TEFMJ TRENDS IN ECONOMICS, FINANCE AND MANAGEMENT JOURNAL

Local Government Financial Performance in North Macedonia: A Quantitative Evaluation Under Decentralization

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DOI: https://doi.org//10.69648/EYPA1502

Trends in Economics, Finance and Management (TEFMJ), 2024; 6(2): 31-44

ijtns.ibupress.com

Online ISSN: 2671-3365

Application: 15.10.2025

Revision: 29.11.2025

Acceptance: 25.12.2025

Publication: 30.12.2025

Zafirova, A., & Velichkovska, K. (2025). Local government financial performance in North Macedonia: A quantitative evaluation under decentralization. Trends in Economics, Finance and Management Journal, 7(2), 31-44. https://doi.org//10.69648/EYPA1502

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BALKAN JOURNALS

Abstract

The financial performance of the municipalities is very important because it shows how decentralization is functioning in practice and whether local governments are coping with the responsibilities that have been transferred to them. In recent years, municipalities have been given much greater responsibilities – from public services to infrastructure projects and at the same time they were given much greater financial freedom. The Republic of North Macedonia is an interesting example of this, because the decentralization process in our country began relatively early and is constantly being evolved over the years. Therefore, the aim of this research e to compare municipalities in the Republic of North Macedonia through the financial performance management index (FPMI) for the period 2021–2023. The results of the FPMI model show that there are clear and lasting differences among municipalities in Macedonia in the way they manage their financial position in the period 2021–2023. Municipalities with stronger own-source revenues and more active capital investment generally achieve better results. Those with limited fiscal space face greater difficulties and tend to rely more heavily on intergovernmental transfers. This paper adds to the existing literature in a way that unlike the private sector in which the assessment of the financial condition of companies has been extensively researched, research on the assessment of the financial condition of local self-government units (LSGUs) is insufficient, especially when it comes to a small and underdeveloped country like the Republic of North Macedonia.

Keywords: financial indicators, municipalities, Republic of North Macedonia, fiscal decentralization, financial performance management index (FPMI)

Introduction

In a period of increased financial instability and uncertainty, many local governments in developing countries face the almost impossible task of financing the local infrastructure and facilities needed to meet the basic needs of a growing urban population. Local finances often suffer from the inability to generate revenues, often limited by inadequate regulatory frameworks or unfavorable political structures, creating a vicious circle of budget shortfalls, stifling urban conditions, and economic stagnation. A large number of municipalities, especially in developing countries, depend mostly on central government transfers.

For sustainable and responsible fiscal policy, municipalities in developing countries must use an increasing percentage of their own financial resources from tax and non-tax revenues collected through user taxes and fees.

Local governments are closest to citizens, so delegating more responsibilities to the local level and providing more funds is a step forward in creating more functional municipalities and more efficient service delivery. They take care of many important areas that directly affect the lives of citizens. They are responsible for education, social protection, environmental protection, utilities, sports and recreation, fire protection, etc., so it is very important for them to have stable finances.

Since the beginning of July 2005 and with the adoption of the Law on Financing of Local Self-Government Units (2004), a period of fiscal decentralization has begun. Fiscal decentralization actually represents the financial independence of the LSGUs in the Republic of North Macedonia.

The goal of fiscal decentralization is to create conditions for LSGUs to mobilize financial resources through their own source revenues, such as local taxes, fees, and charges, but also through transfers from the central government and through their own borrowing. The experience of these 15 years shows that the process of fiscal decentralization is a long-term and gradual process that is often accompanied by fiscal instability and a lack of financial resources, which generates inequality among municipalities. This situation is most often a consequence of insufficient realization of own revenues as well as an insufficient percentage of transfers from other levels of government to cover the expenditures of the LSGUs.

The possibilities and solutions for improving the financial capacities of local governments should be sought in the structure of the revenues and expenditures of municipalities and the possibility of their optimization. This would also make them more competitive on the capital market if they were to borrow, which would enable greater and more efficient economic development in the future, and thus the opportunity to fulfill their basic function of providing better living conditions for citizens, as emphasized by the authors Oates (1999), as well as Bird and Smart (2010).

Due to the great importance of the financial stability of local governments, the purpose of this research is to compare municipalities in the Republic of North Macedonia through the FPMI index for the period 2021–2023.

This paper adds to the existing literature in a way that, unlike the private sector, in which the assessment of the financial condition of companies has been extensively researched, research on the assessment of the financial condition of LSGUs is insufficient, especially when it comes to a small and underdeveloped country like the Republic of North Macedonia.

Literature Review

Fiscal decentralization is a topic that has been lingering in public finances for years. It is often presented as a universal solution for many problems in the public sector, but the truth is that things are not that simple. The basic idea is, roughly speaking, to give more power to the local level – more money, more responsibilities, more right to decide.

Theorists such as Bahl and Linn (1992) and Oates (1999) have long argued that when municipalities have greater decision-making autonomy, the services they provide become better, closer to the real needs of people, and a kind of natural accountability is created. Later, other authors continue to develop the same line of argument. They wrote that transparency was improving, that resources were being spent more wisely, and that citizens were having more influence over the money spent. And this appears logical – when decisions are made closer to the people, there is a greater chance that the public resources will be allocated towards well-justified purposes . But, as with all good ideas, there is a "but." Decentralization without capacity – without trained people, without functional systems, without a good administrative structure – can very easily create chaos. No theory can fix that. In some countries, municipalities get responsibilities but don't have enough revenues. Others get a huge amount of resources but don't have enough control over spending.

Bird and Smart (2010) emphasize that true accountability exists only when the revenues are generated locally, not when the state always "patches" the financial gaps. Shah (2006) speaks of the need for performance-based systems, while Rodden (2004) warns against so-called "soft budget constraints", when municipalities know that even if they make mistakes, the central government will bail them out. Because of these risks, many countries have been trying, in recent years, to measure what exactly is happening at the local level.

As a result, various indices emerge – including the FPMI – to provide quantitative evidence of where the problems are and where some progress is being achieved. It is often mentioned in the literature that successful decentralization depends not only on the transfer of competencies but also on whether local institutions can manage the funds they receive. Smoke (2015) says that the allocation of functions is only one part, and that the real challenge is the capacity to manage those functions.The World Bank (2020) and OECD (2022) consistently emphasize that transparency and data monitoring are the foundation for sound fiscal management under decentralization.

On the other hand, Koprić, Marčetić, and Škarica (2021) emphasize that stable financial rules and professional staff are equally important. Indices like FPMI are used precisely to bring order to that "forest" of data. If anything has value, it is the ability to see how financially healthy a municipality is: whether it has revenues, whether it spends rationally, whether it invests, and whether it borrows too much. At the international level, these indicators have long been used for comparison between countries, but also between municipalities within the same country. More recent analyses in our country, such as those by Kostadinovska and Risteska (2022), indicate that if local government wants to be stable, then it must have clear, measurable indicators. Without measures, there is no real accountability.

Research by Rodden (2006) shows that differences between municipalities can be very large even when they all operate under the same legal framework. Therefore, in this paper, we pose the first hypothesis:

H1: Municipalities in the Republic of North Macedonia are likely to have significant differences in financial performance in the period 2021–2023.

Regarding revenues, Oates (1999) points out that municipalities with greater financial autonomy operate more efficiently. Our State Audit Office (2022) also notes that many municipalities have a problem with low levels of own revenues. Therefore, we expect:

H2: A higher share of own-source revenues means better financial performance of the municipalities in the Republic of North Macedonia.

Many authors confirm the thesis that, unlike the current operational expenditures of municipalities, capital expenditures are much more significant when it comes to stimulating the growth and development of municipalities, as well as in terms of strengthening their financial capacities. Capital expenditures represent the only profitable spending for municipalities, because capital investments have the potential to generate their own revenues in the future.

H3: The increase in profitable capital expenditures has a positive impact on strengthening the financial performance of the municipalities in the Republic of North Macedonia.

According to the World Bank (2019), sustainable borrowing implies that local governments should not borrow more than they can repay in order not to jeopardize their financial stability.

H4: High levels of indebtedness negatively impact the financial performance of the municipalities in the Republic of North Macedonia.

Methodology

This research applied the FPMI in order to assess the efficiency of the financial performance of the municipalities in the Republic of North Macedonia in the period 2021-2023. Simply put, FPMI attempts to answer a very practical problem: how does a municipality fare financially, both in the short and long term? Instead of everyone interpreting the numbers in their own way, the index takes key financial indicators, processes them in the same way, and creates a single, unified value. This allows for easy comparisons — both between municipalities and over time.

In order for the FPMI index to be calculated for every municipality, each indicator is converted to a scale from 0 to 1, and then all the resulting values are averaged. Since every indicator is important to us — be it liquidity, income, debt, capital investments — they all receive equal weight. The formula used for calculating the FPMI is the following:

$$FPMI_{it=} \frac{\sum_k wk * N(X_{kit)}}{\sum_k wk} , \qquad (1)$$

,where $FPMI_{it}$ denotes the fiscal performance index for municipality i in year t; X_{kit} represents the observed value of the k-th financial indicator; $N(X_{kit})$ is the normalized score of that indicator and wk denotes the weight assigned to each variable.

Normalization, or converting numbers to a common scale, is necessary because municipalities are different; some are very large, others very small, taxes are different, and both revenues and expenditures range in very different amounts. With the Min–Max method, each value is compared to the lowest and highest value across all municipalities. This way, all data gets an "equal chance" to reflect the real situation. For indicators where higher values are desirable — such as own revenues, capital expenditures, or the current financial balance — normalization is moving in a positive direction. Conversely, for indicators that show weaker performance when increasing — like debt or budget deficit — the value must be inverted for the score to remain comparable. The formula applied for normalization of the five indicators is the following:

$$N(Xkit)=1-\frac{X_{kit}-\min(X_k)}{\max(X_k)-\min(X_k)} \qquad (2)$$

Notable, the FPMI index covers exactly the five areas that best capture the municipality's financial "health": how much revenue it generates on its own (OS/TR), how much it invests in capital long-term projects (CE/TE), how liquid it is (CR), how much debt it has (D/TR) and whether it keeps its expenses under control (BB/TT).

After we calculate the FPMI, each municipality is categorized under three groups, such as weak, moderate, or good. This is not just a theoretical determination; such groupings are often used by international organizations when monitoring local governments in different countries.

In order for the research to be conducted, we took publicly available data from the Ministry of Finance, municipal budgets, and reports related to fiscal transparency (PEFA), for the period 2021-2023. Additionally, because we build our research around a representative sample of municipalities in the Republic of North Macedonia, we selected 16 municipalities which fall under three structured criteria: amount of approved last year's municipal budget, number of residents, and type of municipality (urban or rural).

Results

The Financial Performance Management Index (FPMI) was created to make it easier to compare how municipalities manage their finances under fiscal decentralization. It uses five basic indicators — own-source revenues (OS/TR), capital spending (CE/TE), liquidity, debt levels (D/TR), and the budget balance (BB/TT). When these indicators are brought together into one score, the index shows how financially stable a municipality is and how well it handles its resources. Table 1 shows an overview of the indicators that make up the FPMI, by municipality, for the period 2021-2023. The trend symbols presented in Table 1 reflect whether the municipality's financial performance has improved, stagnated, or deteriorated over the period 2021–2023, while the band classification (Weak, Moderate, Good) represents the municipality's current performance level based on the FPMI value. Based on the FPMI scores, municipalities were grouped into three performance categories: those with values below 0.40 were classified as 'Weak', municipalities with values between 0.40 and 0.59 as 'Moderate', and municipalities with FPMI values of 0.60 and above as 'Good'. This combined approach allows for a simultaneous assessment of both the dynamic evolution and the current financial position of each municipality.

Table 1:

Overview of indicators (FPMI), by municipality, for the period 2021-2023

Municipality	OS/TR	CE/TE	CR	D/TR	BB/TB	Trend	Band
Gostivar	0.61	0.30	1.36	0.04	0.00	▬	Weak
Ohrid	0.76	0.31	1.50	0.11	0.06	▲	Moderate
Bitola	0.58	0.45	1.72	0.08	0.02	▬	Moderate
Kavadarci	0.55	0.44	1.49	0.34	0.01	▼	Weak
Strumica	0.64	0.45	1.85	0.16	0.04	▲	Moderate
Shtip	0.64	0,32	1.46	0.03	0.07	▬	Moderate

Kriva Palanka	0.27	0.36	1.25	0.22	0.00	▲	Weak
Aerodrom	0.71	0.24	1.32	0,00	0.01	▼	Weak
Bogovinje	0.47	0.37	1.64	0.00	0.01	▲	Moderate
Debrca	0.27	0.42	1.62	0.05	0.09	—	Moderate
Novaci	0.14	0.40	0.84	0.04	0.02	—	Weak
Rosoman	0.24	0.63	1.84	0.00	0.04	▲	Good
Konche	0.06	0.46	0.91	0.00	0.05	▼	Weak
Zrnovci	0.23	0.40	1.67	0.31	0.34	▼	Weak
Rankovce	0.21	0.46	1.99	0.00	0.05	▼	Moderate
Zelenikovo	0.30	0.44	1.92	0.43	0.00	▲	Weak
Average values	0.42	0.41	1.33	0.09	0.05		

The indicator of own revenues in relation to total revenues shows us own taxes and revenues as a share of total revenues. The low values obtained as a result for this indicator indicate the dependence of municipalities on other sources of financing, which, in the case of municipalities in the Republic of North Macedonia, are funds provided by transfers from the central government. If the indicator shows a higher percentage, it indicates that the municipality provides sufficient own funds to cover its expenses, and thus shows a higher degree of self-sustainability. From Table 1, we can see that the average rate of participation of own revenues in total revenues in the period 2021-2023 is around 0.42. This means that around 42% of the total revenues of municipalities are obtained by collecting mainly tax funds from the population. The Municipality of Ohrid shows the highest value for this indicator with 76%. With this data, it can be concluded that the Municipality of Ohrid and all other municipalities that generate more than half of their revenues through tax collection are financially more self-sustainable compared to municipalities that do not generate even half of their total revenues from taxes. The tax revenue indicator in relation to total revenues for the Municipality of Konce is only 6%, and for the Municipalities of Rankovce and Zrnovci it is around 20%. This is a very low value for the indicator and indicates complete dependence on other sources of financing for these municipalities, reducing their ability for self-sustainability to the lowest level.

From Table 1 it can be seen that the average value of the indicator for capital expenditures in relation to total expenditures is 41%. The Municipality of Rosoman allocates the largest portion of its funds for capital investments with 62%, while the Municipality of Aerodrom allocates the least funds for this type of expenditure with only 24%. As many as 15 municipalities from the representative sample record a rate of average capital expenditures in relation to total expenditures that is less than 50%. Municipalities in the Republic of North Macedonia must find a way to reduce their current operating costs and direct their funds into capital investments that will strengthen their financial capacity. However, it should be noted that not all capital investments have had the opportunity to generate revenue. Therefore, it should be ensured that the trend of increasing capital expenditures is directed towards real investments that will generate revenue in the future or improve the overall living conditions in the municipality.

In continuation of Table 1, values for the indicator of current operating revenues in relation to current operating expenses (liquidity indicator) of the municipalities from the representative sample for the period from 2021 to 2023 are shown. The higher the values for this indicator, the more funds the municipality has left for spending after covering its current operating costs. These funds could then be used for capital investments that would directly improve the financial capacity of the municipality. Accordingly, higher values for the liquidity indicator indicate financially stable and liquid municipalities. The municipalities of Rankovce, Zelenikovo and Bitola show the highest liquidity rate. Two municipalities included in the analysis do not generate enough current operating revenues to cover their current operating expenses, which is why their liquidity rate is less than 1. These are the municipalities of Novaci and Konce.

From the data obtained in this research, it can be noted that the municipalities in our country are either debt-free, such as the Municipalities of Aerodrom, Bogovinje, Rosoman, Konce and Rankove, or are averagely indebted, such as the Municipality of Zelenikovo with as much as 43% and the Municipality of Kavadarci with 34%, the Municipality of Zrnovci with 31% and the Municipality of Kriva Palanka with 22%. The low indebtedness of the remaining municipalities in the Republic of

North Macedonia does not reflect the strong financial capacities of the municipalities. From the analysis so far, we have already concluded that the municipalities do not generate enough of their own funds, which makes their financial capacities relatively weak. The low indebtedness of municipalities is mainly a reflection of their weak financial capacities, which makes them insufficiently creditworthy for borrowing, as there is a risk that they will not generate sufficient funds in the future to be able to repay the borrowed funds. Borrowing money from the municipality to cover its current operating costs is not smart at all and should not be implemented.

Additionally, we can note that the average amount of budget balance in relation to the total balance of the analyzed municipalities for the period from 2021 to 2023 is 5%. The largest amount of budget surplus is achieved by the Municipality of Zrnovci, and the smallest by the Municipalities of Aerodrom and Bogovinje. From here, we can draw a very positive conclusion that all municipalities in the representative sample generate more revenue than expenditure, and no municipality shows a budget deficit in the period from 2021 to 2023.

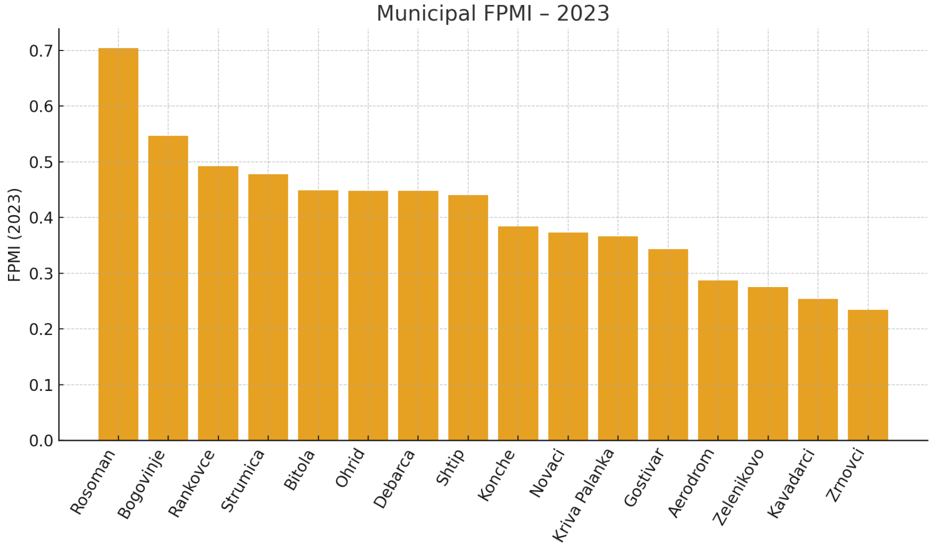
The trend lines that are part of the FPMI analysis show that the municipalities of Ohrid, Strumica, Kriva Palanka, Bogovinje, Rosolman, and Zelenikovo are recording an improvement in their financial performance, but, on the contrary, the municipalities of Kavadarci, Aerodrom, Konce and Rankovce, in the period 2021-2023, have worsened their financial stability and independence.

The results of the FPMI model show that there are clear and lasting differences among municipalities in Macedonia in the way they manage their financial position in the period 2021–2023, which is visually presented in Figure 1.

Muncipality Rosoman is at the top of the table, with the highest index (0.70). This means that the municipality operates very stably, it demonstrates good liquidity, low debt levels, and balanced spending. It also manages to maintain a solid base of its own revenues and continuously invests in infrastructure – a strong sign of financial sustainability. On the other side of the graph we have the Municipalities Kavadarci (0.27) and Zrnovci (0.24). These municipalities have the lowest FPMI score in the analyzed period and a strong dependence on central transfers. The municipalities of Strumica (0.48), Bitola (0.45), Ohrid (0.44), Debarca (0.44), and Shtip (0.43) are in the middle of the scores scale. These municipalities show solid yet moderate results overall. They generally keep their costs under control and maintain stable liquidity, but their progress in capital investment and broadening their revenue base is noticeably slower.

Figure 1:

Ranking of municipalities by FPMI in 2023



With FPMI scores from 0.24 to 0.70, we can conclude that there are significant differences between the municipalities in the Republic of North Macedonia. The average FPMI of around 0.43 indicates that most municipalities are at an intermediate level, while only a few of them manage to achieve high standards. These results also support the idea that municipalities with more financial autonomy and careful management of debt and spending tend to achieve stronger overall financial performance.

Conclusion

The analysis conducted in this research achieved its primary goal, namely to compare municipalities in the Republic of North Macedonia through the FPMI index for the period 2021–2023. Urban municipalities generate far more of their own revenues than rural municipalities. This disparity in the financial capacities of municipalities affects the quality of life and the quality of public goods and services that the municipality is obligated to provide to its citizens. Therefore, municipalities with lower total revenues are not able to provide equal living conditions as financially stronger municipalities could, which in some cases leads to the centralization of the population in certain municipalities or regions. These arguments confirm hypotheses H1 and H2.

Municipalities use the majority of their revenues to cover their current operating costs. This is an inefficient way of spending municipal money, at the expense of insufficient capital expenditures that will yield future financial benefits. Therefore, municipalities that have solid amounts of profitable capital investments are also more financially stable, which confirms hypothesis H3.

The weak financial capacities and low level of generated own revenues of municipalities lead to their weak creditworthiness and limited sources of borrowing. The low level of generated own revenues categorizes municipalities as inadequate for borrowing due to the risk that they will not be able to generate sufficient financial resources in the future to be able to repay the borrowed funds. Due to the inability to borrow and collect additional funds to carry out its obligations and responsibilities, the central government maintains its financial stability through transfers to municipalities; therefore, we are unable to accept or reject hypothesis H4.

Several practical recommendations follow from these findings. First, municipalities should have more financial independence and a wider revenue base, particularly by improving the collection of property taxes and utility charges. Second, capital projects need to be carefully prepared and carried out in a transparent manner so they can generate long-term value. Third, borrowing should remain strictly controlled and limited to investments that can produce measurable returns. Fourth, regular monitoring of financial results—using instruments such as the FPMI—can help strengthen financial discipline and identify problems early. Finally, greater transparency and accountability would improve public trust and provide stronger support for the decentralization process.

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