DESCRIPTIVE ANALYSIS OF THE FINANCING OF LOCAL SELF-GOVERNMENT UNITS WITH SPECIAL REFERENCE TO THE MUNICIPALITY OF STRUMICA

Katerina Koleva
Ss. Cyril and Methodius University in Skopje, Faculty of Economics – Skopje, Republic of North Macedonia, dinkovakaterina92@gmail.com
Suzana Makresanska Mladenovska
Ss. Cyril and Methodius University in Skopje, Faculty of Economics – Skopje, Republic of North Macedonia, suzana.makresanska@eccf.ukim.edu.mk

Abstract: The financing of local self-government units is a fundamental aspect of municipal governance, directly influencing the capacity of these entities to deliver essential public services and promote local development. This paper offers a comprehensive descriptive analysis of the financing mechanisms utilized by local self-government units, with a specific focus on the municipality of Strumica in North Macedonia. By examining the various sources of revenue and the allocation of expenditures, this study provides insights into the fiscal dynamics that shape the municipality's financial health and operational efficiency. Strumica, like many municipalities, relies on a mix of own revenues, intergovernmental transfers, borrowing, and external aid. Own revenues, primarily derived from local taxes and fees, are crucial for maintaining financial autonomy. However, the potential of these revenues is often limited by economic conditions and administrative challenges in tax collection. Intergovernmental transfers from the central government constitute a significant portion of Strumica's budget, underscoring the municipality's dependency on these funds to finance essential public services and infrastructure projects. While these transfers are vital, they also introduce challenges related to fiscal dependency and variability in funding.
Borrowing is another critical component of Strumica's financial strategy, primarily utilized for capital investments in infrastructure. The municipality's borrowing practices are regulated to ensure fiscal discipline and sustainability. However, the reliance on borrowing necessitates careful debt management to avoid fiscal stress. Additionally, Strumica benefits from international aid and donations, particularly from the European Union and other international organizations. These funds support various development projects, from environmental initiatives to cultural preservation, enhancing the municipality's capacity to meet its developmental goals. Expenditure management in Strumica is directed towards key sectors such as public services, education, infrastructure, and social welfare. Efficient allocation and control of expenditures are essential to meet the diverse needs of residents within budgetary constraints. The municipality faces several fiscal challenges, including limited revenue generation capacity, high dependence on central government transfers, and increasing expenditure pressures. Addressing these challenges requires comprehensive financial management strategies that enhance local revenue generation, ensure reliable intergovernmental transfers, and maintain prudent debt levels. The case of Strumica highlights the complexities and challenges inherent in the financing of local self-government units. Effective financial management is crucial for ensuring fiscal stability and promoting sustainable local development. This analysis underscores the importance of a balanced approach to municipal financing, emphasizing the need for enhancing local revenue bases, securing stable intergovernmental support, and managing expenditures efficiently. The insights drawn from Strumica's experience provide valuable lessons for other municipalities facing similar fiscal challenges, contributing to broader discussions on improving the financial sustainability and autonomy of local self-government units.
Keywords: local self-government units, financing, Strumica

1. INTRODUCTION

The financing of local self-government units is a critical area in public finance and local governance literature, influencing the ability of municipalities to deliver essential services and infrastructure. The financing of local self-government units is a multifaceted issue, influenced by theoretical principles of fiscal federalism and practical considerations of revenue generation, intergovernmental transfers, borrowing, and expenditure management. The theory of fiscal federalism provides a foundational framework for understanding the financing of local self-government units. Oates (1972) and Musgrave (1959) highlight the principles of fiscal decentralization, advocating for the allocation of financial responsibilities to the government level best positioned to meet local needs effectively. These principles underscore the importance of local revenue generation and efficient allocation of intergovernmental transfers.Municipalities generate their own revenues primarily through local taxes, fees, and charges. Bird and Slack (2004) discuss the advantages and challenges of local taxation, emphasizing the need for a well-designed tax system that balances efficiency, equity, and administrative simplicity.

Shah (2007) outlines the different types of transfers, including general-purpose and specific-purpose grants, and their impact on local government functions.However, reliance on these transfers can lead to fiscal imbalances and dependency, as noted by Bahl and Linn (1992).Borrowing is another financing mechanism for municipalities, used primarily for capital investments. Martell and Guess (2006) explore the conditions under which local governments should engage in borrowing, emphasizing the importance of maintaining fiscal discipline and ensuring the sustainability of debt levels.International aid and donations contribute significantly to local government budgets, particularly in transitional economies. Sacks (2012) examines the role of foreign aid in enhancing local governance capacities and promoting development.Efficient expenditure management is critical for the financial health of municipalities. Schick (1998) highlights the importance of budgetary reforms and expenditure control mechanisms to ensure effective public service delivery. Smoke (2001) discusses strategies for enhancing local fiscal autonomy, such as improving tax administration, diversifying revenue sources, and advocating for more predictable and fair intergovernmental transfers.

2. FISCAL DECENTRALIZATION AND SYSTEM OF LOCAL SELF-GOVERNMENT IN THE REPUBLIC OF NORTH MACEDONIA

2.1. A brief overview of history

Local authorities had a large number of powers and managed a large part of local finances in the pre-independence period, as part of the then Yugoslav federation. Local revenues came from the then municipal tax on sales of products and services, as well as the tax on sales of real estate and rights, with more than 70%. Prior to the period of independence, local governments lost their powers along with fiscal resources, leading the country towards large-scale centralization. With the adoption of the new Constitution of 1991, local self-government was again promoted as a fundamental value of the constitutional order, since municipalities are defined as units of local self-government that are financed from their own sources of income, determined by law and with income from the Central Government, and which are independent in the performance of the powers established by law (Article 114, The Constitution of the Republic of Macedonia is the highest legal act in the Republic of Macedonia.)Then, the period of territorial division follows, which defines the local self-government units. In 1996, Macedonia signed the European Charter for Local Self-Government, which was ratified by the Parliament in 1997 through the acceptance of European principles in the area of local self-government, which were very vaguely specified and implemented, thus the level of fiscal decentralization in the period from 1996 to 1999. is at a very low level, that the World Bank registered Macedonia in the lowest place in Europe in terms of the degree of fiscal decentralization. In 2002, a new Law on Local Self-Government was adopted, which provided for a much wider range of competences and greater financial autonomy. In 2004, the territorial borders of the municipalities were revised in accordance with the Framework Agreement, but the process of decentralization until 2012 took place very slowly in terms of the adoption of new laws and the implementation of the existing ones.

2.2. Distribution of competences from the central government to the local self-government units

The goal of fiscal decentralization is actually strengthening of municipal capacities by transferring the competences from the Central Government to the local authorities. In addition to the competences, the provision of financial resources for their execution is provided by decentralization. Such competences refer to education, child protection, culture and care of the elderly, as basic and first-level competences, and the second phase implies replenishment of those in charge by making independent decisions on employment and dismissal of employees in the taken over public institutions, as well as control over the financing of salaries. At the same time, the decentralization process itself implies the fulfillment of criteria for the verification of fulfillment of which the Commission for monitoring and evaluation of the fulfillment of the decentralization criteria is responsible for the transition from the base to the next phase of decentralization.

2.3. Distribution of revenue sources from the Central Government to the local self-government units

The process of fiscal decentralization in itself is not characterized by success in simply transferring the competences from the Central to the municipal level. It is safe to say that the transfer of responsibilities to the local level, complete with the decentralization of revenue sources, is a successfully implemented process of fiscal decentralization. The strengthening of fiscal municipal capacities is a basic principle in the decentralization process. In order to increase the collection of their own revenues, the units of the local self-government have the obligation to renew their own databases of taxpayers, all in order to be able to realistically assess the income base and at the same time plan the funds intended for spending. With the law on financing the local self-government units from 2004, the municipalities were assigned the following sources of income: (1) Own revenue sources: Local taxes, local fees, income from property, income from donations, income from fines, income from self-contribution, other income determined by law, (2) Personal income tax as a joint tax, whereby the Central Government retains the autonomy in determining the tax, its administration and collection, so that a part of it is given to the local units according to the origin of the income (3) Fiscal transfers from the central budget and from the budgets of the funds as a general and dominant source of income for local authorities and such subsidies are from: revenues based on VAT and belong to the group of non-purposed subsidies and other subsidies that are purposeful, namely: block subsidies , grants for delegated authority and capital grants.

2.4. Fiscal transfers from the central budget – special emphasis on VAT revenues

In the context of title transfers and the financing of local self-government units, it is important to mention various types of transfers and common taxes. These financial sources are typically outlined in legislation governing the financing of local governments. Here's a structured overview based on such a framework: **(1) Personal Income Tax (PIT)**: A common tax shared between the central government and local authorities. Personal income tax constitutes a significant revenue source for both levels of government. It is typically collected by the central government and then distributed to local authorities based on specific criteria, such as population, fiscal capacity, and expenditure needs. **(2) Value Added Tax (VAT)**: A major source of revenue for the central government, with a portion allocated to local authorities. VAT is a consumption tax levied on the value added to goods and services. The revenue from VAT is often shared between the central and local governments to ensure adequate funding for local public services. **(3)Dedicated Transfers**: These are earmarked funds provided by the central government for specific purposes. Dedicated transfers ensure that local governments have the necessary resources to carry out particular projects or services, such as education, healthcare, and infrastructure development. **(4) Capital Transfers**: Funds allocated for capital projects, such as the construction and maintenance of infrastructure. These funds help local governments undertake significant investments that may be beyond their financial capacity. **(5) Block Transfers**: General-purpose funds provided by the central government that local authorities can use at their discretion. Block transfers offer flexibility to local governments, allowing them to allocate resources according to their specific needs and priorities. This type of transfer supports local autonomy and enables better tailoring of services to local demands.By following the structure outlined in the law on the financing of local self-government units, which lists these sources of financing in a specific order, it ensures clarity and alignment with legal provisions. This structured approach helps in understanding the various financial mechanisms in place to support local governance and development.

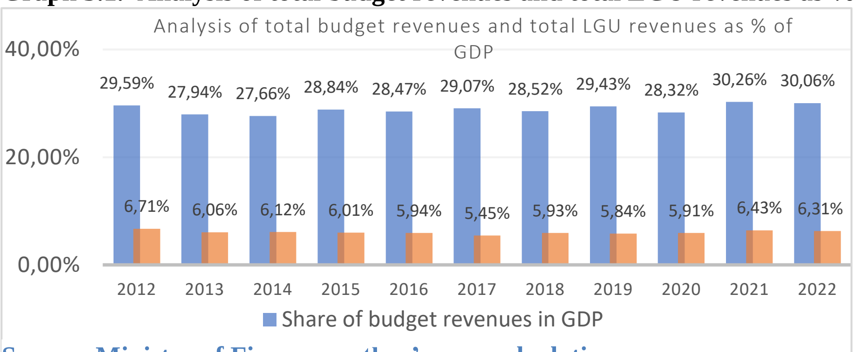
In relation to non-targeted subsidies, significant changes have been implemented to better align with the latest legal framework and enhance the financial support for local authorities. Here is a revised and updated explanation of the allocation process and criteria for distributing Value Added Tax (VAT) revenues to municipalities, based on the most recent legal amendments. As of the latest legal update, the percentage of revenues allocated to local authorities from VAT has been increased. Initially set at 3% of VAT revenues in December 2009, this percentage was later raised to 4.5% of the total revenues from the total collected VAT in 2013. However, this has now been changed to 6% to provide better support to local municipalities. The decree on the methodology for the distribution of VAT revenues to municipalities specifies the distribution of funds as follows: **(1)Fixed Part**: where the amount is 3,000,000 denars and the recipients are All municipalities in Macedonia, including the municipalities within the city of Skopje and the city of Skopje itself. **(2)Variable Part** where the distribution is allocated in 88% to municipalities in Macedonia (excluding the city of Skopje) and 12% to the municipalities in the city of Skopje and the city of Skopje. The main **criteria for distribution** is explained as **65%** based on the municipality's share of the total population of Macedonia, excluding the city of Skopje, according to the latest population census data, **27%** based on the municipality's share of the total area of Macedonia, excluding the city of Skopje, according to the determined borders of the municipalities and **8%** based on the municipality's share of the total number of settlements, excluding the city of Skopje, as per the law on the territorial organization of local self-government. In addition to the basic fixed and variable parts, the latest legal solution introduces two more components to the distribution methodology: **(1)Equalization Part**: whose purpose is to reduce disparities between municipalities by providing additional funds to less financially capable local authorities.The main criteria is determined based on fiscal capacity and expenditure needs of each municipality. **(2)Performance Part** whose purpose is to incentivize municipalities to improve their performance in governance, service delivery, and fiscal management and the main criteria is allocated based on performance indicators such as efficiency in revenue collection, quality of public services, and effective use of allocated funds. This revised allocation methodology ensures that the distribution of VAT revenues is more equitable and performance-driven. The introduction of the equalization and performance parts aims to support financially weaker municipalities and encourage better governance practices across all local authorities. The overall approach is designed to enhance the financial sustainability and operational efficiency of municipalities, ultimately benefiting the residents and contributing to balanced regional development.

3. THE LOCAL REVENUE STRUCTURE IN THE REPUBLIC OF NORTH MACEDONIA

The structure aims to provide municipalities in North Macedonia with a diverse range of revenue sources to ensure financial autonomy and the ability to fund local services and development projects. In the following, the trends of

movement and the structure of income in the period from 2012 to 2022 are shown. The source of data is the database of the Ministry of Finance. On the chart 3.1. the share of total budget revenues in GDP and the share of total units of local self-government in GDP are shown. The total revenues of the local self-government units as a relative indicator with GDP participate with an average of 6% in the analyzed period, with the highest in 2012 with a participation of 6.71% in GDP and the lowest in 2017 with 5.45%. This percentage has increased with the start of the second phase of the fiscal decentralization process, which percentage now amounts to 6%.
As for the structure of the LGU's income, it has not changed in the analyzed period, i.e. the transfers from the central government to the local government comprise the highest percentage, an average of 49.7%.

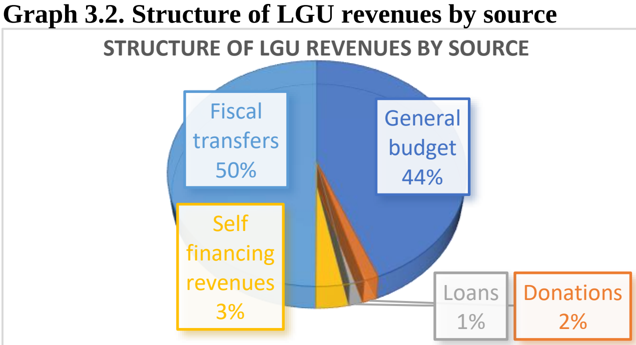
Graph 3.1. Analysis of total budget revenues and total LGU revenues as % of GD



Source: Ministry of Finance, author's own calculation

A significant moment in the analysis of the revenue items from the budgets of the local self-government units is their transparency, which is reflected through the responsibility for the administration of local taxes. Fiscal transparency helps in highlighting the possible risks and the biggest benefit it brings is providing the necessary information for the citizens with which they can call the Government to account. The structure of LGU revenues in the last decade has been almost unchanged. Half of the revenues are subsidies - transfers from the central government to the local government, the basic budget participates with 43%, self-financing activities participate with 3% in the total revenues of the LGU and the rest of the revenues from donations and loans with an average annual participation of 1.4%. The LGU heavily depends on external financial sources (grants and transfers). There is a relatively strong base budget, which is also crucial for the financial structure.Minimal self-financing and reliance on donations and credits indicate potential areas for financial improvement and increased local revenue generation.

Graph 3.2. Structure of LGU revenues by source



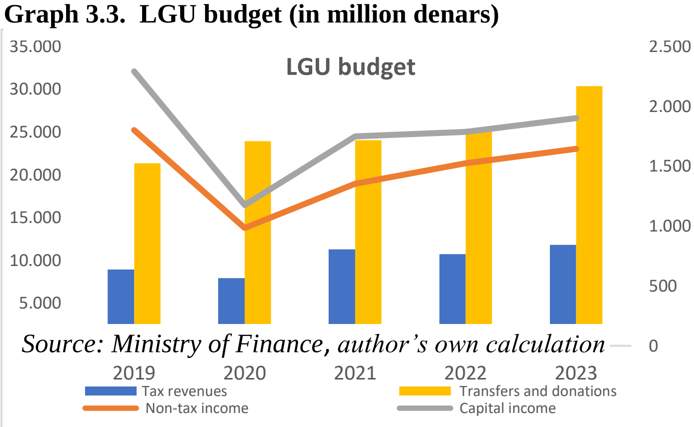
Source: Ministry of Finance, author's own calculation

The graph 3.2. depicts the Local Government Unit (LGU) budget from 2019 to 2023, showing the trends in different sources of revenue: tax revenues, transfers and donations, non-tax income, and capital income. **Tax Revenues** remained relatively stable over the five-year period and slight increase observed from 2020 to 2023, indicating a gradual improvement in local tax collection or tax base. **Transfers and Donations** show a significant dip in 2020, likely due to economic impacts or reduced transfers from higher levels of government. Recovery and growth observed from 2021 onwards, surpassing 2019 levels by 2023. This indicates an increased reliance on or availability of external funding and grants over time. **Non-Tax Income** decline observed in 2020, possibly due to economic slowdown or reduced non-tax revenue-generating activities. Gradual increase from 2021 onwards, indicating a recovery and growth in non-tax income sources, although the growth rate is moderate. **Capital Income** decreasing trend from 2019 to 2020, potentially due to reduced capital investments or sales. Steady increase from 2021 to 2023, indicating a resurgence in capital income, possibly from increased capital investments or better asset management. A notable dip across all revenue sources in 2020, likely due to external factors such as economic downturns or policy changes.Post-2020, there is a steady recovery across all revenue categories, with transfers and donations showing the most significant rebound. The consistent rise in capital income from 2021 to 2023 suggests improved asset management or investment strategies.

3.1. The implications of Covid-19 on budget and local revenues with special emphasis on VAT and the attitudes of local self-government units

The Covid-19 pandemic represents a serious danger primarily from a health point of view, but also from an economic point of view, taking into account the negative effects on the global economy. The local self-government units are the closest to the citizens, set up to respond to specific challenges, in response to the crisis and their role in the recovery from Covid-19, which in turn face challenging situations in terms of municipal finances. In order to mitigate the effect of Covid-19 in the operation of the municipalities, the Government adopted a measure - Changing the calculation of the basis for financing the units of local self-government, with which, when allocating funds for the units of local self-government instead of only for the previous year as until now , the calculation of the average VAT collection for the previous three years will be taken into account. Also, a regulation was adopted in public finance that enables the use of funds in unusual situations, i.e. the use of the Budget Reserve, in which according to the Law on Budgets in Article 11 there are funds with a permanent and current budget reserve, and within the local self-government units , according to the Law on Financing of Local Self-Government Units, Article 31 provides for a reserve in the amount of 3% of the total planned funds from the basic budget of the municipality.

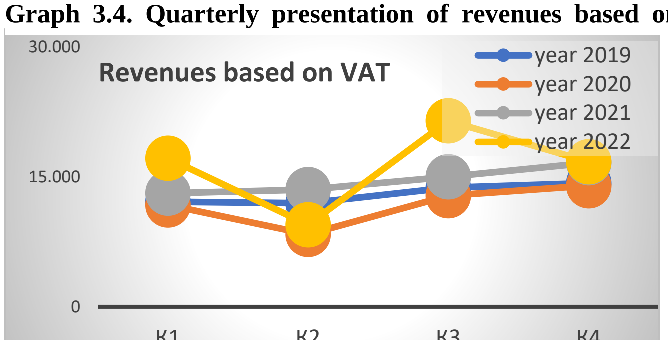
Graph 3.3. LGU budget (in million denars)



Source: Ministry of Finance, author's own calculation

Municipalities, despite the possibility of using the permanent reserve which is legally established and given the possibility to use it in foreseeable situations such as the Covid-19 pandemic, the local self-government units do not use it enough as an opportunity to deal with the negative effects. An increased share for the municipalities from shared taxes, primarily from VAT, specially created transfers to deal with Covid-19, direct financial assistance, establishment of fiscal rules for the amount of obligations and reduced expenditures of the Central Government are part of the recommendations that the Municipalities make in Authority to mitigate the impact of the pandemic on the work of local self-government units. As for the tax revenues based on VAT in the Budget in the time before and after the corona crisis, during 2020, including the third quarter, they follow an identical trend as in previous years in the same period. In the month of March 2020 and continuously in the months of the second quarter, VAT revenues are decreasing with considerable intensity, especially in April and May compared to the same months of the previous year.

Graph 3.4. Quarterly presentation of revenues based on VAT (2019-



Source: Public Revenue Authority, author's own calculation

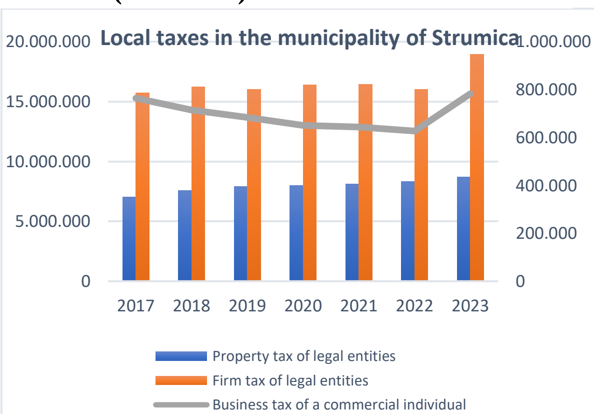
The intensity of the decline in VAT-based revenues is weaker in the third quarter, so already in the month of August, the fall again follows the trend of seasonal expectations. Cumulatively for the first 9 months of 2020, compared to the same period in 2019, VAT revenues decreased by 12.91%, while cumulatively for the first 9 months of 2020 compared to the same period in 2021, VAT revenues recorded an increase of 26.35%. Revenues based on VAT during the pandemic period are shown in the following tabular and graphic displays. In the total tax revenues in the Budget of the Republic of North Macedonia in the period from 2008 to 2022, on average the value added tax has the largest percentage, namely 49.17%, then excise taxes with 21.58%, personal income tax with 14 .49%, profit tax accounts for 8.81%, import duties with 5.95% and the rest of 3.25% is accounted for by other taxes.

3.2. Municipality of Strumica - basic characteristics

The municipality of Strumica is an urban municipality located in the southeastern part of the Republic of North Macedonia, with 49,995 inhabitants according to the last population census in 2021. The municipality is in the upper middle group according to the income per capita and according to the municipal fiscal capacity. The municipality of Strumica is distinguished by experienced practices for participatory budgeting, whose local budget has a realization of 83.5%, which makes it a municipality that reasonably implements financial management, through a prudent approach to planning budget revenues and expenditures. It is considered that tax morale in the Municipality of

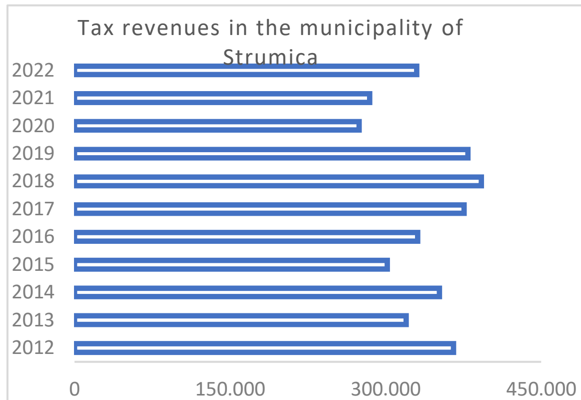
Strumica is at a high level considering that the collection of property taxes is over 90%, and this is the result of sending the calculations for property tax obligations in March, through rare and easy warnings with enabling collection in installments during the fiscal year. The municipality believes that greater coordination with the Central Government can have a positive effect on financial management. Regarding the total tax revenues in the municipality of Strumica, there are no large fluctuations in the trend. The maximum tax revenues were achieved in 2018, and the minimum in 2020 are also the result of the Covid-19 pandemic. From the tax department in the Municipality of Strumica, data was obtained on property tax for legal entities, company tax for legal entities and company tax for individual traders. From the table shown above, which refers to the local taxes in the municipality of Strumica, the property tax for natural persons and the company tax for legal persons shows a slight increase over the years, both in the bet that has been realized and in the total number of decisions issued. While in the case of the company tax of an individual trader, we have some stagnation and an unnoticeable increase in the current year 2023, compared to the past years.

Graph 3.5. Local taxes in the municipality of Strumica (2017-2023)



Source: Tax Department in the Municipality of Strumica - author's own calculation

Graph 3.5. Tax revenues in the Municipality of Strumica (2012-2022)



Source: Budget of the Municipality of Strumica - author's own calculation

4. CONCLUSION

The descriptive analysis of the financing of local self-government units, with a particular focus on the Municipality of Strumica, provides valuable insights into the fiscal landscape of the Republic of North Macedonia. Through the examination of fiscal decentralization, the distribution of competences and revenue sources, and the structure of local revenues, this study highlights the evolving role and financial autonomy of local governments. The historical overview and the analysis of the fiscal transfers, especially concerning VAT revenues, illustrate the gradual shift of financial responsibilities from the central government to local self-government units. This shift is crucial for enhancing the efficiency and responsiveness of local governance. The detailed assessment of the local revenue structure, supported by various graphs, offers a clear picture of how local government units (LGUs) generate and manage their finances. The analysis of the implications of Covid-19 on local budgets, particularly the fluctuations in VAT revenues, underscores the challenges faced by LGUs in maintaining financial stability during economic disruptions. Focusing on the Municipality of Strumica, the study provides an in-depth look at the local tax structure and revenue trends over recent years. This case study exemplifies the broader trends observed across the Republic of North Macedonia, while also highlighting unique local dynamics. Overall, this comprehensive analysis underscores the importance of continued fiscal decentralization and robust financial management at the local level to foster sustainable development and improved public services in the Republic of North Macedonia.

REFERENCES

Bahl, R., & Linn, J. (1992). *Urban public finance in developing countries*. New York: Oxford University Press.

Bird, R. M., & Slack, E. (2004). *International handbook on local and regional government*. Cheltenham: Edward Elgar Publishing.

Distor, C. B., & Khaltar, O. (2022). What motivates local governments to be efficient? Evidence from Philippine cities. *Sustainability*, *14*(15), 9426. https://doi.org/10.3390/su14159426

Eyraud, L., & Lusinyan, L. (2020). Decentralizing spending more than revenue: Does it hurt fiscal performance? *Economic Inquiry, 58*(1), 358-380. https://doi.org/10.1111/ecin.12828

Filippetti, A., & Sacchi, A. (2020). Decentralization and economic growth reconsidered: The role of regional authority. *Regional Studies, 54*(7), 952-965. https://doi.org/10.1080/00343404.2019.1619920

Institute for Government. (2023). Local government funding in England. *Institute for Government*. https://www.instituteforgovernment.org.uk

Martell, C. R., & Guess, G. M. (2006). Development of local government debt financing markets: Application of a market-based framework. *Public Budgeting & Finance, 26*(1), 88-119.

Martell, C. R., & Guess, G. M. (2019). The financing of local self-government units in transition economies. *Public Budgeting & Finance, 39*(2), 25-45. https://doi.org/10.1111/pbaf.12233

Miller, D., & Waters, R. (2021). *Local government and sustainable development*: Evidence from European cities. Journal of Urban Affairs, 43(3), 413-430

Musgrave, R. A. (1959). *The theory of public finance: A study in public economy*. New York: McGraw-Hill.

Oates, W. E. (1972). *Fiscal federalism*. New York: Harcourt Brace Jovanovich.

Schick, A. (1998). Why most developing countries should not try New Zealand's reforms. *The World Bank Research Observer, 13*(1), 123-131.

Shah, A. (2007). *Local budgeting*. Washington, DC: The World Bank.

Smoke, P. (2001). *Fiscal decentralization in developing countries: A review of current concepts and practice*. Geneva: United Nations Research Institute for Social Development.