

## ASSESSMENT OF THE QUALITY OF PUBLIC FINANCIAL MANAGEMENT IN THE MUNICIPALITY OF AERODROM USING THE PEFA METHODOLOGY

### Abstract

*Effective institutions and systems of public finance management (PFM) play a key role in the implementation of national development policies. Therefore, the aim of this paper is to evaluate public expenditures and financial accountability, that is, to evaluate the current results of the public financial management system in the Municipality of Aerodrom. For this purpose, an adjustment was made to the PEFA framework and six indicators were selected to be evaluated in the selected municipality. The analysis in this paper is based on the guidelines issued by the PEFA secretariat for the functioning of the framework and provides a ranking for all indicators and their dimensions for the period 2021-2023. From the conducted analysis, it can be concluded that the areas of public financial management that are regulated by law are respected at a solid level and the scores are quite high when it comes to the Municipality of Aerodrom. However, there is still room for improvement, especially in the area of realization of transfers from higher levels of government and dedicated transfers, realization of expenditures and the budget preparation process. Therefore, this paper can also serve as a proposal for further legal regulations in some of the areas of public financial management.*

**Keywords:** public financial management, PEFA, Municipality of Aerodrom

**JEL Classification:** H7

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## Introduction

Effective institutions and systems of public finance management (PFM) play a key role in the implementation of national development policies.<sup>2</sup> Quality PFM is the sum of all available resources, the delivery of services and the realization of goals derived from public policies. If implemented in the right manner, it ensures the efficient collection of public revenues and their adequate and sustainable use. Due to the free movement of capital on a global level, international organizations such as the IMF, the World Bank, the European Commission and the governments of more advanced countries such as France, Norway and Switzerland have given broad support as early as 2001 to the initiative to harmonize the assessment of PFM by establishing a standard methodology and reference tools for diagnostic evaluation of public finances. The PEFA analysis of the municipalities is expected to provide an input that will serve as a basis for dialogue on strategies and priorities for public finance reforms at a municipal level.

The aim of this paper is to assess public expenditures and financial accountability (PEFA), i.e. to evaluate the system of public finance management in the Municipality of Aerodrom. For this purpose, an adjustment to the PEFA framework was made and six indicators were selected to be evaluated in the selected municipality. The indicators were selected in order to focus on the most important aspects of the functioning of the local government units and the effective functioning of Municipal Councils.

The PEFA framework was developed in 2001 by the World Bank, the European Commission and other partners as a support to the public financial management reforms. The latest amendments are from 2016 when appropriate adjustments were made in order for the framework to be applicable at the local level. To the existing indicators a new indicator was added, HLG-1, to assess the transfers that municipalities receive from the central government.

The analysis in this paper is based on the criteria for each performance indicator as set out in the framework and provides ranking for all indicators and their dimensions for the period 2021-2023.

The structure of this paper continues with an explanation of the methodology used, a brief description of the selected local self-government unit (Municipality of Aerodrom), assessment of the selected indicators and ends with a brief conclusion and recommendations for further reforms in the system of public financial management.

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<sup>2</sup> Bingham, R. (2009): "Local government management", Magor

## 1. ASSESMENT METHODOLOGY

This paper has been prepared following the guidelines issued by the PEFA Secretariat for the functioning of the framework. The latest version of the 2016 PEFA methodology, which is widely used, serves as a recognized standard for evaluation of the PFM. The 2016 PEFA version incorporates the changes, the reforms and the best practices in the PFM that occurred over the previous decade. PEFA 2016, is built on the previous versions from 2005 and 2011 and has 4 new indicators, expands and refines the existing indicators and harmonize the baseline standards for good and effective PFM. The PEFA 2016 completely replaces the PEFA 2011 version.<sup>3</sup>

Each indicator selected to be analyzed in this paper is evaluated with grades from A to D followed by an explanation of the procedures and the processes in the municipality and explanation of the assessment based on the PEFA criteria for each indicator. The evaluation and the grading of the selected indicators is done strictly according to the guidelines given by the PEFA methodology. The timeline which is analyzed is according to the recommendation in the methodology used, from 1 to 3 years and covers the period from 2021 to 2023.

Indicators that have more than one dimension are evaluated according to the recommended grading method M1 or M2. Those indicators where the M1 method is applied are graded with the lowest score and with a “+” sign if one or more dimensions have received higher score. When applying the M2 method, an average score is taken based on the scale given in the PEFA methodology.

## 2. BASIC INFORMATION ABOUT THE MUNICIPALITY

According to the official data published by the State Statistical Office of the Republic of North Macedonia, based on the 2021 census, the total number of inhabitants in the municipality of Aerodrom is 77,735, which is 7.9% more than in 2002 when the total number of inhabitants was 72,009. According to the latest census, there are 27,895 households in this municipality.<sup>4</sup>

The municipality of Aerodrom covers an area of 20 km<sup>2</sup>: urban area 10.4 km<sup>2</sup> or 60% and 9.6 km<sup>2</sup> or 40% rural area. The municipality is consisted of seven settlements: Michurin, Aerodrom, Jane Sandanski, Lisiche, Novo Lisiche, Regionalen Centar, Gorno Lisiche and Dolno Lisiche.

The boundaries of the municipality are from the bridge of the railway over the

3 PEFA Secretariat (2019): “Framework for assessing public financial management”

4 State Statistical Office of the Republic of North Macedonia

Vardar river-a tripoint of the municipality of Aerodrom, Centar and Gazi Baba and moving along the transport center “Skopje”, the railway in the direction to Veles and the Markova Reka bridge, continues along the border of the cadastral municipality of Dolno Lisiche to the Vardar river and turns opposite to the bridge of the railway over the Vardar river.

The municipality is governed by the Major Mr. Dejan Miteski and the Municipality Council, which consists of 27 members-representatives of the citizens elected in general, direct and free elections by secret ballot. On matters within its competencies, the Council sets up committees. Council committees are constituted as permanent and intermittent.<sup>5</sup>

### **3. EVALUATION OF THE PERFORMANCE OF THE PUBLIC FINANCIAL MANAGEMENT**

The purpose of the PEFA based assessment is to evaluate the public financial management, focusing on the functional performance of the municipality, based on indicators that are relevant for an effective functioning of all public financial management actors, including Councils and councilors. Some indicators require triennial data i.e. the most recent completed fiscal year and the previous two fiscal years. The timeframe for evaluation of the indicators is from 2021-2023.

#### **3.1 HLG-1 Transfers from higher levels of government**

This indicator assesses the degree of realization of the transfers from higher level of government (Central government) in accordance with the originally approved budget and whether they are provided according to an acceptable timeframe. The indicator contains three dimensions: realization of transfer from higher levels of government, realization of transfers which have a specific purpose and timeliness of transfers from higher levels of government. To obtain an overall score for this indicator, the M1 method (WL-weakest link) is used. Subject of the assessment are the years 2021, 2022 and 2023.

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<sup>5</sup> Official website of municipality of Aerodrom

**Table 1 Summary of result of indicator HLG-1**

<b>INDICATOR/ DIMENSION</b>	<b>GRADE</b>	<b>EVALUATION CRITERIA</b>	<b>EVIDENCE USED</b>
<b>HLG-1: Transfers from higher levels of government</b>	<b>B+</b>		
HLG-1.1: Realization of transfers from higher levels of government	B	Transfers have been between 94% and 112% of the initial budget estimate in at least 2 of the last 3 years.	Realization of transfers is 72% in 2021, 95% in 2022 and 102% in 2023 of the initially approved budgets.
HLG-1.2: Realization of transfers which have a specific purpose	A	The difference between the initial budget estimate and the actual transfers which have a specific purpose is 5% or less in 2 of the last 3 years.	Realization of transfers which have a specific purpose is 99%, 100% and 100% in 2021, 2022 and 2023 respectively.
HLG-1.3: Timeliness of transfers from higher levels of government	B	Actual transfers have been distributed evenly throughout the year, or with a certain front-load in 2 of the last 3 years.	Transfers are timely and evenly distributed throughout the year, in 2 of the last 3 years.

Source: Author's calculations

The overall score for the indicator HLG-1 for the municipality of Aerodrom is B+ (Table 1).

### 3.2 PI-1 Expenditure realization

This indicator measures the extent to which the realization of the total budget expenditures reflects the initially approved amounts for the current year. There is only one dimension for this indicator. Subject of the assessment are the years 2021, 2022 and 2023.

**Table 2 Summary of results for indicator PI-1**

INDICATOR/ DIMENSION	GRADE	EVALUATION CRITERIA	EVIDENCE USED
<b>PI-1: Expenditure realization</b>	<b>C</b>	Realization of total expenditures is between 85% and 115% of the initially approved total expenditures in at least 2 of the least 3 years.	The realization of expenditures from the initially approved budget is 74%, 86% and 85% in 2021, 2022 and 2023 respectively.

Source: Author's calculations

The overall score for the indicator PI-1 for the municipality of Aerodrom is C (Table 2).

### 3.3 PI-17 Budget preparation process

This indicator measures the effectiveness of the participation of relevant actors in the budget preparation process, including political leadership and whether the participation is orderly and timely. Effective participation requires an integrated top-down and bottom-up budgeting process, involving engagement from each party in orderly and timely manner, in accordance with a pre-established budget preparation calendar.<sup>6</sup> It contains three dimensions and uses the M2 method (AV-average) to add the results of the dimensions. The assessment time frame for the dimensions 17.1 and 17.2 is the last budget submitted to the Municipal Council, while for dimension 17.3 are the last three years.

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<sup>6</sup> The law on budget in the Republic of North Macedonia, Official Gazette of the Republic of North Macedonia" number 64/2005, 04/2008, 103/2008, 156/2009, 95/2010, 180/2011, 171/2012, 192/2015, 167/2016 and 203/2022

**Table 3 Summary of results for indicator PI-17**

<b>INDICATOR/ DIMENSION</b>	<b>GRADE</b>	<b>EVIDENCE USED</b>	<b>SOURCE OF INFORMATION</b>
<b>PI-17: Budget preparation</b>	<b>C</b>		
PI-17.1: Budget calendar	A	There is a clear annual budget calendar, it is generally respected and allows the authorities to complete their detailed estimates in a timely manner.	Budget calendar published on the municipality's website.
PI-17.2: Guidelines for preparation of the budget	D	The budget circular is submitted to the competent authorities in a timely manner but does not contain the ceilings, thus the quality of the circular is poor.	Interview with the head of the department of financial affairs and the department for budgeting.
PI-17.3: Submission of the budget to the Municipal council	D	The local government has not submitted the annual budget proposal to the Council at least one month before the start of the fiscal year in two of the last three years.	Interview with the head of the department of financial affairs and the department for budgeting.

Source: Author's calculations

The overall score for the indicator PI-17 for the municipality of Aerodrom is C (Table 3).

### 3.4 PI-22 Unsettled obligations

This indicator measures the unsettled obligations and the extent to which they can cause a systematic problem in this regard, and how they are being brought under control. Unsettled obligations are areas of outstanding liabilities and they represent a form of non-transparent funding. Unsettled obligations can cause increased costs for the municipality.<sup>7</sup> This indicator has two dimensions and uses the M1(WL) method for evaluation. The time frame for the dimension 22.1 are the last three completed fiscal years and for the dimension 22.2, the situation in the municipality at the time of the assessment is analyzed.

**Table 4 Summary of results for indicator PI-22**

INDICATOR/ DIMENSION	GRADE	EVALUATION CRITERIA	SOURCE OF INFORMATION
<b>PI-22: Unsettled obligations</b>	<b>A</b>		
PI-22.1: Amount of unsettled obligations	A	Unsettled obligations are not more than 2% of the total expenditures in at least 2 of the last 3 completed fiscal years.	K1 and K2 forms generated by a software and obtained from the department of finance and budgeting.
PI-22.2: Monitoring of unsettled obligations	A	Regular reporting of unsettled obligations to the Council, Ministry of Finance and to the public through the municipality's website.	Interview with the department of finance.

Source: Author's calculations

<sup>7</sup> The law on financial support of local self-government units and individual beneficiaries established by local self-government units for financing due and unpaid liabilities



The amount of unsettled obligations at the end of the year is 0%, 0% and 13% of total realized budget expenditures for the year 2021, 2022 and 2023 respectively. Therefore, the overall score for the indicator PI-22 for the municipality of Aerodrom is A (Table 4).

### **3.5 PI-28 Annual budget reports**

This indicator assesses the comprehensiveness, accuracy and timeliness in the submission of information for the implementation of the budget. Since it is a legal obligation for municipalities to submit quarterly reports to the Municipal Council at the end of each quarter, there is a possibility of monitoring the budget implementation and the possibility of taking possible corrective measures.<sup>8</sup> According to the legal framework in the Republic of North Macedonia, the Mayor must submit quarterly reports to the Municipal Council for adoption, no later than 4 weeks after the end of the quarter. The municipalities prepare three types of quarterly reports:

- K1 - for the implantation of the budget,
- K2 - for the realization of outstanding and unpaid obligations and
- K3 - data on municipality's indebtedness, if the municipality is in debt with loans.

This indicator has three dimensions and it is evaluated using the M1 (WL) method. The timeline frame is the last fiscal year, 2023.

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<sup>8</sup> The law on budget execution in the Republic of North Macedonia, Official Gazette of the Republic of North Macedonia" number 191/2016, 196/2017, 238/2018, 265/2019, 307/2020, 287/2021 and 282/2022

**Table 5 Summary of results for indicator PI-28**

<b>INDICATOR/ DIMENSION</b>	<b>GRADE</b>	<b>EVALUATION CRITERIA</b>	<b>EVIDENCE USED</b>
<b>PI-28: Annual budget reports</b>	<b>A</b>		
PI-28.1: Coverage and comparability of reports in terms of compliance with budget estimates	A	The scope and classification of the data should allow for immediate comparison with the initial budget. The information should cover all items included in the budget projections.	The coverage and classification of the data allows for direct comparison with the initial budget. Quarterly reports (K1, K2 and K3) are prepared in which the budgeted amounts can be compared with the actual realized amounts.
PI-28.2: Dynamics and timeliness of the issuance of reports	A	The reports are prepared quarterly, are issued within four weeks of the end of the quarter and are submitted to the Council for adoption.	Reports are prepared quarterly and are issued within 4 weeks of the end of the reporting period.
PI-28.3: Quality of information	A	The data in the financial statements are accurate, reliable and correspond to the actual situation.	There is no concern or doubt about the accuracy of the data.

Source: Author's calculations

The overall score for the indicator PI-28 for the municipality of Aerodrom is A (Table 5).

### 3.6 PI-29 Annual financial statements

This indicator assesses the extent to which annual financial statements are complete, timely submitted and aligned with national accounting standards and financial reporting standards for the public sector, allowing them to be comparable, while reflecting the accountability and transparency of the public finance system. This indicator has three dimensions and uses the M1 (WL) method for adding the scores of different dimensions. The timeframe evaluated is the last fiscal year for the dimensions 29.1 and 29.2 and the last three years for dimension 29.3

**Table 6 Summary of results for the indicator PI-29**

INDICATOR/ DIMENSION	GRADE	EVALUATION CRITERIA	EVIDENCE USED
<b>PI-29: Annual financial statements</b>	<b>A</b>		
PI-29.1: Comprehensiveness of financial statements	A	The annual report of the municipality's budget is prepared annually and it is comprehensive from a view point of complete data on revenues, expenditures, financial resources and liabilities.	The annual report of the municipality of Aerodrom is prepared on an annual basis and includes full information on revenues, expenditures, financial and material assets, liabilities, guarantees and long-term loans.

PI-29.2: Timeliness of submission of financial statements to the State institute for revision	A	By March 15 of the current year, the municipality's final account of the budget should be submitted to the Council and by March 31 to the Ministry of Finance. By February 28 it should be submitted to the Central registry, State institute for revision and Public revenue office.	The report on the final account of the budget is submitted within the statutory deadline to all competent authorities.
PI-29.3: Accounting and financial reporting standards used	A	The International accounting standards for the public sector (IPSAS) should apply to all statements and any inconsistencies are disclosed in the notes accompanying the financial statements.	The national legislation in which IPSAS are embedded are fully respected and the data presented in the financial statements are accurate, reliable and reflect the actual situation.

Source: Author's calculations

The overall score for the indicator PI-29 for the municipality of Aerodrom is A (Table 6).

## Conclusion

In order for the municipal budget to be useful for implementation of policies, it is necessary to be objective and implemented in accordance with legal regulations.

It is very important for the budget to be realistic and practical in order to maintain fiscal discipline since excessive or insufficient budgeted revenues have a serious impact on the municipality's financial stability and can lead to increased debt and debt servicing costs. Unplanned changes to the budget structure can disrupt budget allocation priorities.

Transfers from the Central government have been realized in amounts between 94% and 112% in two of the last three years. The difference between the initial budget estimate and the actual transfers which has some purpose, is 5% or less in two of the last three years. The transfers have been transferred to the municipality in a timely manner and evenly distributed throughout the year in two of the last three years.

Realization of total expenditures is 74%, 86% and 85% in 2021, 2022 and 2023 respectively.

The budgeting process is legally regulated and this municipality meets the legal requirements (PI-17). The municipality of Aerodrom has a clear budget calendar, the budget units are provided with the budget circular on time which gives sufficient time of six weeks to submit their requests but the budget circular does not provide the budget planning ceilings. The draft version of the budget is submitted to the Council one month before the start of the new fiscal year. Participation in the budgeting process by the relevant budget units, the Mayor, the legislative authorities, the civil society organizations etc. is crucially important in the planning and budgeting process and supports decision making of budget allocations consistent with the total expenditures.<sup>9</sup>

The amount of unsettled obligations in the municipality of Aerodrom is equal to zero in 2021 and 2022 and it is not more than 2% of the total realized expenditures in at least two of the last three completed fiscal years and is therefore rated with the highest-grade A (PI-22). The municipality prepares a K2 form for reporting outstanding obligations on a quarterly basis and submits them to the Ministry of Finance and the Council within one month of the end of the quarter and publish them on the official municipality's website.

The municipality issues quarterly reports for the implementation of the budget (PI-28). Preparation and issuance of these reports is made within 15 days after the end of each quarter. The information in these reports are

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9 Arsov, S. (2008): "Financial management", Skopje

accurate because they are extracted directly from the municipality's system and are directly comparable with the initial budget. Quarterly reports provide a solid basis for analysis and making decisions related to the implementation of the budget. The indicator of timeliness, accuracy and comparability of annual budget statements is evaluated with the highest grade.

Regular reporting on budget execution throughout the year not only allows monitoring of expenditures but also facilitates the identification of problems that can lead to significant changes in the budget execution process. Inadequate information and records may reduce the availability of evidence necessary for an effective audit and oversight of funds and may provide an opportunity for loss, corrupt public procurement or misuse of resources.

With regard to the annual financial statements (PI-29), the legal requirements are met. They are complete and timely submitted to the competent authorities. Accounting is conducted according to the applicable standards, IPSAS, on a cash basis.

From the performed analysis, it can be concluded that the areas of public financial management that are regulated by law are respected at a solid level and the scores are quite high when it comes to the municipality of Aerodrom. However, there is still a room for improvement in certain areas that are of particular importance to the municipality's financial stability, especially in terms of realization of transfers from the Central government, the realization of expenditures and the budget preparation process. All of these improvements would lead to an improvement in the financial stability and overall situation of the municipality of Aerodrom. Therefore, this paper can serve as a proposal for further legislative regulations of some areas of public financial management.

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