separatist tendencies that might have been prevented through improvement of the intensity of decentralisation and with expansion of competences and responsibilities concerning local fiscal matters. More exactly, this was the case in Republic of Macedonia. Therefore, the fiscal devolution as the highest stage of decentralisation was used for resolving these problems (or conflicts) and at the same time presented a part of the overall public sector reform in the country.

Fiscal decentralisation today produces new qualitative elements, making it different in comparison with the one taking place 30-40 years ago in the

developed OECD states. This newly established fiscal decentralization in the SEE states refers both to post-socialistic regimes and newly established local democracies. In order to avoid a broad-brush characterisation of local financial systems' characteristics in each SEE state separately, the case of the Republic of Macedonia is examined separately.

### **3 Fiscal Decentralization in the Republic of Macedonia: What has been done in the Past 20 Years?**

In 1991 the Macedonia's constitution was enacted, proclaiming sovereign, independent, unitary country, with local governance as one of the core civil rights that has to be secured by the state. In legal terms, decentralization was intended to take a part, a Law on Local Taxation and Local financing was expected in first six months. But the civil war and conflicts starting in 1994 in the Balkan region, made Macedonian policy makers become precautionary with decentralizing of fiscal powers that may lead to aspirations for higher financial autonomy of some territorial parts. They assumed that recent history of ex federation's dissolution and the ongoing events of fighting for separation of territories, demonstrates that the passions might not be overcome without difficulties.

Furthermore they remain even in the minds of those looking for a different approach from the central government towards their everyday problems, especially in ethnic diverse communities like Macedonia, Serbia, and Kosovo. The fiscal rationality in this context might seem irrelevant when faced with some everyday problems of the people living in those local units (safety, war conflicts, etc). In other words, if there is a multiethnic population, placed in a particular part of the territory, and if a tax or any fiscal authority is transferred in an improper dosage at local level - it may become a weapon for separation from the country. That was the unofficial excuse for not introducing local tax system. The official explanation from the state authorities was that the country needs time to build central state sovereignty, strengthen state tax powers, establish state institutions, become worldwide recognized etc. Therefore, local public services, local needs, civil rights of local government and decentralization were put a side, although the Law on Local Taxation was set in the new Civil Constitution as a high priority legal act to be brought.

#### **3.2 The "Foggy" Decentralization for Over 15 Years**

Almost 15 years of "foggy" decentralization passed during the 1991-2005 period. De jure decentralization and local taxation were set up symmetrically and organized at each municipal level by the legislator, but de facto that was not a proper decentralization, because of the absent financial and managerial authorization. There were some decentralized functions on local level for example for communal activities, but, they were not financed or managed by the local authorities. All financial sources belonged to the central authorities that

transferred them partially and/or under political pressure. The local expenditures participated less than 1 % of the national GDP. From theoretical point of view, if we follow the Western world approach of stages in decentralization and rank the transfer of functions in categories centralism, de-concentration, decentralization and devolution (as highest form of decentralization accompanied by fiscal decentralization), we consider this period in Macedonia as a de-concentration or foggy decentralization. But the state needed more local democracy, local government empowerment, fiscal autonomy and upgraded local fiscal system. That need was recognized both on academic level, by feasibility projects, from international experts and foremost by the citizens, following the bottom-top wisdom of local governance (Maksimovska and Phuong 2008).

It should be highlighted that in 1999, the Republic of Macedonia started an ambitious decentralization reform program by adopting some legal acts and international documents, which was seen as an important starting point for furthering democratic transition in the country. But due to the economic and political factors, the progress was slow. In that period, the European Chapter of Local self Government (Act of the Council of Europe) was ratified by Macedonia, which means it became part of the domestic legislation. Still, the most important legal acts were not brought into the day light.

In 2001 the armed conflict in Macedonia begun, based on an ethnic and political intolerance. The war conflict ended with the Agreement in the city of Ohrid in August 2001, and therefore it is called the Ohrid Framework Agreement. Among many issues, there is a clear legal provision that imposes new Law on Fiscal Decentralization, where the minorities and ethnicity should be treated differently, in political, in administrative, in social and at the end in economic sense. That forced the adoption of an asymmetric approach in terms of the fiscal decentralization.

The administrative and territorial reform of local governments followed in 2004 (as a result of the Ohrid Framework Agreement) and it created larger municipalities by merging the existing ones or creating ethnically concentrated municipalities. The former 123 local governments were consolidated into 84 units organized in one-tier system (including 10 sub-municipalities in the City of Skopje, exclusively sorted by two-tier local self government). This administrative change had an impact on ownership and financing of local communal enterprises, causing various relations among municipalities that had been using jointly communal services in the previous territorial organization (Maksimovska 2008). The reforms started to move forward in a positive way. Communal affairs, tax administration and tax collection matters, managerial questions, local capacity building, inter-municipal collaboration, strengthening local infrastructure and other purely local government issues become the glue for the same territory, at the



same time, in the same state, while the story of fiscal decentralization was going on successfully.

The main conclusion today is that the Republic of Macedonia is a state with a rich experience in terms of applying different local government finance systems.<sup>2</sup> Also, after careful examination of all factors, the ending remark is that the fiscal decentralization reforms in Macedonia's local government were driven by political, legal and economic factors such as:

- the pressure from the Ohrid Framework Agreement;<sup>3</sup>
- the constitutional amendments in 2001;
- the recommendations of the ratified international documents (such as European Charter for Local self Government);
- the need to establish functional Local government system, and
- the necessity to foster the local economic development by decentralizing communal, educational, cultural and other sectors.

### **3.3 The Brand New Local Government Finance in 2005**

The implementation of the fiscal decentralization in Macedonia was a process divided in two phases, which encompassed a step-by-step progression in all areas, especially in the fiscal. Namely, the entire fiscal decentralization process was based on local own resources revenues and asymmetric transfers of fiscal resources set up upon specific formulas for financing different local activities and responsibilities. At the start, the Law assigned own fiscal resources such as property taxes, fees, compensations and user charges to support the financial stability and straighten the local budget autonomy.

During the Phase 1 (2005-2007), key responsibilities were transferred to municipalities in areas including: communal services, education, culture and sports, environment, social services, civil defense, fire fighting and local economic development. Phase 2 officially started in September 2007 when 42 municipalities were allowed to enter Phase 2 because they met the criteria defined in the law such as "no arrears to suppliers and creditors". Phase 2 involves further decentralization of education and health care, other fiscal responsibilities and gives opportunities for borrowing. Borrowing could be easily detected as an opportunity for capital investment in communal services, since significant portion of the communal enterprises' assets was in a bad shape. However, in September 2007, 24 other municipalities were admitted, bringing up to 66 as a total number of municipalities in the second phase, which could use the benefits of the new local fiscal system such as borrowing. By the end of 2009, more than 85% of total number of municipalities succeeded in administrative, financial and political capacity building. Today there is just one municipality left from the second phase of fiscal decentralization.

The local financial system is composed by enlarged financial competences and responsibility for local governments. The system is unique because it has just one tier between central authorities and municipal authorities. The capital, the City of Skopje, has separate and specific status in local, political, administrative and noticeably in fiscal terms. Municipalities are equal in terms of fiscal decentralization, with symmetrically assigned local responsibilities in different areas.

According to the Law on Financing Local Self-Governments, municipal revenues are:<sup>4</sup>

- Own-source revenues, i.e.,
  - (i) local taxes, of which the property taxes are the most important;
  - (ii) local fees and user charges; and
  - (iii) other local taxes established by law.

Since the start of the first phase of the fiscal decentralization in July 2005, municipalities have been given expanded powers under the Law to collect and administer these revenues instruments. The central government has no fiscal authority over them;

- Revenues from Personal Income Tax (PIT).

Municipalities are entitled to: (i) 3% of the PIT levied on salaries of physical persons with domicile and residence in the municipality; and (ii) 100% of the PIT of physical persons performing craft activities in the territory of the municipality in accordance with the Law on Craft Activity. In 2007, the PIT rate was 12%, reduced to 10% in 2008, up to today;

- Revenues from donations from physical persons or corporations; and
- Grants from the central government, the most important of which are: (i) the value added tax (VAT).

Municipalities receive 3% and since 2012 they receive 4 % of the total VAT revenues, based on the amounts collected the previous fiscal year<sup>5</sup> and (ii) earmarked grants, which were used in the first phase of decentralization to finance activities transferred to LSGUs in education (primary and secondary schools, except for salaries), social protection (day care centers and retirement homes), fire fighting and culture (museums, cultural institutions, etc.).

For municipalities that have passed to the second phase, these earmarked grants have been replaced by block grants which included funds for financing wages in the areas of education, social care and culture. Fire fighting will continue to be financed by earmarked grants specially set up for that activity.

- Local-self tax.

Besides the traditional and well-known fiscal and non-fiscal local revenues, such as the local taxes, fees and user charges, the self-taxation fee is an instrument that is inherited from the ex federation, but shows

remarkable results. It is designed to be set by referendum decision by the local tax payers and then, conditional upon the successful adoption, to be used for financing infrastructure projects, such as water distribution, waste management schooling etc.

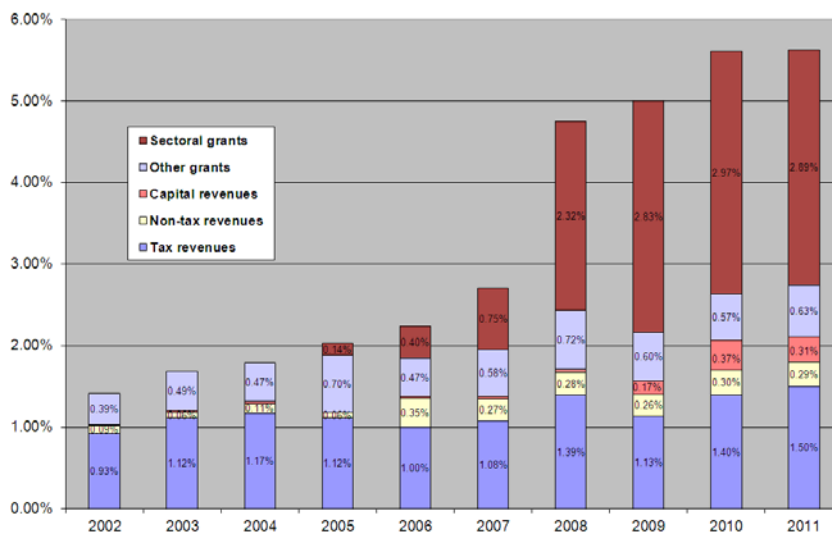
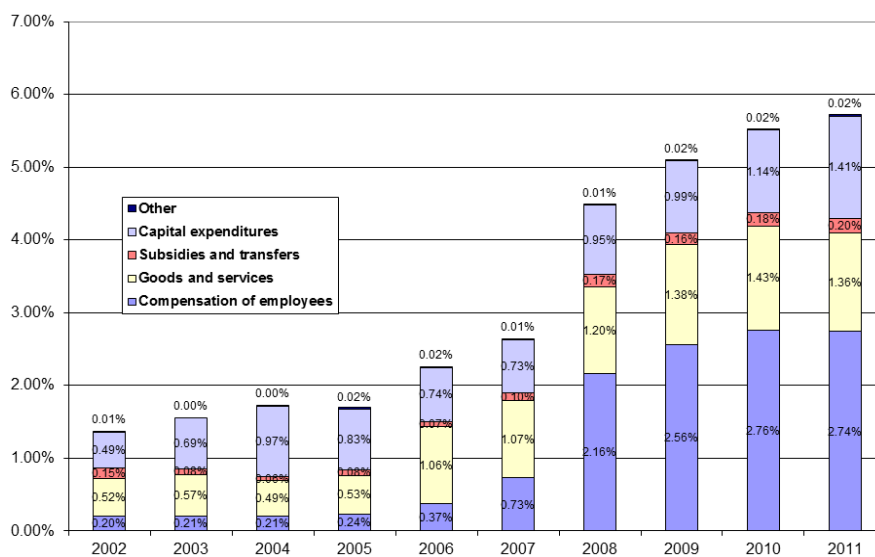
Local financial management is enabled by the new financial and administrative powers, including the right to determine local tax rates; complete budget autonomy; responsibilities for collection and use of non-tax revenues (fees, user charges, loans, local securities); and rights for introduction of self-contributions.<sup>6</sup> Since 2011, the ownership of the construction land is transferred to the local authorities, in terms of the authorization to sell, rent or use it in other way.

There are new broad opportunities for achievement successful local financial management, including through the new system of accountability and responsibility, the system of central monitoring and support by State Commissions and Ministry of Finance and Local-self government. The municipalities have access to the capital market in terms of issuing local bonds and/or borrowing from commercial banks or central government budget

The City of Skopje has the same revenue structure as other municipalities, but following the metropolitan wisdom, it is given special status. Therefore, it is consisted as a two-tier system (the City as a distinct municipality with special status and ten municipalities with the same status - and nearly same functions - as the rest of the municipalities). The distribution of revenues between the City and the sub-municipalities is based on mathematical formulas set in the law, in order to shield from political influence (Maksimovska 2011).

### **3.4 The Composition and Level of Local Fiscal Revenue and Expenditure**

There is very interesting and challenging information about local revenues and expenditures, both from a historical (as evidence of progress) and an academic perspective, for producing examinations in sense of policy options and solutions. Figures 1 and 2 demonstrate the past and current state in local revenues and expenditures.

**Figure 1:** Sources of local budget revenues in Macedonia (2002-11, in % of GDP)**Figure 2:** Local expenditure by economic items in Macedonia (2002-11, in % of GDP)

Source: Authors' calculations based on Ministry of Finance data.

### **3.5 An Overall Assessment of the Local Financial System in Macedonia**

In general, there is a significant progress in fiscal decentralization. The main characteristics are as follows. The share of locally-raised revenues in local budgets significantly declined as a result of the second phase of decentralization, but between 2004-2011 local expenditures increased 3.6 times while own-source revenues increased only 1.9 times. The own-source revenue is increasing in absolute terms, but because of the substantial central budget transfers, its share is effectively reduced. In the municipalities of the City of Skopje, own-source revenues cover only 80% of own expenditures, excluding education, child day care, senior care, culture, and firefighting. Thus, municipalities can affect at most by 30 percent their own revenues, which account for less than one-third of their total expenditures, meaning that at the margin, local government control only 10 percent of their total revenue.

The major portion of own-source revenues comes from one-off charges, such as development fees and taxing property transactions as opposed to annual property taxes. Using VAT collections to determine the total grant pool has no link to policy objectives or priorities or macroeconomic trends affecting the costs of local government services.

At the side of local taxation the progress is the most impressive, in terms of administration and collection. At the other, non fiscal side, the Macedonia faces problems in the implementation of borrowing on local level, either from the commercial banks, or at the capital market by issuing local bonds.

There are many obstacles to bank lending to municipalities, including the quality of municipalities' financial reports and accounts, lack of long-term planning, ignorance of bank policies and procedures, etc. but experience in other countries shows that two major issues must be solved: (i) Lack of collateral from municipalities, which cannot use their assets as loan guarantee; and (ii) Adequate borrowing terms. Many municipalities claim they cannot pay the on-going interest rate of about 7%-8% per annum. Also, the maturity of bank loans, typically less than 10 years, is too short for long-term gestation projects, such as sewerage or solid waste management and control.

### **3.6 Comparative Analysis of Local Revenue and Expenditure in Macedonia with the SEE region**

Goods and services are already heavily taxed by the national government in all SEE States. It implies that Macedonia is a leader in having tax sharing as a grant from the VAT. At other side, income and wealth are under-taxed in Macedonia, even compared to low-tax EU countries, such as Bulgaria and Croatia. Existing

direct taxes fall disproportionally on formal employment and large businesses. Therefore, new local taxes should cover this tax gap before increasing burden on those already in the tax net.

On average, expenditures of local governments in the EU countries are 12% of GDP, and the SEE countries have local expenditure between 4 and 7% of GDP. Only in four EU countries are local government expenditures below Macedonia's level. For Macedonia's values of these factors, the comparable benchmark level of recurrent local expenditures is 4.5% of GDP. As of 2011, the level of expenditures by Macedonia's local governments stands at 5.7% of GDP, out of which 4.3% of GDP in recurrent expenditures. The progress is substantial, given that between 1991 and 2003 this share did not exceed 1% of GDP and Macedonia ranked among least decentralized countries in the world (Maksimovska 2008).

Other area for comparison is the municipal borrowing (see Horváthová et al. 2012 for an excellent review of the nexus between fiscal decentralization and public debt among the EU member states). Municipal bonds are the preferred local governments' financing modality in the developed world, because the risk is spread among thousands or millions of bond holders. However, most developing countries and emerging economies at the same income level as the Republic of Macedonia must still rely on credit from commercial banks or specialized development banks to fund their investment needs because their financial system is not developed enough and because there are few bond takers, beside banks and a few institutional investors, such as pension funds and insurance companies. Macedonian municipalities could not succeed in borrowing from commercial banks, without strong support by the central government budget. The acceptable interest rate for the municipalities is between 5 and 6% per annum, but the commercial banks required additional risk premium of 5-6%. Municipalities in most SEE countries are still not prepared to enter the capital markets, neither by bond issuance nor by bank loans.

#### **4 Fiscal Decentralization and Federalization: Lessons from the Republic of Macedonia**

As already noted in the introductory section, the federalization is a headache of policymakers not only in Macedonia, but also in the other SEE countries. Generally, one can conclude that the international practice offers a wide variety of experiences. Therefore, the answer on the question about further fiscal decentralization is set up upon the nexus with federalization. Federalization often seems to sustain loyalty to the nation-state rather than to weaken it: by defusing potential internal conflicts along creedal, ethnic or linguistic lines, it lends the nation-state greater resilience, tenacity and strength.<sup>7</sup>

The presence or absence of federalism in diverse societies suggests that federalism can make an important contribution to national unity and cohesiveness. On the other side, it can lead to fragmentation if some empowerment is given in constitutional terms. But, when one follows the European experience, over the centuries, Switzerland has successfully overcome the tendencies of its French, German and Italian elements to fall apart, most likely, because of its decentralized, cantonal system of government accommodates local and linguistic differences so well. More recently, Canada met the threat of secession by Québec by devolving more autonomy to the province and its French-speaking inhabitants. The Macedonian constitution neither provides for nor gives a base for enacting other legal acts that can support federalization. In Macedonia these questions can be set up only in the Constitution. Hence, any further enlargement of fiscal local powers would not harm or narrow the unitary structure of the state.

By contrast, countries that are held together chiefly by the force and propaganda of strongly centralizing régimes or dominant ethnic or sectarian groups (even if they are nominally “federal” systems) tend to divide up along their internal fault lines once that centralizing power is removed.

There is no straightforward answer, because it depends on the country-specific circumstances, but from a legal point of view, the decentralization rules sometimes differ significantly between federal and unitary states. In federal states, the allocation of powers is usually specified in the constitution and any change may require a constitutional amendment. In all major federal states, rules for constitutional amendment require that at least a majority of sub-central governments must approve the amendment. By contrast, in a unitary state, such as the United Kingdom, reallocation of powers is achieved either by legislation in the national parliament, or by national referendum: the agreement of any sub-central level of government per se is not required (Lockwood 2004).

The conclusion for SEE unitary countries is: if we follow this simple rule, there is no trade-off between fiscal decentralization and federalization. The well-known theory of Wallace Oates (1972) on decentralization and the inspiring work of many academicians across the world (e.g., Bird (2003), who explains the fiscal decentralization as a tradeoff between “glue or solvent” are supporting our conclusion. Moreover, the theory conforms to the reality, as evidenced by many facts for the SEE region: the current position of unitary SEE countries, the ongoing fiscal decentralization project, the economic development in many regions in SEE countries, do not lead to federalization. On the contrary, fiscal decentralization is an effective weapon for sticking together, especially in diverse variety of municipalities, in economic, administrative, ethnical or legal terms.

One of the safe corollaries from the vast literature is the need for an equalization scheme in the unitary state as a remedy to avoid federalization. A series of unitary

countries spend nearly as much through subnational governments than do most decentralized federal countries (this includes France and Spain). So here the equalization scheme as a need is evident (Martinez Vazquez and Frank 2013). But, in some less decentralized, or let us qualify them as de-concentration models of local governments, equalization still needs to come up, without neglecting the need to account for inequities in municipal spending. Hence, the conclusion is that the equalization scheme needs to be implemented in unitary states that have regional disparities, leading to policy options of possible federalization.

But ensuring equalization – although it is treated as the most difficult – is insufficient for escaping the gaps of fiscal decentralization in the future. We will justify that in the next section, by offering some policy options and solutions that can have a positive impact on the decentralization development.

## 5 Conclusions and Recommendations

Fiscal decentralization is a condition sine qua non for development of local governance as one of the main democratic achievements. Federalization or separation of territories is not going to be a final result of pushing forward the local autonomy of municipalities in SEE countries. Based on these two premises, we offer some policy guidelines for the fiscal decentralization in the SEE countries.

First, an important conclusion is that the common practices of fiscal decentralization in SEE countries show that placing tax powers to different subnational units on equal footing does not work uniformly well in all countries. Therefore, the asymmetric approach in local taxation should still be policy relevant. At the same time, while some regions or municipalities need strengthening of local tax collection, others are in need of new local fiscal instruments (mainly, the metropolitan areas). The candidates for the new tax instruments for local governments are: personal property and motor vehicle tax; betterment levies; business license (patent) tax; and a local surtax on the national PIT.

Second, in the area of improvement of local services infrastructure, it is also clear that no country – whether highly or less decentralized, or whether unitary or federal – can escape the need for coordination with the central state authority. Therefore, the need for equalization and management of infrastructure development by the central state remains. This is a common case for Croatia, Macedonia and Serbia. The possible solutions are as follows:

- redesign of some local functions as delegated, financed with conditional grants;
- redefinition of client population for services provided to residents of other municipalities (e.g., firefighting, high schools, culture);



- alignment of capital grants primarily to direct local projects toward national priorities;
- adoption of multi-year planning framework, which can ensure linkages among policy making, planning and budgeting, and
- support of local borrowing by central budget grants.

Third, not just Macedonia, but all other SEE countries had shown impressive progress with decentralization, although not at the same pace and in all dimensions. This refers mostly to the situation in Croatia, Bulgaria, Bosnia and Herzegovina, and Montenegro. Therefore, it is a good time to evaluate the entire process and to take rebalancing steps focusing on equalization schemes and performance measurement of local services provision.

Additionally, one of the possible actions is to impose hard instead of soft budget constraints in the less developed municipalities, which again leads to an asymmetry. Here the jurisdiction is very important to be recognized as needed and justified in approaching to the economic benefits. In other words, legal acts should contain asymmetry in provision of public goods in different regions and municipalities, in accordance with the regional development goals. The trade-off between the legal symmetry and economic development adequate to the current capacities of each side, makes it understandable. For sure, the extent of the formalization of such asymmetry is left for further debate.

Fourth, in regional context, we also find strong evidence in the literature that a higher number of tiers of government leads to overall higher jurisdictional fragmentation. We hypothesize that this is the case because when intermediate levels of government assume subsidiary responsibilities for local governments, the smaller local governments have less of an incentive to consolidate into larger jurisdictions. This finding has immediate policy consequences for countries (such as, Croatia or Bosnia and Herzegovina) that are reconsidering the elimination of some tier off and are struggling with the administrative burdens. On the other side, eliminating tiers of intergovernmental relations can lead to losing the advantages of the vertical assignment of local responsibilities. Therefore, the case of Macedonia is surely not a representative one, but the case of Slovenia can be an interesting avenue for future research.

The general conclusion is that these policy options are not straightforward or strictly applicable just to the SEE countries, but to other developing countries as well. However, the story of fiscal decentralization is not free of political tensions and significant trade-offs need to be negotiated. There is a room for creating more policy options and solutions, but having in mind the big picture, we can be sure we are standing at the right direction.

## Notes

<sup>1</sup> Important exceptions are the Republic of Hungary and the Republic of Bulgaria.

<sup>2</sup> There are several stages in the history of inter-governmental relations in Macedonia: the 1974–1990 period named as extreme fiscal decentralization; the 1991–1995 period considered as an extreme centralisation of financial relations; the 1996–2001 period of fiscal de-concentration, and the 2002–2004 period of declarative fiscal decentralisation.

<sup>3</sup> The Ohrid Framework Agreement is Political Agreement of the major political parties of the ethnic Macedonians and ethnic Albanians in Macedonia, August 2001, as finalization Agreement of the armed conflict in 2001.

<sup>4</sup> Law on Financing Local Self-Governments, Official Gazette of Republic of Macedonia, 61/04.

<sup>5</sup> 3 % of the “VAT grant” aimed for local municipalities revenues going to municipalities are transferred to a special fund called the reserve fund for assistance to fiscally weak municipalities, i.e., those which have raised less than 25% of their potential tax revenues.

<sup>6</sup> Local self-contributions are a fiscal instrument that has been used traditionally in the ex Yugoslavia as a self-fee for capital investments. Today the Council of the LGSU could introduce the self-fee under the criteria set in the Law, after the citizens give an approval by different forms of agreement (for example, referendum).

<sup>7</sup> This is de jure, but de facto, the capital market on local level is not developed yet.

<sup>8</sup> Federalism has also served to reintegrate nations torn apart by war - for example, as Daniel Elazar argued, even as American federalism “provided the framework for the disruption of the Union [in the Civil War], it also made possible the reunification of the nation as a stronger and ‘more perfect’ political order ... [T]he existence of federalism prevented the victorious North from confronting the defeated South with an ‘either-or’ proposition, namely, demanding that the Southerners accept reunification on the North’s terms alone or forever be denied their rights as Americans.” Daniel J. Elazar, *Civil War and the Preservation of American Federalism*, 1 *Publius: The Journal of Federalism* 39, 55 (1971). None of this, of course, is to say that federalism is always a success story. In some recent instances, federalism has not served to quiet internal differences. See: Krislov (2001).

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