

Subnational public finance in the European Union

Editorial

2011 started rather well for many European countries...but, the intensifying sovereign debt crisis over the summer threw the region's economies back into turmoil. The price to pay for this new crisis was very high for States, companies, financial establishments and especially the citizens of the affected countries. However, could the crisis perhaps be an opportunity to rethink the European project, the role of public powers, our economic models or even our way of life?

At the heart of the turbulence, the subnational public sector is often less visible but absolutely essential: it is close to the people it governs and is directly affected by the current crisis and thus plays a key role in maintaining social cohesion. As a leading investor, it has one of the keys for returning to sustainable growth. As a public player, lastly, it is directly involved in the comprehensive effort to restore public accounts, which is an unconditional factor in providing a better tomorrow for future generations. In this respect, the crisis is an opportunity to redefine the role and the governance of the public sector across the central, regional and local levels.

Although the outcome of the crisis is highly uncertain, many issues need to be tackled on the European level including evaluating the crisis' impact on territories, identifying institutional and financial reforms, analysing the way investment funding is provided and, lastly, observing reactions, initiatives and responses provided everyday by local and regional authorities.

This is the objective of this study on European subnational finance conducted by Isabelle Chatrte, Head of international research at Dexia Crédit Local, in close collaboration with the Council of European Municipalities and Regions and experts from national associations of local authorities who contributed to this paper.

We hope that it will provide clarity and comparative information on these complex questions that are not explored often enough. Consequently, we also hope that it will foster dialogue and contribute to decision-making by everyone involved in territorial development.

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European subnational investment falls again in 2011

■ Summary

The relative improvement in the economic and social environment in the first half of 2011, combined with efforts made by local authorities to optimise their revenue and to better control their expenses, allowed the subnational public sector to consolidate its main budget balances in 2011. Although, on an individual basis the situation in certain countries grew worse.

The public sector deficit at the subnational level dropped from 0.8% of GDP in 2010 to 0.7% in 2011. Higher subnational tax revenue, which increased 5.5% after contracting sharply due to the crisis, was the main reason why local authorities' funding needs were lower. Improved tax revenue and income from assets and fees offset the 4.9% drop in transfers to local authorities, resulting from cost-saving measures taken by central governments under national plans to shore up budgets. In total, subnational revenue was stable in 2011 (+0.2%).

Subnational expenditure, which had already slowed in 2010, continued to fall slightly in 2011 (-0.2%) to reach €2,109 billion, i.e. 16.7% of GDP and 34.0% of public expenditure. For the first time in eleven years, personnel expenditure and purchase of goods and services were down. Growth in social services, which had been very strong since the outset of the crisis because of automatic stabilising mechanisms and discretionary measures to foster cohesion, has started to weaken under the effects of lower unemployment in several European countries in 2011.

The drop in expenditure was also a result of a marked decline in direct investment at the subnational level (-6.6% in 2011), which came on the heels of a weak 2010: the combined drop over the two-year period was nearly 14%. At €204bn in 2011, this investment accounted for two-thirds of European public investment.

Total subnational debt accumulated at a slower rate (+3.1%) and stood at €1,563 billion in 2011, i.e. 12.4% of GDP and 15.0% of public debt. For the local level alone (i.e. excluding federated or quasi-federated entities), these figures fall to €743bn, or 5.9% of GDP and 7.1% of public debt. Local debt is almost exclusively allocated to investments, pursuant to the Golden Rule, which has been a real "dogma" governing local finance for decades in many European countries.

Local investment could once again come under pressure in 2012 as the economic and social crisis deepens, uncertainty is generated by institutional and territorial reforms, austerity measures are stiffened and, lastly, access to external sources of funding becomes more difficult.

Methodology

Data

The primary source of data used in this study was Eurostat, the statistical office of the European Union, which centralises and processes data from national public sources (national statistics institutes, central banks, ministries, etc.).

Data was extracted on 2 May 2012 covering all 27 Member States of the European Union. This data remains provisional and will be updated at the end of October 2012 by Eurostat.

The classification of data is based on the European System of Accounts (ESA 95), the standard methodology used by Member States of the European Union.

Several restatements were made for this analysis, including:

- **United Kingdom:** restatement of public investment expenditure for 2005 in order to neutralise an exceptional measure that affected the central administration that year.
- **France:** 2010 local public sector tax revenues and grants were restated in order to incorporate the initial effects of the abolition of the professional tax: the temporary compensation paid by the State for 2010 was re-assigned to tax revenues pending the allocation of new tax revenues to local authorities in 2011.

The data covers the period 2000-2011. 2011 data are provisional.

Analysis scope

Public sector: classified as S13 under ESA 95, it comprises four sub-sectors:

- **S1311:** central administrations;
- **S1312:** federated States (*Germany, Austria and Belgium*) and quasi-federated (Spanish Autonomous Communities) and related public entities;
- **S1313:** local authorities and related local public entities (see "local public sector" below);
- **S1314:** social security funds.

S13 data is consolidated (neutralisation of financial cross-flows) as well as those of each subsector between their different components. However, data is not consolidated between subsectors (i.e. the sum of the subsectors "S1311 + S1312 + S1313 + S1314" is greater than "S13").

Subnational public sector: includes the two sub-sectors S1312 and S1313. The data is not consolidated between the two sub-sectors.

Local public sector: classified S1313 by the ESA 95, it comprises local authorities with general competencies (local and regional governments) and bodies with more specialised competencies (responsibilities vary from one country to the next). As mentioned above, data within the local public sector is consolidated.

Note: in previous versions of this analysis, Dexia Crédit Local restated the accounts of the Spanish Autonomous Communities by reintegrating them in the local public sector (S1313) given that *Spain* remains a unitary State (Eurostat considers them federated entities). Following the

2009 reform of the financing system of Autonomous Communities, which has been fully operational since 2011, it was decided to no longer proceed with this restatement and keep data from the Autonomous Communities within the Federated States sector by considering them quasi-federated entities (S1312).

Key indicators

Public expenditure by category: current expenditure (intermediate consumption, personnel, social spending, subsidies and other current transfers, interest charges, taxes) and capital expenditure (direct capital expenditure and capital transfers, excluding capital payments on borrowings).

Direct investment expenditure: gross fixed-capital formation (P51) and acquisitions less non-financial assets (land and other non-financial non-produced assets).

Indirect investment expenditure: capital transfers.

Expenditure by economic function: according to the ten areas defined in the Classification of the Functions of Government (COFOG).

Tax revenue: taxes on production and imports (D2), current taxes on income and wealth (D5) and capital taxes (D91). Note: they include both own-source and shared tax revenues.

Non-tax revenues: in opposition, all other revenues: tariffs and fees, property income, current and capital grants, social contributions

Budget balance: deficit/surplus is defined as the net lending/net borrowing as laid out in the Protocol to the Maastricht Treaty (B9A) restated for interest on debt swaps. It measures the difference between all expenditure and revenue.

Public debt: gross debt as defined in the Protocol to the Maastricht Treaty (i.e. the financial assets of the public administrations are not deducted). The definition does not include all financial liabilities: derivative financial products, accrued interest as well as other payable accounts are excluded. It is consolidated in nominal value at the end of the year.

Currencies

Data was extracted directly in euros. For countries outside of the euro area, an annual average exchange rate was used for all indicators, except public debt for which the exchange rate at 31 December was used.

Changes

Annual and multi-year changes are all calculated, except otherwise indicated, in constant euros (in volume terms) so as to not take into account inflation measured in terms of the GDP deflator (2000 = 100). Changes between 2000 and 2011 are average annual changes in volume.

Table of contents

- | | |
|---|--------------------------------------|
| ■ Macro-economic environment and public finances (p. 3) | ■ Revenue and taxation (p. 12) |
| ■ Territorial organisation and reforms (p. 6) | ■ Expenditure and investment (p. 19) |
| | ■ Budget balance and debt (p. 29) |

2011 provisional data

Macro-economic environment and public finances

Renewed deterioration of the economy at the end of 2011 after a slight improvement in 2010

The improvement in the **economic situation**, which was already weak in 2010 (+2.0% increase in GDP in volume terms) and during the first half of 2011 in the EU, will not have lasted very long. In fact, growth began to deteriorate once again in the summer of 2011 due to effects, notably, from the sovereign debt crisis, crumbling investor and consumer confidence, fiscal austerity measures, which weighed on domestic demand, and, lastly, the slowdown in global growth, which limited exports.

GDP increased by 1.5% in volume on average in the EU 27, with particularly strong disparities from country to country. Three countries saw their GDP drop in 2011: *Greece* – in recession for the 4th consecutive year – *Portugal* and *Slovenia*. Thirteen countries – including *Italy*, the *United Kingdom*, *Spain* and *France* – recorded weak growth of less than 2%. However, GDP expanded by more than 3% in eight countries including *Germany*, *Sweden*, *Poland* and the three Baltic countries. The latter three countries have staged a remarkable comeback: in 2009, their GDP had collapsed (-16% on average).

Job creation has suffered from the slowdown, increasing by a mere 0.2% in the EU 27 in 2011 and in seven countries this figure was negative. The unemployment rate (9.7%) remained stable in 2011 at the EU level. On a per country basis, joblessness dropped in 14 countries but increased by over 0.2pt in 9 countries including the *United Kingdom*. It surpasses 14% in five countries: *Ireland*, *Lithuania*, *Latvia*, *Greece* and lastly *Spain* where it reached 21.7%.

Driven by increasing energy prices and indirect taxes, **inflation** increased appreciably in 2011. Prices rose by an average of +3.1% across Europe versus +2.1% in 2010. On a per country basis, the price increase ranged from +1.2% in *Ireland* to +5.8% in *Romania*. It surpassed +4% in six countries including the three Baltic countries and the *United Kingdom*.

Drop in expenditure and rise in public revenue in 2011

Despite contracting economic activity in the last quarter of 2011, public finances improved markedly in 2011 as a result of budget

Key macro-economic indicators in 2011

	GDP (€bn)	GDP (€per capita)	GDP 2010 / 2011 (% volume)	Inflation rate (%)	Annual avg. unemployment rate (%)
Austria	301.3	35,786	+3.1	+3.6	4.2
Belgium	368.3	33,549	+1.9	+3.5	7.2
Bulgaria	38.5	5,159	+1.7	+3.4	11.2
Cyprus	17.8	22,026	+0.5	+3.5	7.8
Czech Republic	154.9	14,693	+1.7	+2.1	6.7
Denmark	239.8	43,056	+1.0	+2.7	7.6
Estonia	16.0	11,918	+7.6	+5.1	12.5
Finland	191.6	35,559	+2.9	+3.3	7.8
France	1,996.0	30,606	+1.7	+2.3	9.7
Germany	2,570.8	31,437	+3.0	+2.5	5.9
Greece	215.1	19,018	-6.9	+3.1	17.7
Hungary	100.8	10,104	+1.7	+3.9	10.9
Ireland	156.4	34,848	+0.7	+1.2	14.4
Italy	1,580.2	26,012	+0.4	+2.9	8.4
Latvia	20.0	9,715	+5.5	+4.2	16.1
Lithuania	30.7	9,530	+5.9	+4.1	15.4
Luxembourg	42.8	82,651	+1.6	+3.7	4.8
Malta	6.4	15,266	+2.1	+2.4	6.5
Netherlands	602.1	36,074	+1.2	+2.5	4.4
Poland	370.0	9,692	+4.3	+3.9	9.7
Portugal	171.0	16,057	-1.6	+3.6	12.9
Romania	136.5	6,394	+2.5	+5.8	7.4
Slovakia	69.1	12,692	+3.3	+4.1	13.5
Slovenia	35.6	17,362	-0.2	+2.1	8.2
Spain	1,073.4	23,271	+0.7	+3.1	21.7
Sweden	387.1	40,993	+3.9	+1.4	7.5
United Kingdom	1,737.1	27,689	+0.7	+4.5	8.0
TOTAL EU 27	12,629.5	25,107	+1.5	+3.1	9.7

consolidation measures adopted by most Member States starting in the spring of 2010, which were reinforced in 2011. In the words of the Commission, public finances shifted in 2011 from a "stabilisation phase" to a "consolidation phase".

Public expenditure growth began to stabilise in 2010 and in 2011 it started to drop (EU average: 1.5% decrease in volume). As a percentage of GDP, it has shrunk by two points since the 2009 stimulus plans, to stabilise at 49.1% in 2011.

Main public finance indicators in the EU in 2011

	€bn	€per capita	% of GDP	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
Expenditure	6,201	12,330	49.1	+2.2%	-1.5%
...of which direct investment	306	610	2.4	-	-7.4%
Revenue	5,637	11,210	44.6	+1.3%	+2.9%
...of which tax revenue	3,283	6,530	26.0	+1.0%	+3.2%
...of which non-tax revenue	2,354	4,680	18.6	+1.7%	+2.4%
Balance	-565	-	-4.5	-	-
Debt	10,422	20,720	82.5	+4.1%	+4.7%

In particular, **direct investment** (-7.4%) plummeted, which was the second consecutive year it had done so. As a percentage of GDP, it fell from 2.9% to 2.4% between 2010 and 2011.

Public revenue, which was very depressed in 2009 (-5.4%), confirmed the turnaround that began in 2010 recording a 2.9% increase in 2011. Specifically, tax revenue, which had imploded under the effects of the economic and social crisis (-8.4% in 2009), increased in 2010 and especially in 2011 (+3.2%). These good revenue figures resulted from a slight improvement in the economic picture as well as tax measures included in austerity plans.

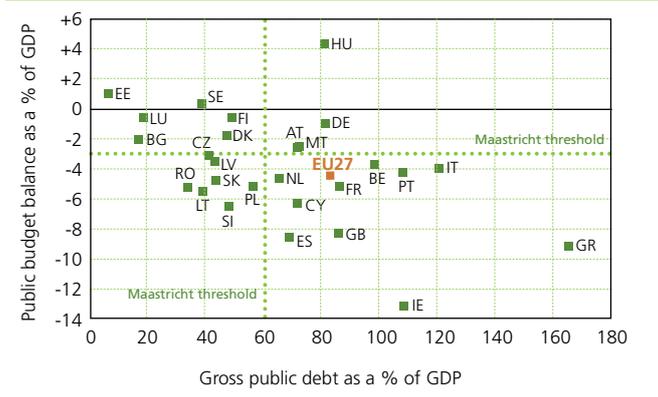
The deficit shrunk but public debt continued to expand in 2011

The public deficit in the EU continued to decrease in 2011 finishing the year at 4.5% of GDP compared with 6.5% in 2010. In all, 24 Member States recorded an improvement in their public balance as expressed as a percentage of GDP versus 2010, two recorded a decline (*Slovenia* and *Cyprus*) while one remained stable (*Sweden*). Three countries had a budget surplus in 2011 including *Hungary*, whose bottom line had been in deficit (-4.2% of GDP) in 2010. Ten countries were in compliance with the Maastricht threshold of 3% of GDP in 2011, versus only five one year ago.

Public debt (€10.422 trillion in 2011 in the EU 27) as a percentage of GDP continued to expand in 2011. The EU 27's public debt/GDP ratio increased by 2.5pts on average, reaching 82.5% and even by more than 10pts in *Cyprus*, *Portugal*, *Ireland* and *Greece*. In all, it rose in 20 countries in 2011. Fourteen countries had a ratio that complied with the Maastricht limit (60% of GDP) while four countries surpassed the 100% bar. In volume terms, the increase in outstanding public debt has slowed (+4.7% in 2011 vs. +9.3% in 2010 and especially +14.5% in 2009) on the back of a brightening economic backdrop and shrinking deficits.

Several countries refinancing rates increased as a consequence of the sovereign debt crisis. Since the crisis, interest rates paid on 10-year government bonds have risen sharply while spreads between countries have widened, especially compared with the German Bund, which is the Eurozone's benchmark for this asset class.

Public administrations' budget balance and debt in 2011



2012 uneven; recovery could continue in 2013

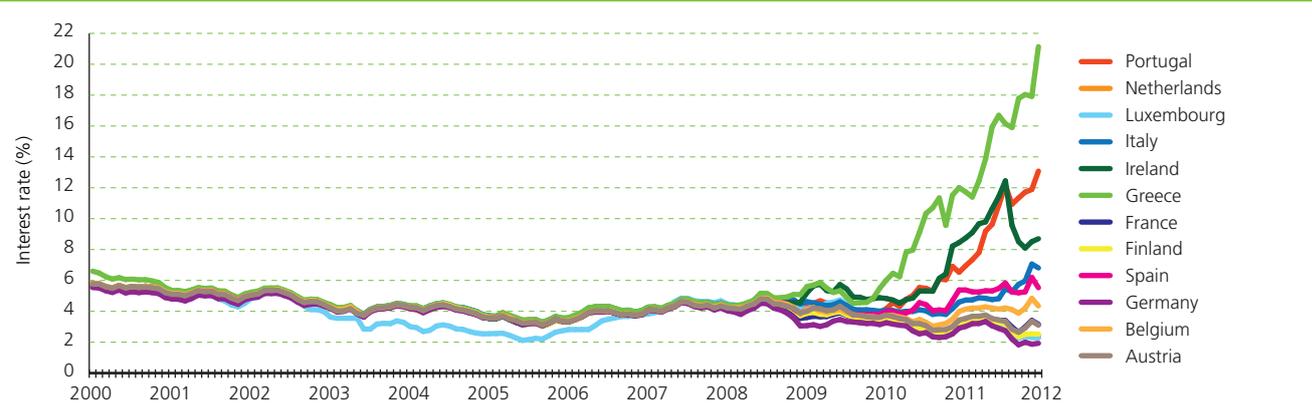
Although the **economic contraction** lasted into the first half of 2012, a **recovery**, albeit a meek one, could get underway in the second half of the year. According to forecasts from the European Commission dating from May 2012, GDP growth in the EU is expected to be flat in 2012 (0.0%) with a dozen countries in recession and 8 others growing by less than 1% (See chart). Exports will be the biggest growth driver. Domestic demand and private investment are expected to be held back by a number of different factors including high unemployment, flat wages, a high level of household debt, inflation, tight lending conditions, etc. In 2013, the recovery could be gradually sustained (+1.3% in the EU 27) if domestic demand and private investment improve on the back of global production growth, renewed confidence and low interest rates.

Only in 2013, with the return of growth, could the **labour market situation** be expected to improve although unemployment would still remain high (same level as 2012, i.e. 10.3%).

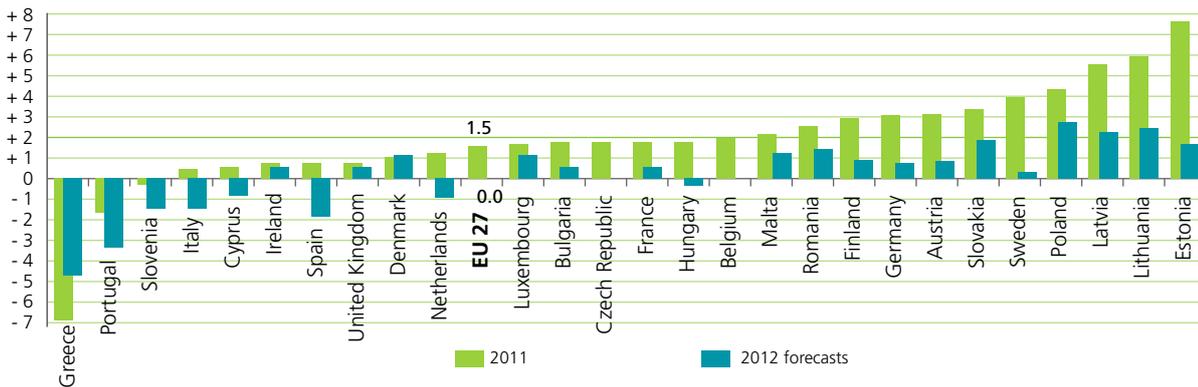
Inflation should start to fall gradually in the second half of 2012, before dropping below the 1.8% threshold in 2013.

This **outlook** remains **fragile** amid an environment that is stressed, on the whole. Indeed, **risk** remains high on account of the spectre of a worsening sovereign debt crisis (risk of financial contagion and credit crunch) and/or geopolitical uncertainty (with repercussions possible on the price of oil).

Change in interest rates paid on 10-year government bonds since 2000



Change in GDP in 2011 and 2012 forecasts (% in volume y-o-y)

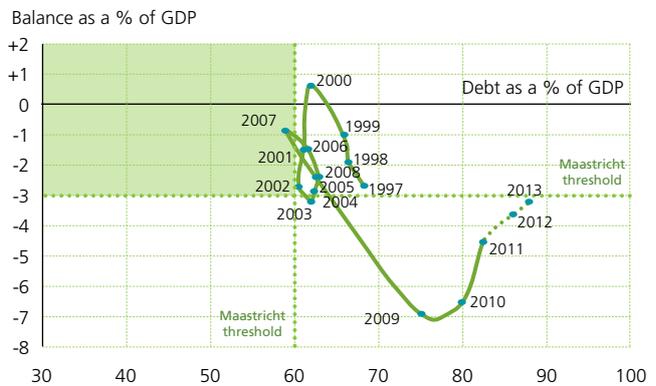


Public accounts expected to improve in 2012 and 2013

According to the European Commission's spring forecast, which was published in May 2012, the EU 27's public deficit is expected to continue to shrink due to the continuation of measures aimed at shoring up budgets combined with a tepid economic recovery. The deficit/GDP ratio is projected to fall to 3.6% in 2012 then 3.3% in 2013.

The current upward trend of the public debt/GDP ratio is predicted to continue, but less steeply. It would increase from 86.2% in 2012 to 87.7% in 2013 (See graph).

Movement in balance and public debt as a % of GDP in the EU 27 1997-2011 and 2012-2013 forecasts



2011 – 2012: implementation of new economic governance for Europe

In order to avoid the euro area from breaking up, the European Commission and the EU Member States have begun to substantially reinforce economic governance tools in Europe. Since the start of 2011, significant breakthroughs have been made in several areas, including:

- **Financial oversight:** launch, on 1 January 2011, of three new European financial oversight bodies for the banking sector (EBA), insurance sector (EIOPA) and the capital markets (ESMA);
- **The resolution of financial crises:** strengthening the European Financial Stability Facility (EFSF), which was created in May 2010 for bailing out European countries encountering financial difficulty (*Ireland, Portugal and Greece*) and bringing forward, to 1 July 2012 (i.e. one year early), the date the European Stability Mechanism (ESM) is set to take effect in an effort to build a permanent firewall designed to protect the euro area from future sovereign debt crises.
- **The "European Semester":** implementation, from 1 January 2011, of the first mechanism for coordinating national fiscal policies (*via* "stability and convergence programmes") and economic policies (*via* "national reform programmes"). It is an oversight mechanism that takes place over an annual cycle of six months and includes four stages.
- **"The Six Pack":** a group of six texts (five regulations and one directive) that seek to reinforce the Stability and Growth Pact by:
 - reinforcing "fiscal oversight" of Member States via more restrictive mechanisms for preventing and correcting fiscal imbalances (procedure for excessive deficits).
 - creating "macro-economic oversight" of Member States aimed at detecting internal and external economic imbalances upstream by using dashboards and correcting those imbalances through a new system of financial sanctions.

The treaty outlines the demands applicable to Member States' fiscal frameworks and the quarterly publication of fiscal data related to local authorities.

- **The "Euro Plus Pact" (March 2011):** adherence of 23 Member States to a new agreement to strengthen European economic convergence, increasing competitiveness, employment, financial stability, fiscal policy coordination and the solidity of public finances.
- **The "Two Pack":** currently, the European Parliament is considering two additional measures aiming to reinforce fiscal oversight of countries in the euro area, which could be adopted before the summer of 2012. The first measure would bolster the European Commission's control of national budgets. The second measure aims to avoid the bankruptcy of euro area members by allowing them to be put under the legal protection of the European Commission.
- **The "Treaty on Stability, Coordination and Governance" (TSCG):** signed on 2 March 2012 by 25 Member States is the new European budget treaty that outlines the creation, by signatory Member States in the euro area especially, of quantitative national rules for balancing the budget applicable to all public administrations (broad interpretation of the "golden rule") that must be binding and written out in the Constitution or at least in a law. The Treaty must be ratified by a minimum of 12 Member States in order to go into effect.
- **European summit held in Brussels on 28 and 29 June 2012:** an agreement was reached on several short – and long-term measures including a Growth Pact that will allocate €120bn to stimulate economic activity, intervention by the bailout funds (EFSF and ESM) to directly recapitalise struggling banks and a fledgling banking union that will start with banking oversight to be operational by end – 2012.

Territorial organisation and reforms

In 2011, there were nearly 90,400 local and regional governments in the EU

The European Union is comprised of 27 Member States, including three with a federal structure (*Germany, Austria, Belgium*), a quasi-federal State (*Spain*), and 23 unitary States. Despite their unitary structure, some of these latter States have a heterogeneous territorial organisation. As such, *Portugal, United Kingdom* and *Finland* include regions on only a part of the national territory (autonomous regions of *Madeira* and *Azores*, the "devolved" nations *Scotland, Wales* and *Northern Ireland, Kainuu* and the *autonomous island province of Åland*). As a "regionalised" unitary State with regions that have "ordinary" as well as "special" status, *Italy* has a special place in the European landscape.

Eleven countries have just one level of subnational authorities, i.e. municipalities; nine others have two levels (municipalities and regions) while the remaining seven, which are some of the biggest countries in the EU, have three levels: municipalities, regions and intermediary entities (i.e. departments, provinces, counties, etc.).

In 2011, there were a total of **90,380 subnational governments in the EU 27** (See table), including 89,149 municipalities, 981 intermediary entities (departments, provinces, etc.) and 250 "regions" belonging to the 2nd or 3rd level. Among these regions, there were 31 federated and quasi-federated entities: the 16 *Länder* in *Germany*, the nine Austrian provinces, the six regions and communities in *Belgium* and 17 Autonomous Communities in *Spain*.

The economic crisis was an opportunity to step up the movement toward **reorganising territories** and to rationalise and pool resources in an effort to increase the efficiency of local public action. **Institutional organisation of power** has also changed considerably in the last few years in Europe, with sometimes discrete federalisation, decentralisation or recentralisation processes unfolding, which in some cases led to reducing the autonomy of local authorities and

their financial capacities. These territorial and institutional changes affected subnational authorities at all levels.

The European municipalities in 2011

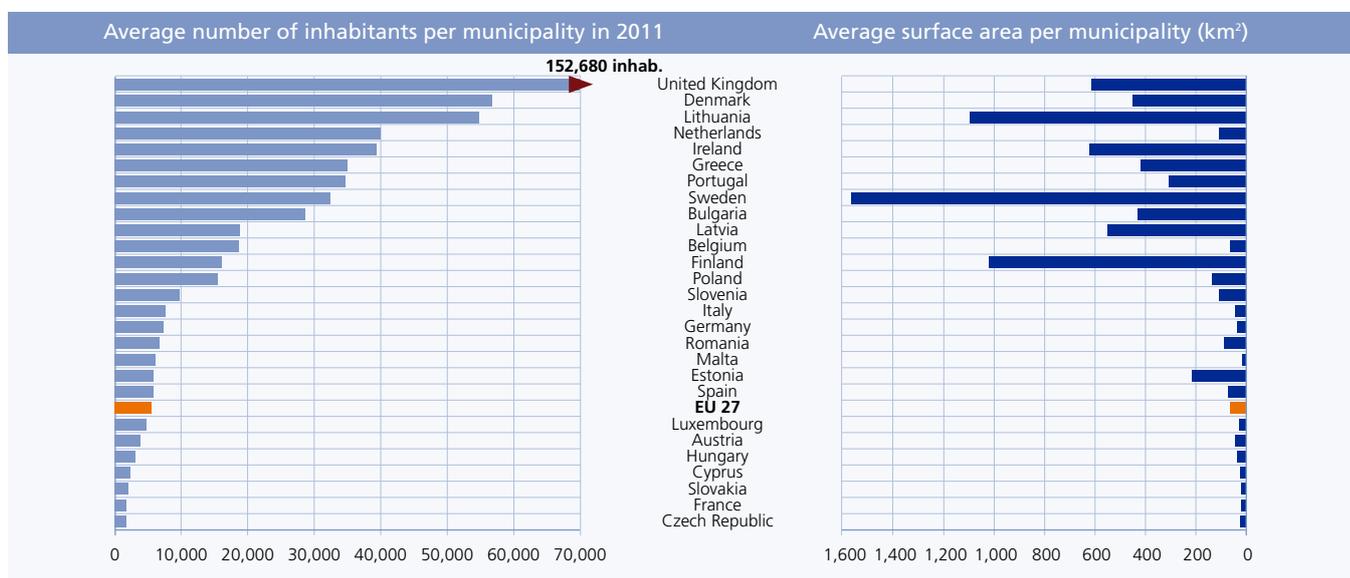
Of the 89,149 municipalities in the 27 Member States of the EU in 2011, nearly 80% were located in just five countries: 41% in *France*, 13% in *Germany*, 9% in *Spain* and *Italy* and finally 7% in the *Czech Republic*.

In 2011, the average European municipality totalled **5,630 inhabitants across a surface area of 49km²** although substantial disparities exist from country to country. There were less than 5,000 inhabitants on average per municipality in seven countries, including three of which had less than 2,000 inhabitants (*Czech Republic, France* and *Slovakia*). On the other end of the spectrum, municipalities total more than 30,000 inhabitants on average in eight countries. The *United Kingdom* is an extreme case with 152,680 inhabitants on average. In these countries with large municipalities, there is also the structured sub-municipal level, comprised of "localities" that are sometimes given legal status (parishes in the *United Kingdom, freguesias* in *Portugal, seniūnija* in *Lithuania*, etc.)

From municipal mergers to inter-municipal cooperation

The municipal landscape has changed radically in the past few decades, particularly in the last 10 years (reduction in the number of municipalities from 271 to 98 in *Denmark* in 2007 and by 524 to 119 in *Latvia* in 2009). Municipal mergers have picked up with the crisis and austerity plans:

- **In Greece**, as part of its *Kallikratis reform* of local administrations, the number of municipalities went from 1,034 to 325 in January 2011, i.e. a three-fold decrease (See inset).



- **In Germany**, municipalities continued to be merged in several *Länder*. In 2010 and 2011, the Land of *Saxony-Anhalt* lost $\frac{3}{4}$ of its municipalities (from 840 municipalities to roughly 220). In all, the number of German municipalities has dropped 7% in four years, i.e. from 12,456 in 2007 to 11,553 in 2011.
- **In Luxembourg**, there were 106 municipalities at 1 January 2012 versus 116 in 2009. The downward trend is poised to continue and by 2017 there is expected to be 71 municipalities in *Luxembourg* with the critical mass of a municipality being set at a minimum of 3,000 inhabitants as set out by the government's territorial reorganisation programme.
- **In Finland**, the new government seeks to step up the current pace of mergers launched in 2007 (the PARAS programme of municipal services restructuring), which gradually reduced the number of municipalities from 431 in 2006 to 336 in 2011. The new policy begun in 2012, entitled "New municipalities 2017", aims to implement municipal organisation with various configurations depending on the urban or rural nature of territories and to promote the creation of an infra-municipal level. At the same time, municipal competencies are likely to be strengthened, particularly for social services.
- **In Ireland**, the government announced in June 2011 it was encouraging mergers between cities and counties and the streamlining of the urban authority system.
- **In Spain**, the government has been preparing, since 2012, a municipal streamlining plan affecting municipalities of less than 5,000 inhabitants, i.e. 84% of current municipalities. The plan would merge or encourage municipalities to cooperate within inter-municipal groups. To facilitate these mergers, competencies would be distributed depending on population size. The region of *Castile and León*, which is home to nearly 2,200 municipalities with less than 5,000 inhabitants, would be the most concerned by this policy. The basic law on local government will also be revised, notably Article 25, which defines the competencies of each municipality. These competencies are expected to be reduced and clarified. Part of the competencies of municipalities with under 20,000 inhabitants could be taken over by the provinces.

Despite being stepped up in several countries, this trend continues to meet stiff resistance. This is the case in **France**, for example, (meagre success of the "new municipalities" of which only 13 are expected to be created in 2012 and 2013) and in **Luxembourg** where the merger process is moving forward slowly (a new assessment of the situation is expected for 2013). At times, the trend has been stopped in its tracks. In **Northern Ireland**, the reform that would have cut the number of districts from 26 to 11 with the May 2011 elections was cancelled in May 2010 and postponed to 2015. In **Italy**, the plan for eliminating small municipalities of less than 1,000 inhabitants, which was part of 2011 austerity measures, seems to have been abandoned in favour of greater inter-municipal cooperation.

Governments are increasingly encouraging **inter-municipal cooperation**, which is seen as an alternative to merging municipalities or as a complementary route. It has taken different forms including simple delegation agreements or shared services or more integrated and institutionalised forms of cooperation.

- **In Italy**, the municipalities with fewer than 5,000 inhabitants will have to share their resources starting in 2013 (group purchasing, municipal unions) while reducing the number of municipal councillors.
- **In England**, the government has asked districts to sign *Shared Service Agreements* for certain public services.
- **In Ireland**, the local authorities are encouraged to set up shared services in waste treatment and water services as well as rent recovery, tariffs and fees.
- Moreover in the **Netherlands**, municipalities continue to merge and a reduction in the number of local elected officials is under consideration. At the same time, the pooling of municipal administrations is being encouraged via the creation of shared service centres.
- **In Portugal**, a vast reform of the local government was launched in 2011. Besides eliminating some of the parishes, the reform will strengthen competencies and financial resources of the 23 "inter-municipal communities" and two metropolitan areas including *Lisbon* and *Porto*.

Institutional reforms in countries the Troika is monitoring

Heavily affected by the financial and economic crisis, several countries in the EU asked for an IMF bailout to help them overcome budget and external imbalances. In 2008 – 2009, **Hungary, Latvia and Romania** were part of the first wave of rescues by the IMF and the European Commission. In 2010 – 2011, **Ireland** (December 2010), **Greece** (May 2010) and **Portugal** (May 2011), all three members of the euro area, also reached out for assistance in the form of strengthened cooperation between the IMF, the Commission and the European Central Bank, dubbed the "Troika". The Memoranda of Understanding (MoU) that were signed with these countries include major territorial and institutional reforms. The goal is to streamline territorial organisation and to reduce and optimise public spending through reinforcing decentralisation.

In Portugal, the current reform of local government is founded on the *Green Paper* published in October 2011 and the MoU with the Troika. It includes four parts: reform of local public companies, of territorial organisation, municipal/inter-municipal management and financial management as well as reform of local democracy. New competencies will be delegated by the State to municipalities and inter-municipal groups whose financial resources will be increased. Some 1,500 civil parishes (*freguesias*, administrative subdivision of municipalities), out of a total of 4,259, will be eliminated. A vote on the laws is scheduled for the summer of 2012.

In Greece, the *Kallikratis reform*, adopted as part of the 3852/2010 law and operational since 1 January 2011, is both a territorial reform (merging municipalities, replacement of departments by regions) and institutional reform. The new municipalities were given more competencies and resources (personnel, grants), which are transferred by the State but generally inherited from the old departments (school transport, welfare, urban planning agencies). Thirteen new regions, including two "metropolitan regions", were created to ensure regional development primarily. The number of municipal companies should also plummet from 6,000 to 2,000. For its part, the central State set up new territorial organisation with seven administrative departments (*dioceses*).

In Ireland, the *Reforming Local Government* plan, which has been under discussion since the 2007 *Green Paper*, was resuscitated in the summer of 2012. It is part of the Programme for a National Government and aims to increase decentralisation. The goals of the reform are to strengthen local authorities' competencies, functions, leadership and financing mechanisms. Local councillors were consulted starting in June 2012 notably regarding the possible election of mayors through direct elections. Although, the project aimed at consolidating "regional authorities" seems to be on hold.

- **In Wallonia**, municipalities may be asked to create municipal communities in order to manage certain competencies at the municipal and provincial level (See below).
- **In France**, territorial reform, set up as part of the law passed on 16 December 2010, aims, in particular, to complete and streamline the inter-municipal map, has made significant progress. Since 2012, a departmental plan for inter-municipal cooperation has been completed in two-thirds of French departments. It will enable the enlargement of the scopes of existing inter-municipal groups with their own-source tax resources (*groupements de communes à fiscalité propre*) and it will also combine them with the last isolated municipalities. Plans would reduce both the number of groupings of municipalities with own-source tax revenue by 20% (from 1,828 to 1,477) and the number of inter-municipal syndicates (*syndicats de communes*).

The institutionalisation of the "metropolitan phenomenon"

In the last few years, several European countries have stepped up inter-municipal cooperation at the urban centre level. The objective is to make the "metropolisation" phenomenon a political-institutional reality and improve **the governance of the "metropolitan areas"** as well as capital cities.

- **In the Netherlands**, with the emergence of the project of the "Metropoolregio" metropolitan region, which covers *Rotterdam* and the *Hague*;
- **In Finland**, *Helsinki* and its surroundings are treated differently under the "New municipalities 2017" programme.
- **In Italy**, the law passed in March 2009 created a special status for *Rome* and for nine metropolitan cities (*Turin, Milan, Venice, Genoa, Bologna, Florence, Bari and Naples, and Reggio Calabria*);
- **In Portugal**, the territorial reform currently underway aims to reinforce the competencies of the metropolitan zones of *Lisbon*

and *Porto* created in 2003, which have already been reformed once (2008). A project to give two metropolises an institutional structure is currently under discussion, which could lead to the creation of metropolitan municipalities with expanded competencies and greater financial autonomy.

- **In France**, under the territorial reform of 2010, metropolises (over 500,000 inhabitants) and metropolitan centres (over 300,000 inhabitants) will be set up. The first metropolis (out of eight potentially) was created on 1 January 2012 (*Nice-Côte d'Azur*) in addition to five metropolitan centres on 1 June 2012. The governance of *Grand Paris* has not yet been determined.
- **In Poland**, the 2009 bill has been rekindled. It aims to create a dozen metropolitan areas. This renewed interest has followed proposals by the European Commission regarding the programming of structural funds for the 2014 – 2020 period (5% of funds could be allocated to urban development projects).
- **In England**, launch of the "City Deals" process, which consists of giving ten of England's biggest cities new competencies if they consolidate the way in which they are governed. The failure of the local referendums in May 2012 – which proposed to elect mayors via direct elections in 10 cities (9 year and 1 nay votes) – is liable to slow the process.
- **In Ireland**, the "Local Government (*Dublin* Mayor and Regional Authority) Bill 2010" created the position of an elected mayor to manage *Dublin* and its region and handle questions of territorial development, housing, waste and water management as well as regional transport.
- **In Greece**, following territorial reform and regionalisation, the metropolises of *Attica* and *Thessaloniki* will be given an institutional structure within a regional framework. The metropolitan regions will manage issues related to transport and communications, the environment and quality of life, territorial planning, urban development as well as security.

Decentralisation in France and in England

It is often tempting to compare *France* and *England*, as their demographic, economic and political landscapes are relatively similar, e.g. both have a central State that is traditionally strong. However, in terms of territorial organisation and decentralisation, the two countries have chosen relatively different paths: in *France*, a uniform territorial organisation and "political" decentralisation together with financial decentralisation; in *England*, an asymmetrical territorial organisation and a more "functional" and technical decentralisation, along the lines of the New Public Management, without real financial autonomy. *France* and *England* are currently experiencing a new transformation phase of their territorial organisation. How have these two governance models evolved? Let's take a look at the main directions...

England is currently undergoing a period of profound institutional change as the Localism Act, which was signed on 15 November 2011, went into effect in April 2012. This reform is part of a broader "Big society" (vs. "Big government") project designed by the new British government. The reform plans to transfer many State responsibilities to local authorities and civil society (as opposed to the public or private sectors). The idea is to give local groups (cooperatives, mutuals, neighbourhood communities, citizen and volunteer groups, charities, social enterprises, etc.) local services. Social initiatives are being particularly targeted as well as culture and education (free schools for example).

The law intends to push decentralisation forward. It also gives local authorities a general power of competence excluding the ability to raise taxes.

The economic power of major cities and London is expected to be extended to the areas of housing and economic development. Local councils will also be in charge of public health starting in April 2013, which has been a function carried out by the central State.

In addition, a reform of local government funding aiming to increase financial autonomy is being prepared (See revenue section). Lastly, several layers of State control (e.g. Audit commission) and governance of local public action were abolished because they generated bureaucracy and additional procedures.

In **France**, a major reform of local authorities, which includes several parts (distribution of competencies, creation of territorial councillors, inter-municipality, metropolisation, reforms of local taxation and equalisation mechanisms, co-financing framework, local democracy, etc.), was begun under the law passed on 16 December 2010 and several finance laws thereafter. It led, notably, to the loss of tax autonomy for local governments, particularly regions and departments. With the new government formed in 2012, a new stage has been set towards strengthening decentralisation. Act III of decentralisation (in reference to "Act II" of 2003 – 2004) was announced for 2013. It plans to transfer new responsibilities (employment, training, European policies) and re-expand local tax power and reorganisation of local democracy (limiting the accumulation of political positions, local initiative referendums, etc.). Part of the territorial reform of December 2010 is likely to be abrogated, notably those concerning the new "territorial councillors".

Intermediary levels being reformed

Present in seven EU countries, intermediary-level authorities occupy a unique position between regions and municipalities. They have been the subject of an ongoing debate in these countries and the crisis has provided an opportunity to hasten changes to these entities:

- **In England**, the two-level system, which remains in place in some rural areas, is disappearing with counties being gradually replaced by unitary authorities.
- **In Italy**, the elimination of 110 provinces as elected entities had been taken under consideration in 2011 in the aim of cutting fiscal costs. However, the plan was dropped in June 2012 as the project met resistance and because of the fact that it would have required a constitutional amendment. It appears that the government is leaning towards combining provinces, the number of which could be brought down to 60. A decision confirming this strategy is expected to be made in July 2012.
- **In Spain**, under the current review of the basic law on local authorities, the provinces could take over competencies currently carried out by the municipalities.
- **In Belgium**, the provincial level is also being reformed but in varying ways depending on the region. In *Wallonia*, certain provincial competencies will be taken up by the regions (roadways) or transferred to communities of municipalities. In *Flanders*, the provinces stand to lose some of their competencies (education, culture and health) and only maintain competencies related to the territory. In the two regions, the number of elected officials from the provinces would also be cut.

In France, however, the territorial reform begun in 2010, which projected, notably, to set up new territorial councillors that would govern in general councils (department level) and regional councils (regional level) in 2014 is likely to be revoked in 2012 under the aegis of the new government. This project could have been a prelude to a

potential redefinition of the role of departmental and regional levels and perhaps mergers between regions and departments. A third round of decentralisation is slated for 2013 and the role of departments in the French territorial landscape, particularly when compared with regions and inter-municipal groups, is expected to be discussed.

The reinforcement of regions in Europe: yes... but

The regional level has also been appreciably changed in the last few years. Overall, the regional level has been strengthened, which has resulted in either the attribution of new competencies and resources to existing regions or through the creation of, or experimentation with, new regional levels (from scratch or based on pre-existing administrative entities or policies):

- **In Spain, Italy and Germany**, laws dating from 2009 on financial federalism gave regions greater financial autonomy, even though the crisis has, at the same time, led central governments to strengthen their fiscal control over regions (See the financial sections hereinafter).
- **In Belgium**, the institutional agreement of October 2011 on State reform will translate, starting in 2014, into transfers of competencies towards the federated entities whose fiscal autonomy will be increased (See inset).
- **In the United Kingdom**, a certain form of "federalisation" is underfoot in regions (*Northern Ireland, Wales and Scotland*) whose institutional and fiscal autonomy is being beefed up (See inset).
- **In Poland**, a law passed on 23 January 2009 bolstered the competencies of regions
- **In Greece**, 13 democratically-elected regions, which were given new competencies (*Kallikratis reform*), replaced the 54 departments on 1 January 2011.

Federalism progresses

Besides the two reforms of German federalism (in 2006 and 2008 for financial aspects) and reforms to financing of Autonomous Communities in *Spain* and Italian regions (making reference to the "financial federalism"), profound institutional changes have taken place in the *United Kingdom* and *Belgium*:

In the United Kingdom, since the devolution laws of 1998, which transferred major competencies to the three nations comprising the Kingdom (i.e. *Northern Ireland, Wales and Scotland*), their autonomy has continued to increase even if the process has varied depending on the nation. More recently, a November 2010 referendum extended the powers of the Welsh assembly by attributing it full legislative competency for devolved issues (agriculture, environment, housing, education and healthcare). In *Scotland*, the Scotland Bill of November 2010 will transfer new competencies to the Scottish government and modify its financing: the nation would no longer be funded by British government subsidies but rather through tax revenue transfers (stamp tax, environmental tax).

It would also have the power to modify the income tax scale *via* an additional tax. A referendum is being organised for 2013 or 2014 on Scottish independence.

In Belgium, the institutional agreement on State reform, validated in October 2011, is a major reform of federalism. It would translate, from 2014, into the transfer of competencies from the federal government and social security towards the communities and regions, estimated at 4.4% of GDP in four main areas: employment, healthcare and social assistance (elderly and disabled), family support and justice. The reform also includes the revision of the Special Financing Act, which will lead to the reinforcement of federated entities' financial autonomy (See revenue section). In addition, a reform of provinces was begun in *Wallonia* and in *Flanders*, which will consist of also transferring competencies towards regions, municipalities and inter-municipal cooperation structures.

Regional reforms are still being debated in several countries:

- **In Romania**, where a territorial reorganisation plan was launched in 2011 in the aim of creating 8 to 16 major regions replacing the current departments. Discussions on the exact configuration of the reform are expected to recommence after the June 2012 elections.
- **In France**, the regions, which had lost a major part of their fiscal power with the 2010 fiscal reform, could regain some prerogatives in 2013 with the Act III decentralisation project by the government, which was elected in May 2012.
- **In the Netherlands**, the government wishes to encourage provinces to cooperate, or even merge based on the "*Randstad Province*" model, cooperation between *Northern Holland*, *Utrecht* and *Flevoland*. Their competencies could also change with provinces taking on territorial development and water management.

Discussions in **Bulgaria** (creation of regions), in the **Czech Republic** (reinforcement of regional competencies), in **Cyprus** (creation of a second level) are underway but have not led to concrete results at this point.

This observation regarding the progress of regionalisation should be nuanced, however. In fact, in certain countries, the regional level has been weakened. Moreover, several regionalisation projects have been postponed, or even abandoned. Regionalisation is far from being a *fait accompli*, as demonstrated by the following examples:

- **In Denmark**, the 5 regions created in 2007, by replacing the 14 counties to take on the bulk of health responsibilities, suffer from a lack of legitimacy. Some voices have expressed a desire to eliminate them or transform them into an administrative level of the State.
- **In Slovenia**, while the regionalisation project had been considered a foregone conclusion in February 2011 (creation of 6 regions instead of the 14 outlined in the 2008 bill, which was abandoned), it seems as if the project had been halted yet again.
- **In Hungary**, the former regionalisation project was abandoned with the constitutional reform and the 2011 law on local government. In accordance with the new law on local administration

passed in December 2011, Hungarian counties, just like municipalities, will lose several major competencies (healthcare, notably hospitals, social initiatives and education) starting in January 2012, which will be recentralised. They will be in charge of regional development for the most part.

- **In Portugal**, the regionalisation project on the continent is no longer on the agenda while the two autonomous regions' authority, notably fiscal, is being limited by the austerity programme and the current reform of the local and regional government.
- **In Sweden**, while the status of regions was attributed in 2011 to two new counties (*Halland* and *Götland*), in addition to the two counties that were already experimenting with it since 1997 1998 (*Skåne* and *Västra Götaland*), the project for widespread regionalisation to 2015 seems to have been put on hold. The transformation of all counties into between 6 and 9 regions had been planned by giving them competencies in health matters and regional planning.
- **In Finland**, the government extended in March 2011 the *Kainuu* regionalisation project until 2016 but no longer seems willing to expand regionalisation throughout the country.
- Although the autonomy of the devolved nations in the **United Kingdom** seems to have increased, regionalisation in **England** seems to be more compromised since the government decided in 2010 to eliminate the regional development agencies that would have served as a base for the emergence of elected officials at the regional level. At present, only one region-metropolis, Greater London, has an elected regional assembly and mayor.
- **In Ireland**, austerity measures have interrupted the process of consolidating "regional authorities" and their transformation into elected regions.
- **In Lithuania** and in **Latvia**, recent territorial reforms from 2009 and 2010 were not, in the end, joined by the creation of an elected regional level, like initially planned. In *Lithuania* notably, the administrative counties of the State, which were eliminated on 1 July 2010, were not replaced by elected regions in the end: their competencies were distributed between the State and the municipalities.

Population, surface area and organisation of territories in the EU-27 Member States in 2011

	Population (thousands)	Surface area (km ²)	1 st level	2 nd level	3 rd level
Countries with one subnational government level					
Bulgaria ¹	7,534	111,002	264 municipalities	-	-
Cyprus ²	804	5,695	379 municipalities	-	-
Estonia	1,340	45,227	226 municipalities	-	-
Finland	5,363	338,145	336 municipalities	2 regions (pilot region of <i>Kainuu</i> and the autonomous insular province of <i>Åland</i>)	-
Ireland	4,476	69,797	114 local councils	-	-
Latvia	2,239	64,589	119 municipalities	-	-
Lithuania ¹	3,287	65,300	60 municipalities	-	-
Luxembourg ³	506	2,586	106 municipalities	-	-
Malta ¹	416	316	68 local councils	-	-
Portugal ¹	10,637	92,152	308 municipalities	2 autonomous regions (<i>Madeira</i> and <i>Azores</i>)	-
Slovenia	2,049	20,273	210 municipalities	-	-
Countries with two subnational government levels					
Austria	8,388	83,871	2,357 municipalities	9 Federated States	-
Czech Republic	10,517	78,868	6,249 municipalities	14 regions	-
Denmark	5,546	43,098	98 municipalities	5 regions	-
Greece ⁴	11,305	131,957	325 municipalities	13 regions	-
Hungary	10,000	93,029	3,177 municipalities	19 counties	-
Netherlands	16,612	41,528	418 municipalities	12 provinces	-
Romania ¹	21,431	238,391	3,181 local authorities	41 departments	-
Slovakia	5,430	49,034	2,930 municipalities	8 regions	-
Sweden ⁵	9,378	449,964	290 municipalities	20 counties of which 4 regions	-
Countries with three subnational government levels					
Belgium	10,883	30,528	589 municipalities	10 provinces	6 communities and regions
France ⁶	64,848	633,210	36,697 municipalities	101 departments	27 regions
Germany	81,757	357,027	11,553 municipalities and districts-free cities	301 rural districts	16 Federated States
Italy	60,468	301,336	8,094 municipalities	110 provinces	20 regions of which 5 with special status
Poland	38,187	312,685	2,479 municipalities	379 counties	16 regions
Spain	46,073	505,997	8,116 municipalities	52 provinces	17 Autonomous Communities of which 2 with foral regime
United Kingdom ¹	61,990	243,820	406 local authorities	28 counties	3 "devolved" nations (<i>Scotland</i> , <i>Wales</i> and <i>Northern Ireland</i>)
TOTAL EU 27	501,465	4,409,423	89,149 municipalities and local authorities	1,126 regional or intermediary authorities	105 regions

¹ Existence of a sub-municipal structure level (communities, localities, parishes, etc.).

² Only in the Government controlled area (525 on the entire island).

³ Provisional figure as of 1 January 2012 (on-going municipal reform).

⁴ Since the territorial reform adopted in July 2010 and in effect since 1 January 2011.

⁵ Including the 4 regions (Skåne, Västra Götaland and since 2011, Halland and Götland).

⁶ Including Corsica and the 5 DOM-ROM, i.e. French overseas departments and territories (including Mayotte since March 2011).

Revenue and taxation

Revenue – Subnational and local public sector in the EU – Year 2011

	€bn	€ per capita	% GDP	% Public sector	% Revenue	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
Revenue	2,016	4,010	16.0	35.8	100.0	+1.9%	+0.2%
...Local level alone	1,480	2,940	11.7	26.3	100.0	+2.1%	-0.2%
Tax revenue (own-source and shared)	838	1,670	6.6	25.5	41.6	+2.1%	+5.5%
...Local level alone	529	1,050	4.2	16.1	35.7	+2.2%	+3.5%
Non-tax revenue	1,178	2,340	9.3	50.0	58.4	+1.9%	-3.3%
...Local level alone	951	1,890	7.5	40.4	64.3	+2.1%	-2.2%

Overall stagnation of subnational revenue in 2011

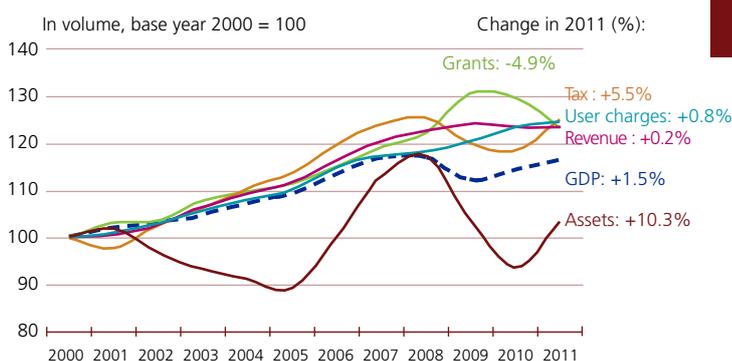
In 2011, the total revenue of the European subnational public sector remained virtually stable compared with 2010 (+0.2% in volume) to reach €2,016bn, i.e. 16.0% of GDP and 35.8% of public revenue.

However, subnational tax revenue jumped markedly in 2011 compared with 2010 (+5.5%). Moreover, property asset income rebounded (+10.3%) while tariff income increased moderately (+0.8%). In reality, grants and subsidies account for overall stagnation: transfers to the subnational public sector dropped appreciably in 2011 (-4.9%), adding to the drop begun in 2010 (-0.6%).

However, other factors blurred the picture, particularly the reforms affecting the subnational public sector. The clearest example is certainly Greece where the transfer of competencies to the local public sector under the *Kallikratis reform*, particularly for social matters, had to be financed through new revenue (See below). Pending confirmation of provisional figures when the reform stabilises, local public sector revenue in Greece will have increased nearly 15% in volume in 2011 (to reach 3.2% of GDP and 7.8% of public revenue) while they had plummeted by 23.4% in 2010 amid an economic backdrop that remains highly unfavourable.

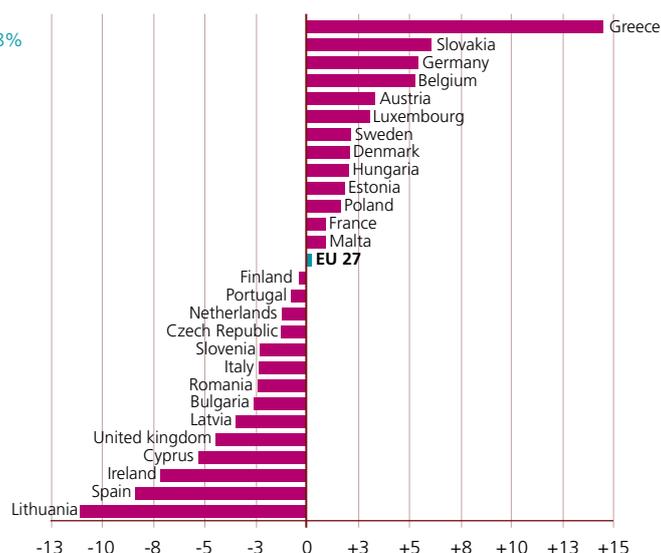
There are numerous other examples where changes in revenue were largely determined by more structural reforms that affected the funding systems of local authorities (tax reform, equalisation mechanisms, fee policies, etc.).

Change in subnational revenue in the EU 27 (2000 – 2011)



On a per country basis, Europe appears, like in 2010, divided in two: subnational revenue increased in 13 countries and decreased in 14 others (See graph). But the line between the two is more difficult to discern than in 2010 where there was a clear distinction between Northern European countries in the first group and the Southern European countries in the second. The effects of the economic situation on tax revenue and temporary measures taken by governments on transfers were responsible for a large part of this split. These factors remain applicable in 2011: where there was simultaneously economic growth and an increase in grants subnational revenue rose.

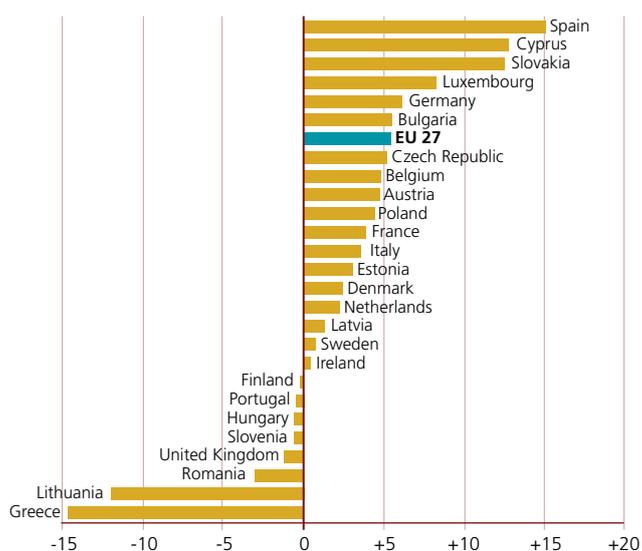
Change in subnational public sector revenue in 2011 (as a % by volume vs. 2010)



Marked recovery of subnational tax revenue

Subnational tax revenue, which includes both own-source and shared tax revenue, reached €38bn in 2011, i.e. 6.6% of GDP and 25.5% of public tax revenue. They are the second largest source of revenue for the subnational public sector: nearly 42% of subnational revenue on average in the EU, but 0% in *Malta* and 61% in *Sweden* (See inset page 15).

Change in own-source and shared taxes of subnational public sector in 2011 (as a % by volume vs. 2010)



Revenue was clearly affected by the economic and social crisis as well as counter-cyclical stimulus measures in 2009 (-4.2%) and 2010 (-1.2%). In 2011, their growth picked up in 7 out of 10 countries; on average in the EU, revenue rose 5.5% in volume.

A more favourable economic situation in several European countries in 2011 is responsible for this development. Improvement in economic activity and property markets, an increase in income and lower unemployment in around fifteen countries resulted in strong tax revenue, particularly own-source and shared taxes, which are backed by **bases that are sensitive to economic fluctuation** (household income tax, corporate profits, added value, property transactions, construction activity, consumption, etc.). This was the case in *Slovakia*, *Luxembourg*, *Belgium*, *Austria*, *Poland*, *Germany*, etc. In *Germany*, for instance, revenue from municipal business tax (44% of local tax revenue) increased 13.2% in value terms in 2011 on the back of a stronger economy (GDP growth of 3.0% in 2011). Likewise, revenue from several shared taxes soared in 2011 in *Germany*: +6.9% for the municipal share of personal income tax (of which 15% was earmarked for municipalities, thus providing 36% of municipal revenue in 2011) and +6.1% for the municipal share of VAT revenue (nearly 5% of municipal tax revenue). Tax revenue of *Länder*, which also mostly comes from personal income tax, VAT and tax on corporate profits, also recorded significant growth. In all, tax revenue expanded 8% by volume for the local public sector and 5.5% for the *Länder*, i.e. a total of 6.1% for the German subnational public sector, which is the same level as prior to the crisis.

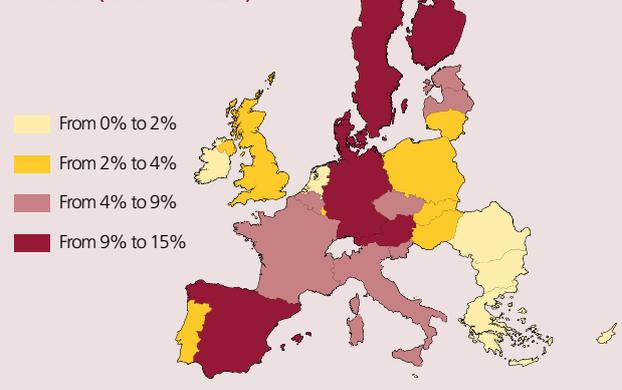
Strong tax revenue can also be explained by the implementation of **comprehensive reforms** of local finances (See inset), like in *Spain*

where funding mechanisms for Autonomous Communities was reformed. Spanish tax revenue rose 15.1% in volume in 2011 for the entire subnational public sector (+24% for the regional level alone) in spite of the economic recession, which automatically weighs on tax revenue.

Subnational taxation as a percentage of GDP in 2011

Subnational taxation accounts for 6.6% of GDP (4.2% for the local public sector alone). This ratio is less than 2% of GDP in eight countries including *Greece*, *Bulgaria*, *Ireland*, *Romania*, the *United Kingdom* and the *Netherlands*. It is greater than or equal to 9% of GDP in the three Nordic countries as well as in the federal or quasi-federal countries (excluding *Belgium*, but the situation is set to change in 2014 as the 6th State reform was adopted in 2011 and new tax competencies are allocated to the regions and communities, which will translated into a quadrupling of their own-source tax revenue).

Weight of subnational tax revenue (as a % of GDP)



These changes also reflect the varying importance of local authorities' use of **tax leverage** when they have the technical and political capacity.

Changes also make it possible to assess the direct and indirect effects of more **temporary tax measures** used by central governments to clean up their budgets concerning shared national taxes (VAT, personal income tax, company income tax, excise tax, etc.) or local taxation (property tax, local taxes on businesses, consumption tax, etc.).

Several types of measures were taken in 2011 that aim to maintain or increase local tax revenue:

- increases to shared or own-source tax rates ; consolidation (elimination of tax shelters) or extension of their bases;
- introduction of new own-source local taxes (tax on secondary residences in *Ireland*, taxes on energy and tourism in *Italy*, etc.);
- broadening of the decision-making power of local authorities for setting of rates and bases notably regarding property tax (See inset on property tax);
- attribution of all or a part of national tax revenue to local authorities, which have only benefited the central State until now (*France*, under the reform of local taxation);
- increase in the fraction of national taxes redistributed to the local authorities (*Finland*, *Spain*, *Latvia*, *France*, etc.). In *Finland* for example, municipalities benefited, for 2009 – 2011, from an increase in the percentage of the corporate income tax revenue that is allocated

Property tax in the spotlight

The property tax is the most common local tax in Europe and is often one of its oldest. Its "permanent", "localised" and "visible" nature make it the most important local tax, closely associated with providing public services in a territory. It offers a relatively more equitable geographic distribution of tax bases between local authorities and to provide stable revenue, even if they do not rise quickly during periods of economic growth. It resisted the crisis well, in general. As such, the crisis provided an opportunity to optimise revenue from this tax. Numerous countries enacted reforms in this direction, which are sometimes imposed by the protocol agreements for countries under the surveillance of the Troika.

In **Ireland**, a tax on secondary residence was created in addition to the "household charge" in 2012 to be replaced by in 2014 by a broader reform of the property tax. In **Portugal**, the highest property tax bracket (IMI) was raised in 2012. In **Greece**, a special tax on property tax was set up in September 2011 and was immediately applicable. The tax will be assessed for two years and will cost an average of €4/m² and it will be collected via the electricity bill. In **Latvia**, the tax rate on unbuilt and built property was increased in 2010 and the taxable base was enlarged. Taxation on residential buildings was also rolled out. From 2012, municipalities will have leverage over the property tax of which they can now set the rates instead of the State. In **Italy**, property tax on primary residences (ICI), which was abolished in 2006, was reintroduced for 2012 under a new single municipal tax (IMU), grouping together the ICI and a residence tax which will depend on the type of building and the composition of the household. Moreover, tax rates on secondary residences have been increased. In **Germany**, a work group was set up in September 2010 to consider how to reform the property tax. In the **United Kingdom**, reform of the taxation of corporate and household property is at the heart of the future local government finance law. In **Bulgaria**, amendments to the law on local taxation and local fees, which took effect in 2011, increased the maximum property tax rate. A more comprehensive reform of the current local taxation system, which has been deemed obsolete, is expected to be enacted in 2012 – 2013. In **Slovenia**, the property tax was reformed on 1 January 2012. A portion of revenue on the new tax, founded on the market value of property, will be distributed to municipalities. In the **Czech Republic**, the property tax rate on built and unbuilt property doubled. However, in **Slovakia**, municipalities' authority to set property tax rates on corporate property has been reduced significantly. Moreover, in **Estonia**, the property tax will be practically abolished in 2013.

In addition, many countries have committed to reforms on land registries, valuation methods on tax bases (founded on property characteristics and their market values or rental value) and their revaluation. The following countries should also be included **Portugal, Greece, Germany, France, Slovenia, Latvia, Spain, Romania** and **Italy**.

to them (from 22% to 32%). In another example, **Latvia** distributed 82% (provisional) of personal income tax to municipalities in 2011 up from 80% as the tax rate was dropped from 26% to 25%.

- raising of top tax rates on local taxes that come in addition to national taxes (*Italy*).

Lastly, **various endeavours have been undertaken** such as improving tax recovery methods, collecting back taxes (*Bulgaria, Italy*), combating tax evasion (*Italy, Cyprus, Greece, Latvia, Ireland*) or modernising land registry systems.

Of course, **not all European countries enjoyed such growth in local taxes**. 2011 tax revenue was lower in eight countries. Several

among them were still confronted, in 2011, by recessions including *Slovenia* and *Portugal*. In *Portugal*, for example, revenue from taxes on property transactions and the local surtax on companies (*derrama*) continued to fall sharply in 2011. Moreover, several governments dropped the rates on shared taxes (e.g. *Lithuania*), reduced the portion redistributed to the municipalities (from 47% to 44% in *Romania* in 2011 for personal income tax) or encouraged holding local tax rates steady in an effort to stimulate growth by reducing the tax burden. In *England*, for example, in 2011 and for the second consecutive year, the UK government has encouraged local councils to freeze the rate on the Council Tax by promising to raise grants: 80% of local councils accepted the deal. Lastly, in *Greece*, where tax revenue fell the most in Europe (though this should be put into context: less than 10% of local revenue comes from taxes), the explanations are adding up including the recession and the effects of the *Kallikratis reform*, particularly the abolition of local entities that had previously benefited from tax revenue.

User fee revenue still increasing

Boosted in 2010 when local authorities were scrambling to find new sources of finance, revenue from user fees and charges, which are generated when public authorities charge people for using a service, continued to increase in 2011.

Growth was slightly down from last year (+0.8% vs. +2.4%). It is uncertain whether local authorities have run out of ideas in this area: transformation of local public services that were once free-of-charge now come at a price, remodelling of user fee rates, increase in fees and charges depending on the user's ability to pay, charges ramp-up, creation of new paying services. Authorities probably have additional ideas and local leeway is limited given that it is a politically-sensitive topic (especially during an election) and users' ability to absorb rate hikes is also limited. In addition, it is also possible that usage rates of some public services will drop or services that are deemed non-essential could be dropped altogether in the wake of austerity plans, even though they generate revenue.

In any case, revenue from user fees and charges is deteriorating in 11 countries, which is offset by an increase in the 16 other countries. The most marked increases and decreases in 2011 were in countries where these revenue are an important revenue contributor for local authorities and generally offset the very minor portion of local taxation. These revenues increased particularly in *Latvia, Cyprus, Bulgaria* and *Slovenia* but lost the most ground in *Greece, Luxembourg* and the *United Kingdom*. In *Greece*, notably, they plummeted nearly 20% in volume, to such an extent that their weight in the budget dropped from 32% in 2010 to 22% in 2011.

In countries such as *Italy, Germany, Portugal* and *France*, growth rates of user fees and charges were relatively high in 2011 (between +2.5% and +4%), attesting to efforts by local authorities to find financial resources by exploring new, wider and more varied areas: household waste removal, parking lots, infant care, after-school activities, greater use of sporting and cultural facilities, use of public transport, healthcare services, elderly care, occupying the public domain, etc.

Asset revenue rebounds

Very volatile by their nature, property revenue is exposed to the very erratic fluctuations mirroring market turmoil in financial investments as well as transactions involving property assets. Property revenue was hit particularly hard by the crisis. In 2009, revenue fell an average of 11.4% in the EU then again by 9.6% in 2010. In 2011, revenue recorded a remarkable (10.3%) turnaround, however, improving in two out of every three countries. Rising interest rates and rents, improving dividends paid to local authority shareholders, sale of financial assets, land and buildings, sometimes as part of privatisation, account for the bulk of this rebound in property revenue in 2011. The biggest increases occurred in *Latvia, Cyprus, Slovenia, Greece* and in *Luxembourg*. On the other hand, they continued to be very depressed in *Portugal* (-22%) *Estonia* (-14.5%), *Romania, Lithuania* and the *Netherlands* (-2.9%) where revenue from the sale of buildable lots dropped (due

to the vulnerability of the property markets), as well as revenue generated from financial assets.

A sharp drop in grants in 2011

The downtrend for grants and subsidies, begun in 2010 as austerity plans were implemented (-0.6%), picked up speed in 2011. Transfers to local authorities dropped an average of 4.9% in volume in the EU, with one in every two countries recording lower figures.

The last two years, when grants have dropped, contrasted sharply with 2009, a year in which revenue rocketed +6.7% under stimulus plans and financial assistance to local authorities: increase in operating and investment grant budgets, activation of exceptional emergency grants and equalisation mechanisms, creation of new funds earmarked for equipment, subsidies boosted, etc.

Revenue structure of subnational budgets in the EU 27 in 2011

Although the weight of total revenue dipped slightly in 2011 (from 46.4% to 44.1%), **grants and subsidies** remained the main source of European subnational public sector revenue with, the percentage of operating grants standing at 39% and investment grants standing at 5%. In about ten countries, grants and subsidies accounted for over 70% of revenue, including *Malta, Romania, Bulgaria, the Netherlands, the United Kingdom* and *Greece*. In *Greece*, notably, grants as a percentage of local revenue climbed nearly 12 points in 2011, rising from 58% in 2010 to 70% in 2011 following the *Kallikratis reform*.

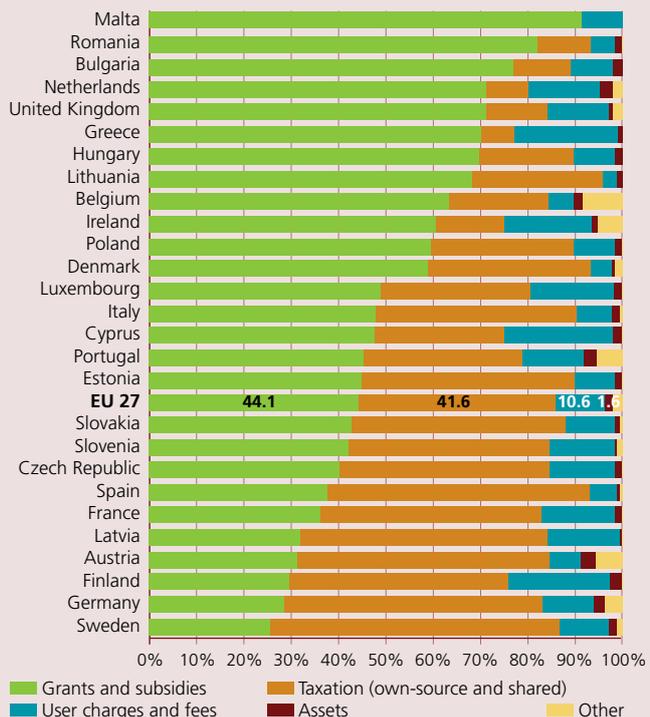
Revenue deriving from taxes provided 41.6% of subnational revenue on average in the EU in 2011, i.e. a little more than in 2010 (39.5%). Local tax does not exist in *Malta* and is under-represented in *Ireland, the United Kingdom, the Netherlands, Greece, Bulgaria* and *Romania* where it accounts for less than 15% of local revenue. At the other end of the spectrum, local taxes are predominant (more than 46% of budgets) in *Finland, France, Latvia, Austria, Germany, Spain* and *Sweden* (61%). In *Spain*, taxes as a percentage of subnational revenue increased 10 points in 2011 after the reform on the financing regime of the Autonomous Communities. For the Spanish regions alone, tax as a percentage of the budget went from 43% in 2010 to 58% in 2011.

This tax revenue derives from both own-source taxes and shared taxation. The latter consists of collecting a tax at the national level and then sharing the revenue between the State and local authorities. The latter receive a fraction of the national tax, which is paid out to them based on redistribution criteria, including equalisation objectives sometimes. Shared taxes are present in about twenty of the EU countries but are more popular in Eastern and Central Europe and the federal countries. Shared taxes are usually income tax on households (in fifteen or so countries), tax on companies (a dozen countries) and, to a lesser extent, VAT. Own-source taxes are when local authorities have a degree of room for manoeuvre on tax rates and bases, although there is sometimes oversight of this autonomy. This mainly includes property tax on built and unbuilt property (in nearly all countries), local tax on economic activity (*Germany, Austria, Spain, Italy, Luxembourg, France, Hungary*, etc.), local income tax (Nordic countries, *Belgium* and *Italy* regarding local surtax on the personal income tax) and miscellaneous taxes, direct and indirect (taxes on property transactions, donations and inheritance, waste, energy, motor vehicles, etc.).

Invoicing local public services and fees generate an average of 10.6% of European subnational public sector revenue. This revenue stream accounts for over 15% of local revenue in around ten countries, particularly *Cyprus, Greece, Finland, Ireland* and in *Luxembourg*. However, it is important to reiterate that these high ratios result from the classification differences depending on the country, given the proximity of the concepts of "fees" and "local tax" the difference between the two is difficult to discern. In *Luxembourg* and in *Greece* for example, several local taxes, which would be considered a local tax in the majority of European countries, are booked in the "other revenue" category alongside fee revenues.

Lastly, **revenue from the sale and the operation of physical assets** (e.g. income from land) and **financial assets** (dividends, interest from deposits and investments, etc.) provided 1.6% of subnational revenue in 2011, and more than 2% in *Germany, Finland, the Netherlands, Portugal* and *Austria*.

Categories of subnational revenue in 2011 (%)



In 2010, and especially 2011, budget cuts by central governments, motivated by the public finance and sovereign debt crisis, have led a number of States **to reduce or freeze both their investment (-9.0%) and operating (-4.3%) transfers to local authorities.** In 2010, only investment grants fell (-6.5%), current grants were relatively buoyant, on average, in Europe (+0.2%).

In 2011, grants and subsidies dropped in volume terms in half of European countries (current grants in 17 countries and investment grants in 15 countries). In *Spain*, transfers to subnational entities dropped the most in Europe (-30.3% in all), due to fiscal restraint and Autonomous Community funding reform, which has been in full effect since 2011 (See inset). The drop was also substantial (between 5% and 12%) in *Latvia, Ireland, Lithuania, Czech Republic, Italy, Slovenia* and lastly the *United Kingdom*, as a result of draconian fiscal consolidation. In *Italy* for instance, where three austerity plans succeeded one another in 2011 alone leading up to "*Salva Italia*" (i.e. Save Italy), transfers to the entire local and regional public sector dropped by around €8bn in 2011 compared with 2010, including €4bn for regions and €2bn for municipalities and provinces. In the *United Kingdom*, it was decided to reduce the main operating grant (i.e. the Formula Grant), by nearly 26%, over the period 2011 – 2014. Lastly, the drop was between 2% and 5% in four countries including *Romania, Bulgaria, the Netherlands* (lower funds for municipal and provincial funds) and *France* (freeze in the volume of State financial assistance to local authorities, excluding the FCTVA, i.e. the VAT compensation fund).

All countries did not have the same experience. In thirteen countries, grants and subsidies to subnational entities increased in volume terms in 2011. This occurred for several reasons:

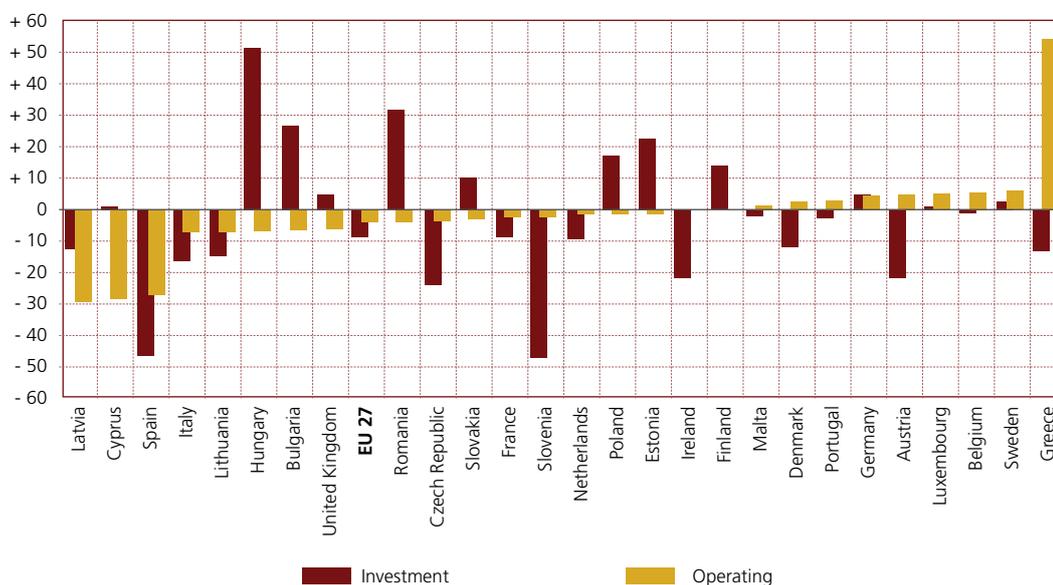
- in some countries, central governments did not want to cut back on assistance to local authorities as they found themselves in a better budget situation. In addition some grants were comprised of different taxes (e.g. *Fonds communal de dotation financière* in *Luxembourg*) or calculated based on indexes that performed well

with growth mechanisms that automatically increase budgets (*Belgium*), the economic recovery also resulted in a budget increase.

- European structural and cohesion funds partially compensated reductions from the central government. Investment grant growth remained strong, primarily in Central and Eastern European countries (*Hungary, Romania, Bulgaria, Estonia, Poland*, etc.). In *Romania*, for instance, European funds accounted for 8% of revenue in 2011 versus 4% in 2010.
- competencies continued to be transferred in 2011 (e.g. in *Romania* in the area of healthcare or in the *Netherlands* for social issues) and resources ensued, although the principle of full financial compensation of transfers continues to be debated;
- implementation of equalisation mechanisms was also able to attenuate the effects of the crisis for the most at-risk municipalities (Nordic countries, *Austria, Germany*, etc.);
- lastly, several central governments have explicitly opted to maintain – or even temporarily increase their grants in order to make up for lost tax revenue. In *Sweden* for example, where grants jumped by 6% in volume in 2011, the government decided to allocate more resources (by temporarily increasing their grants in 2010 and 2011) to local authorities to help them cope with the crisis. In *Germany*, local authorities benefited from investment subsidies again as set out in the law on future investments (*Zukunftsinvestitionsgesetz*) adopted in 2009 and ending in 2012, as well as temporary assistance from the *Länder*.

Lastly, the particular case of *Greece* should be mentioned as grants to local authorities rocketed 37.3% in volume – and even nearly 55% for operating grants. This increase should be put in the context of the *Kallikratis reform* which transferred new operating resources to local authorities that had been given additional competencies in order to compensate for sharply lower tax revenue and user charges.

Change in operating and investments grants of the subnational public sector in 2011 (as a % by volume vs. 2010)



Territorial inequalities and financial equalisation in Europe

Subparagraph 5 of Article 9 of the *European charter of local self-government* encourages countries to set up **solidarity and/or redistribution mechanisms** to correct wealth and responsibility imbalances between the local authorities and to foster a degree of equality. Although equalisation is now recognised as a necessity in a growing number of countries (and in certain countries such as *Germany, Italy, Spain* and *France* it has constitutional force), the size of resources granted to reducing inequality varies tremendously from one country to the next.

The practical methods for applying equalisation are also very diverse and include:

- vertical equalisation (redistribution by the State, or a level higher than the local level, to local authorities) or horizontal equalisation (redistribution between local authorities at the same level);
- upstream (i.e. up-front) equalisation (revenue) or downstream equalisation (expenses or spending needs);
- tax equalisation vs. equalisation from general or *ad hoc* grants.

They are not mutually exclusive and mixed systems that combine different types of equalisation are common. They also change quickly. They are often the subject of technical and political debate, which has taken on greater importance with the crisis – for example, in *Germany* – and as territorial inequalities deepen; they are constantly being adjusted.

Let's look at a few examples of recent reforms...

In Sweden, an audit of the equalisation system, which combines vertical and horizontal redistribution reformed in 2005, has been underway since 2008. The audit already resulted in an initial reform that went into effect on 1 January 2012: streamlining the equalisation rate on tax resources at 115% for municipalities and counties. The cost equalisation grant, which provides horizontal equalisation by levelling the playing field with regard to the cost of services, is also expected to be reviewed in January 2013 aimed at simplifying the methods for evaluating cost disparities and improving transparency.

In Italy, a progressive horizontal equalisation mechanism between regions has been in place since 2001. It is founded on equalisation of revenues and expenditure needs (particularly public health spending). Tension surfaced quickly between the North and the South of the country and it was decided, under Law 42 on federalism in March 2009, to reinforce equalisation via a fund managed by the State. The fund guarantees the coverage of essential public services (healthcare, education, social assistance) in regions with low tax revenue. The funds allocated by the State will be calculated

based on standard cost, for each service based on expenditure in the region that spends the least and no longer on what was spent the previous year (i.e. the historical cost).

In Spain, the existing equalisation system was reformed as part of the 2009 law on financing the Autonomous Communities. The goal is to guarantee a minimum level of public service across the entire territory and to rebalance the regions' resources in order to avoid egregious inequalities from occurring. Regarding the first point, a fund guaranteeing basic public services, three-quarters of which will be funded by regional tax revenue and the remaining quarter by the State, was set up to guarantee egalitarian funding per capita across all regions. The principle of convergence between regions has been maintained with the creation of two funds, which receive additional State financing. The first is a Competitiveness fund that will be shared on an annual basis by regions with low tax income. The second is a Cooperation fund that favours regions that are relatively less rich and have a weaker demographic dynamic.

In France, two main forms of equalisation coexist: vertical and horizontal. The latter is less developed but is gaining ground at present under the reform of the business tax and, more broadly, the rethinking of public deficit, leading to a freeze, in particular, of State grants to local authorities thus making vertical equalisation more difficult to use than in the past. The vast overhaul of tax reform was an opportunity for the government to set up new horizontal equalisation mechanisms. They apply to the entire local public sector and take effect over a period running from 2011 to 2016. During 2012, the Equalisation fund for inter-municipal and municipal resources (FPIC) was implemented. With a goal of redistributing 2% of tax revenues in 2016, it will be more important than the other new equalisation mechanisms: the departmental fund of equalisation of revenue from the transfer tax on property transactions (*droits de mutations*) and the Equalisation funds of the revenue from tax on businesses' added value (CVAE) for the departments and regions. These mechanisms are mainly based on taxes on municipalities in a better financial position; this revenue is redistributed to municipalities that are considered to have limited revenue or whose expenditure is constrained. An evaluation of the effects of these measures, in an effort to adjust the mechanisms as accurately as possible, is already being planned.

In the United Kingdom, the current equalisation system, founded on the "Revenue Support Grant" is both a vertical and horizontal equalisation. Deemed complex and lacking transparency, it is being reformed. Consequently, the future business retention rate is expected to be calculated on the base of equalisation criteria.

Focus on a few recent or future comprehensive reforms for financing local authorities

Spain: the reform of the regime for financing the Autonomous Communities (law 22/2009 from 18 December 2009), initiated before the crisis, has been in full effect since 2011. It has multiple facets. The first consists of increasing the financial autonomy of regions while increasing their tax revenue in order to offset the drop in grants: the redistribution of shared national taxes went from 33% to 50% for income tax and the VAT and from 40% to 58% for the special taxes (tax on beverages, hydrocarbons, tobacco). The regions also have greater leeway with these taxes (ceilings, exonerations, taxable minimum, etc.). The two other facets aim to guarantee basic public services and to improve the equalisation mechanisms of revenue (see inset on equalisation). Moreover, the revision of the law on funding municipalities and provinces, which had been postponed since the 2005 White paper, was announced by the new government in order to improve the way in which their competencies are financed, which would be re-evaluated, among other revisions.

Italy: the law on financial federalism no. 42/2009 modifying the article 119 of the Constitution is applied through eight decrees, which are expected to be adopted before 2016. The objective is to replace a portion of State grants with a share of national taxes and to reinforce the equalisation regarding the calculation of State transfers (See inset on equalisation). Three decrees were issued in 2010 concerning the attribution to the municipalities of a portion of the State's property ("public property federalism"), creation of a legal status for "Rome Capital" and the definition of standard costs. In March and May 2011, four decrees on municipal federalism, tax autonomy of regions and provinces, equalisation funds for the South and the sanctions system were issued. The process was however slowed by the economic and public finance crisis and a number of the 70 concrete measures that have not yet been adopted or implemented. Several tax measures were passed in 2011, some of which were applied in 2012 on property taxation (See inset), the increase of regional and municipal surtaxes on income tax and the reinforcement of the fight against tax evasion.

Belgium: The 6th reform of the State, adopted on 11 October 2011, includes the revision of the Special law relative to the financing of the federated entities. It aims to devolve additional competencies and reinforce the tax autonomy of federated entities and is slated to go into effect in 2014. It will bolster the own-source revenue of regions and communities, to compensate for the elimination of grants from the federal government. The regions will be able to raise additional "enlarged" percentages of individual income tax revenue (*impôt sur les personnes physiques* or IPP), i.e. €10.7bn (reference year 2012), or around 25% of IPP receipts. This "regionalisation" of the personal income tax will be, in the future, the main revenue source of the regions. Their tax competencies will also be increased regarding tax bases and exonerations. The equalisation mechanism, called "national solidarity", was maintained. A transition mechanism will also be set up for a period of ten years.

France: the business tax (*taxe professionnelle*) was abolished and its partial replacement, the territorial economic contribution (CET), itself comprised of a business real estate tax (CFE) and a tax on businesses' added value (CVAE), led to a broader overhaul of the local tax system. The creation of the CET was joined by a flat-rate tax on companies in the electricity grid (IFER) and by new national tax transfers (Special tax on insurance contracts, Tax on commercial premises, etc.). Moreover, a kind of specialisation took place through the transfer of tax responsibilities between subnational levels, which led to less power in setting tax rates, particularly in regions and departments, on the whole. The residence tax (*taxe d'habitation*) is now allocated to municipalities and inter-municipal entities and the tax on built property (*taxe sur le foncier bâti*) has become more important for departments. Regions now only have limited authority to set tax rates (on vehicle registration tax and

on marginal changes to the domestic tax on petroleum products (TIPP) whose ceiling was increased, however).

This reform required direct funding by the State, in the form of extra grants, and brought on the implementation of new "horizontal" equalisation systems started in 2011 (See inset). With the new government elected in May 2012, a new step in financial decentralisation was announced for 2013.

Portugal: a bill on local and regional finances has been on the table since 2012. It would establish a multi-year budget plan, spell out expenditure rules, budget balance and the debt by setting stricter debt limits and finally it would give the State greater fiscal oversight. The regime governing transfers from the State to local authorities will be reviewed as will property taxation. The autonomous regions are expected to have their tax power reduced with regard to exonerations.

United Kingdom: under the Localism reform, the British government launched an in-depth review of the way in which local councils are funded. The Local Government Finance Bill could be put to vote in 2013. The stated goal is to do away with the government Formula grant and replace it with more own resources, anchored by the Council Tax and the business rates for which the local authorities currently have no leeway. Local authorities would also keep part of the revenue from these two taxes according to the principle of "localisation" and "fair return" but with an equalisation mechanism. Also, in *England* a reform is underway of social housing (HRA) funding, which would give local authorities control of social housing and revenues from rents. In exchange, local authorities would also take on the debt of social housing bodies.

The Scottish Parliament will be endowed with taxation powers starting April 2015, with two taxes that will be delegated to it (law on property transactions and tax on use of waste management facilities). A regional income surtax will go into effect starting April 2016.

Germany: in 2010, the federal government charged a "Municipal finance commission" (*Gemeindefinanzkommission*) with drafting proposals for restructuring local authority funding. It focused most of its efforts on streamlining charges weighing on local authorities in order to reduce the widening gap between competencies provided and available resources, to re-examine "standards" and abolishing the business tax, which was deemed too sensitive to economic fluctuation and therefore a source of instability for local budgets. Upon finishing its work in June 2011, an agreement on replacing this tax had not been found. However, following the commission's work, the federal government accepted to ease the rising cost of social expenditure by gradually taking on basic services linked to the ageing population and unemployment (15% in 2011 the 45% in 2012, 75% in 2013 and 100% in 2014).

Czech Republic: a reform is being discussed that would modify the redistribution system of the three shared taxes (personal and corporate income taxes, VAT) from 2013 in order to augment these taxes as a percentage of total local revenue (and drop the percentage of grants) and also reduce revenue disparities between local authorities. This would result in an increase in the shared tax revenue of small municipalities to the detriment of municipalities in cities. This would be offset by (over a transitional period to 2017) State grants.

Slovakia: *Slovakia* wishes to change its local authority funding model by introducing a mixed-tax system (today, shared taxation comes entirely from personal income tax). In 2011, the government proposed sharing several taxes by adding to income tax, business tax, VAT and consumption taxes.

Expenditure and investment

Expenditure and investment – Subnational and local public sector in the EU – Year 2011

	€bn	€ per capita	% GDP	% Public sector	% Expenditure	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
Subnational expenditure*	2,109	4,195	16.7	34.0	100.0	+2.3%	-0.2%
...Local level alone	1,506	2,995	11.9	24.3	100.0	+2.3%	-1.0%
Subnational direct investment	204	405	1.6	66.5	9.7	+1.2%	-6.6%
...Local level alone	179	355	1.4	58.3	11.9	+1.2%	-6.0%

*Excluding capital payments on borrowings.

2011: a slight drop in subnational expenditure

Subnational expenditure began to slowdown in 2010 (-0.1% by volume) and the trend continued in 2011 with spending dropping 0.2% to reach €2,109 billion. For the local level alone, the drop was even a little more marked (-1.0%, reaching €1,506 billion).

The change undoubtedly points to the subnational public sector's new phase of tighter spending controls following several years characterised by increasing expenditure linked to the transfer of competencies and increased demand for local public services. More recently, the involvement of local authorities in stimulus plans and other measures to counteract the economic crisis and its social consequences had increased subnational budgets significantly in 2008 and 2009 (an average of +3.6% by volume).

Starting in 2010, tension on local budgets (increasing deficits) combined with budget cuts imposed by national austerity plans led local governments to reduce their spending.

In 2011, this downtrend in expenditure gained momentum in Europe, affecting nearly two-thirds of countries.

Spending cuts were particularly severe in seven countries, which recorded drops of over 5% and nearly 11% in *Hungary* (See graph).

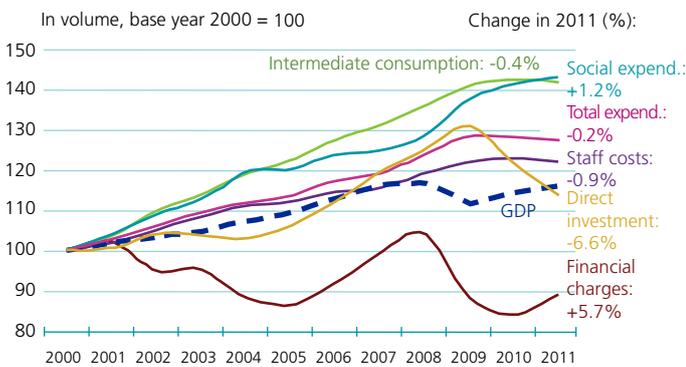
Expenditure related to **optional competencies**, deemed "non-essential", were particularly targeted, but they were not alone: in some countries, especially those facing draconian budgetary restrictions, basic services were affected by budget cuts even though such services are mandatory.

In several countries, lower expenditure also translated the effects of **pooling policies** (i.e. sharing resources of certain services such as local tax collection, fees, rents or the creation of shared service centres) but also a growing trend toward **outsourcing public services** to third parties or private companies and sometimes privatisation of municipal functions and companies (notably in *Germany, Austria, Italy, Spain, Portugal, the Netherlands, the United Kingdom*).

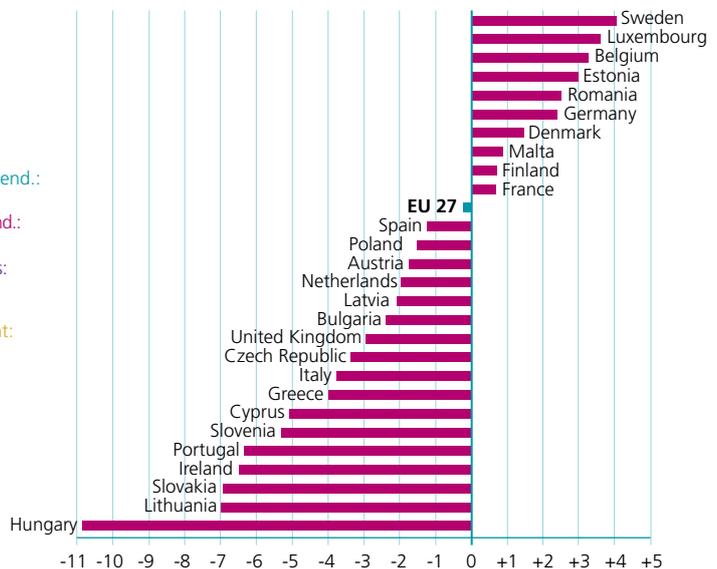
Despite this downtrend, subnational expenditure increased in a dozen countries, sometimes substantially. For most of them, this increase in expenses was combined with rising revenue.

By expenditure category, the overall drop resulted in a slowing of current spending in 2011 (87.1% of expenditure) combined with sharply lower investment spending (12.9% of expenditure).

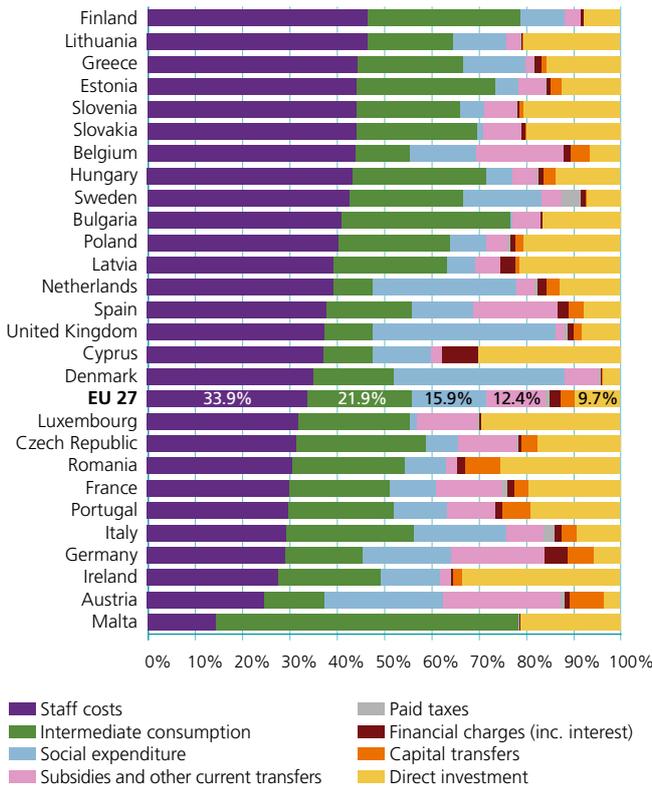
Change in subnational expenditure in the EU 27 (2000 – 2011)



Change in subnational public sector expenditure in 2011 (as a % by volume vs. 2010)



Subnational expenditure by category in 2011 (as a %)



Current expenditure continued to slow in 2011

After ten years of growth, current expenditure in subnational public sector slowed in 2010 and again in 2011. Average European current spending increased a mere 0.9% by volume in 2011. This slowdown was due to the drop (for the first time in 11 years) of the two largest spending items: staff costs and spending on goods and services. However, current subsidies and transfers, social services and financial charges increased in 2011.

Drop in personnel expenditure in a great number of countries

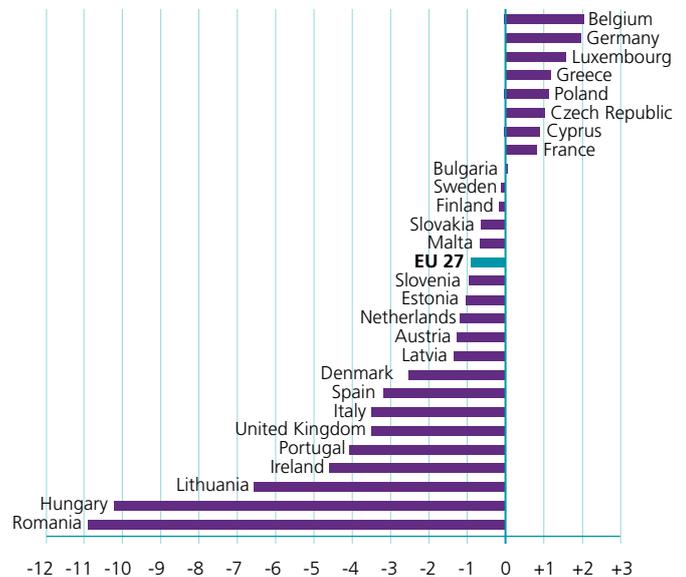
Staff costs are the number one area of subnational public sector spending (nearly €15bn, or 33.9% of expenditure – See graph). Growth in staff costs has been the highest since the early 2000s due to an expanding subnational public sector payroll (resulting from decentralisation policies) and more recently, following measures to prop up public jobs amid the economic crisis (public jobs maintained, subsidised jobs, etc.)

In 2010, the growth rate of personnel expenditure began to soften as the impact of initial austerity measures started to have an impact on the local governments employees. In 2011, it dropped (European average of 0.9% by volume) for the first time in eleven years. In addition, the drop affected nearly three-quarters of Member States, mirroring **the extension and the ramping-up of both redundancy plans** (job cuts, retirees not being replaced, hiring freeze, temporary contracts not being renewed, etc.) and **the drop in wages** (freeze or drop in wages, bonuses/13th month cancelled, etc.), lastly on this list is the initial effects

of measures affecting public retirement (freeze or drop in pension payments, retirement age extended, etc.)

The countries that were most concerned in 2011 – and for the second consecutive year – by these measures at the subnational level were *Romania, Hungary, Lithuania, Ireland, Portugal, United Kingdom, Italy* and *Spain*. Several of these countries benefit from European and international aid programmes and are committed to draconian macro-economic adjustment plans monitored by the Troika (EU, ECB, IMF). Staff costs were cut the hardest in *Romania* in 2011: civil servant salaries, which were already slashed 25% in 2010, were cut another 16% in 2011. Vacancies have gone unfilled (education, police, etc.) and several public services were outsourced. The government also established a ceiling on the number of local civil services, which will be calculated in proportion to the size of the municipality. In *Spain*, wages were down 5% in 2010 followed by a freeze in 2011 for both salaries and hiring. In the *United Kingdom*, budget restrictions resulted in a wage freeze and redundancies: 145,000 local jobs were destroyed in 2011 (not including the 50,000 local jobs that were reclassified as central administration jobs after schools opted to be a part of the Academy School system), which is equivalent to 5% of local authority jobs – and over half of all public job cuts in the country. In *Ireland*, approximately 20% of local jobs have been cut since 2008.

Change in subnational public sector staff costs in 2011 (% by volume vs. 2010)



Unlike in 2010, *Greece* was not on the list of countries where staff costs decreased. In reality, staff costs increased slightly (+1.2%) despite the 2011 *Kallikratis reform*, which substantially reduced the number of local officials and their compensation (avg. 20% drop in wages in 2011). This increased resulted from the transfer of competencies in 2011 (urban planning agencies employees, social protection, student transport), which led to the transfer of nearly 13,000 employees from the State to local authorities.

A few other countries saw their staff costs increase despite the general downtrend, notably in *Luxembourg, Poland, Germany* and *Belgium*. In *Poland*, for example, a recent study indicated that increa-

sing responsibilities borne by local authorities over the past few years have spurred hiring in local authorities and has resulted in a 35% increase in salaries between 2006 and 2011. In *Belgium*, personnel expenditure (44% of subnational spending and 56% for the local level alone) picked up due to a mechanism that indexes salaries in the public sector and local authorities' pension payments to inflation. Pension costs are expected to climb when the pension reform for permanent staff takes effect. Lastly, although staff costs in *France* have remained positive, they grew at the slowest rate ever recorded in the last 15 years (end of programmes transferring State staff to local authorities under *Act II of decentralisation*, freeze in public service index and staff numbers stabilised).

Drop in intermediate consumption in six out of ten countries

Spending on goods and services, the second-largest budget line, (21.9% of subnational spending in 2011) also dropped in 2011 for the first time since 2000. Intermediate consumption spending (e.g. small equipment and supplies, maintenance and repairs, general expenses, heating and electricity, communications and IT, studies, consulting, insurance, etc.) dropped 0.4% despite an increase in certain components such as energy (fuel, electricity) and commodities – or VAT rates, sometimes hikes were included in national austerity measures.

Intermediate consumption spending dropped in six out of ten countries. Budget cuts were drastic in some countries: *Greece* (-36%), in *Lithuania* (-20%) and *Slovakia* (-12%). The drop ranged between 3% and 7% in eight countries including *Ireland*, *Portugal*, *Hungary*, the *United Kingdom* and *Spain*. This trend clearly reflects a fairly broad movement seeking **effectiveness and cost-efficiency**: controlling and streamlining public spending, pooling services, energy savings, drop in general expenses and non-essential expenses, maintenance spending deferred, better management of calls for tender, promotion of e-government, outsourcing to NGOs, local companies and service providers, etc. In *Ireland*, for example, intermediate consumption dropped by 6.5% in 2011 and a work group was set up in April 2011 to monitor the implementation of the Efficiency Report recommendations, which is supposed to improve the performance of public services while cutting 10% from current spending at the local level. In *England*, around 220 local councils agreed to shared service arrangements, a move which is projected to save nearly €200 million.

However, austerity policies have not always had the desired effects on reducing spending on goods and services. In *Romania*, for instance, despite restrictions imposed by the central government on spending on goods and services, overall spending by volume swelled nearly 9%. In fact, local job losses led Romanian local authorities to outsource an increasing number of public services they must provide (maintenance of roadways and parks, waste collection, water treatment, etc.), which has actually increased the cost of services in some instances.

Mixed report on changes in social services

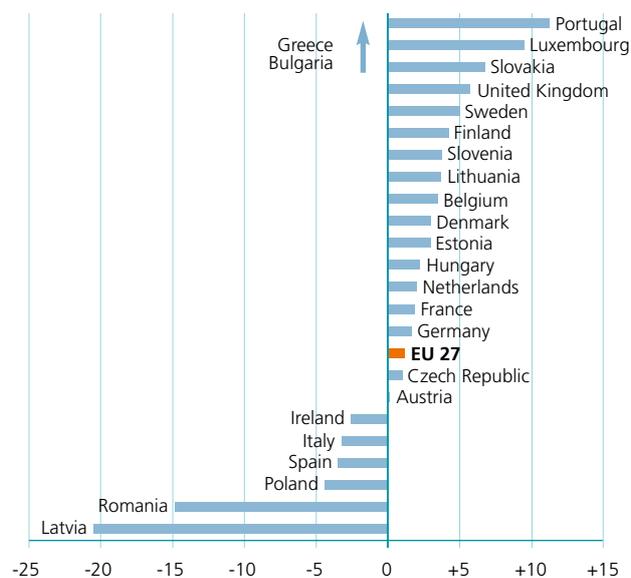
The timid improvement in the EU economic situation in 2011 enabled the average unemployment rate to stabilise; joblessness even decreased in 14 countries. As a result, current spending on social services (15.9% of subnational budgets), which had been very buoyant since the start of the crisis (+7.0% in 2009) started to slow markedly and only increased 1.2% in 2011.

However, growth may have been more moderate in 2011 on average across Europe, but **a certain degree of growth in social services** occurred in many countries. In fact, in seven countries out of ten spending increased, sometimes substantially (over 5.0% growth in seven countries).

In reality, the social fallout of the economic crisis was significant again in 2011, particularly on the jobs front. Generally speaking, the number of people applying for unemployment benefits increased. Other social assistance services were in increasing demand including the guaranteed minimum revenue, housing assistance, healthcare, fight against poverty, assistance to professional integration, etc. This was the case in the *United Kingdom*, for example, where social services grew 5.7% in 2011 (after +5.8% in 2010 and +12.1% in 2009), housing benefits and spending related to Council Tax exemptions granted to at-risk persons (the Council Tax Benefit) increased appreciably.

Like in previous years, the economic picture alone is not enough to explain why social spending increased. In some countries, it came on the heels of **new competency transfers** in this area (See inset on Competency transfers). The best example in 2011 was *Greece* where the *Kallikratis reform* gave municipalities new social responsibilities (childhood protection, the elderly, healthcare and prevention, etc.): although insignificant in 2010, these expenses accounted for more than 13% of 2011 municipal budgets. In Europe, there were other examples of countries that tinkered with decentralisation or **social reforms**, which weighed down the social budget of the subnational public sector in the end. This happened in *Lithuania* (transfer of social competencies from the State to municipalities after provinces were eliminated in 2010), the *Netherlands* (2011 transfer of competencies related to youth, chronic diseases and dependency, benefits to the disabled and back to work assistance programmes) and in *France* where social services have been recently transferred to the departments thus pushing social spending higher (solidarity income support called *Revenu de Solidarité Active*, social assistance for children, care for the elderly and especially the disabled). Although in 2011, this trend slowed somewhat in *France*.

Change in subnational public sector social services expenditure in 2011 (% by volume vs. 2010)



Greece (new competency) and *Bulgaria* (+73%) are not included. *Malta* and *Cyprus*: data not significant.

Lastly, austerity plans have sometimes pushed central governments to partially disengage in the social realm, which automatically put the responsibility of providing social services on the shoulders of municipalities, which are in closer contact with citizens. Although, municipalities do not always have the formal authority to take over these responsibilities. In *Portugal*, amid a heavily-depressed social environment, municipalities and parishes have been forced to play a "social-buffer" role vis-à-vis at-risk persons. These entities are often the last resort for providing meals, housing assistance, medications, basic healthcare among other services. In 2011, portuguese municipal social expenditure climbed 11.2% by volume while municipalities have, in theory, relatively limited jurisdiction in this area.

Over a longer period, the increasing weight of social services (14.2% of EU subnational budgets in 2000 to 16.9% in 2011) reflects **a move toward decentralisation** of social action, greater social needs, **quality standards** and **the cost** of related services (with catch-up effects in the countries of Central and Eastern Europe) as well the impact of **the ageing population**. This has especially been the case in the three Nordic countries (*Sweden, Finland* and *Denmark*) where the pace of change with regard to social services continue to expand.

Recent and future competency transfers potentially increasing expenditure for local authorities

In addition to comprehensive policies for transferring or reorganising competencies such as in *Greece* (*Kallikratis reform*), in *Portugal* (*law on local government*) and in *England* (*Localism Act*) – See "Territorial and Institutional Organisation" – several **partial competency transfers** from the State to local authorities have been enacted or planned in the short term.

A few examples follow:

- In the **Netherlands**, new transfer of responsibilities was enacted under the Pact 2011 – 2015 signed between the government and associations of local authorities (*bestuursakkoord*). Policies favouring youth, back to work programmes, social initiatives (dependency, disabilities) and healthcare (chronic diseases) were allocated to municipalities in 2011. These competency transfers were not entirely offset by equivalent financial resources; municipalities are bound by the Pact to generate efficiency gains of around 5 – 30%. Provinces are expected to be put in exclusive charge of the management of open spaces. However, the regional police forces, which are decentralised entities, are expected to form a national police force (bill is currently being drafted).
- In **Lithuania**, the competencies of the State counties, which were eliminated on 1 July 2010, were redistributed to the central government (22 functions) and the municipalities (8 functions, primarily healthcare, education and social services). 58 others were deemed obsolete or redundant and were abolished.
- In **Poland**, new responsibilities will be given to the local authorities in 2012 (maintenance of nursery schools) and 2013 (waste management). At the same time, local governments must privatise, in 2012 – 2013, many of the public hospitals that fall under their authority.
- **Romania** decided to transfer the management of nearly 375 public hospitals to the local authorities. The new law on education no. 1/2011 will give new responsibilities regarding education to local authorities from 2012. New competencies in the area of healthcare will follow in 2012 or 2013 (creation of a local police force), in accordance with the three acts related to decentralisation, which were passed in May 2009.
- In **Spain**, the revision of the 7/1985 law governing local authorities, which has been planned since the 2005 White paper, should be finalised soon, especially given the urgent need to reduce public spending. The new government has proposed amendments that seek to clarify and reduce municipalities' competencies based on their demographic size and their financial capacities, particularly by better separating mandatory and optional competencies. The responsibilities of municipalities with less than 20,000 inhabitants would be adjusted with some being transferred to the provinces. Education and healthcare would no longer be the responsibility of the municipalities.
- In **Hungary**, recentralisation of powers will start in 2012. The State will take over a vast array of competencies for which municipalities and counties had been responsible until now (See "Territorial and Institutional Organisation").
- Likewise, in the **Czech Republic**, the government is preparing a reform of government. It could, in 2014, result in shrinking local authorities' competencies, which would be transferred to the State.

Subnational expenditure by economic function: an overview of the distribution of competencies (2010 data)

Education confirmed its spot as the number one budget item for the subnational public sector. Since 2000, subnational spending on education has increased steadily (average 3% per year by average in volume terms) to reach nearly €430bn in 2010, i.e. 20.6% of subnational budgets. The weight of education in subnational budgets varies tremendously from one country to the next, however. For instance, it exceeds 30% of budgets in *Belgium*, the *United Kingdom*, *Bulgaria*, *Slovenia*, *Slovakia* and in the three Baltic countries (*Estonia*, *Lithuania* and *Latvia*). In these countries, subnational authorities are responsible not only for investing in and maintaining infrastructure and educational equipment but also compensating teachers and technical and administrative personnel as well as a wide variety of school-related activities (transport, food services, etc.). Subnational education expenditure accounts for 64% of public spending on education in Europe.

The second largest budget line for subnational expenditure is for **social services** (infrastructure and social benefits such as sickness, disability, old age, survivors, family, youth, unemployment, housing, exclusion). Totalling €404bn in 2010, they account for 19.4% of budgets, a rate that exceeds 20% in three Nordic countries (*Denmark*, *Finland* and *Sweden*), the *United Kingdom*, *Austria* and *Germany*. In *Denmark*, this figure reached 55% of local expenditure as the majority of social security flows pass through the municipalities. Over the last ten years, this has increased at an average rate of 3.1% per year by volume in the EU. Despite the heavy weight of social expenditure in subnational budgets, social services only account for 16.5% of the entire public sector's social expenditure. In fact, although there has been a clear movement towards decentralisation in this area (*Greece*, *France*, *Germany*, *Austria*, *Poland*, *Lithuania*, etc.), social protection continues to be provided by the central State for the most part and by social security bodies, in particular.

Spending on **general services** (operating political bodies, general expenditure of administrations, interest charges on debt, etc.) accounts for 15.8% and is the third largest item.

It is followed by **healthcare expenditure**, which has increased an average of 4.4% by volume in the EU. It totalled €277bn in 2010, i.e. 13.3% of subnational budgets (vs. 11.3% in 2000). The weight of healthcare expenditure in budgets exceeded 20% in the three Nordic countries, in *Austria*, *Spain* and also in *Italy* where it reached 47% of subnational expenditure in 2010. In these countries, local authorities – and in particular regions – are responsible for indirect or direct management of public hospitals, specialised medical services and basic healthcare. In contrast, these functions are not provided, or marginally provided, by the subnational public sector in countries such as the *United Kingdom*, *France*, the *Netherlands*, *Belgium* and *Germany* where healthcare expenditure is mostly the responsibility of the central State and/or social security bodies. Across Europe, subnational health spending accounts for an average of a little more than 30% of public healthcare expenditure. Currently in Europe (*Poland*, *Romania*, *United Kingdom*, etc.), a major overhaul of competencies is underway that could change these figures.

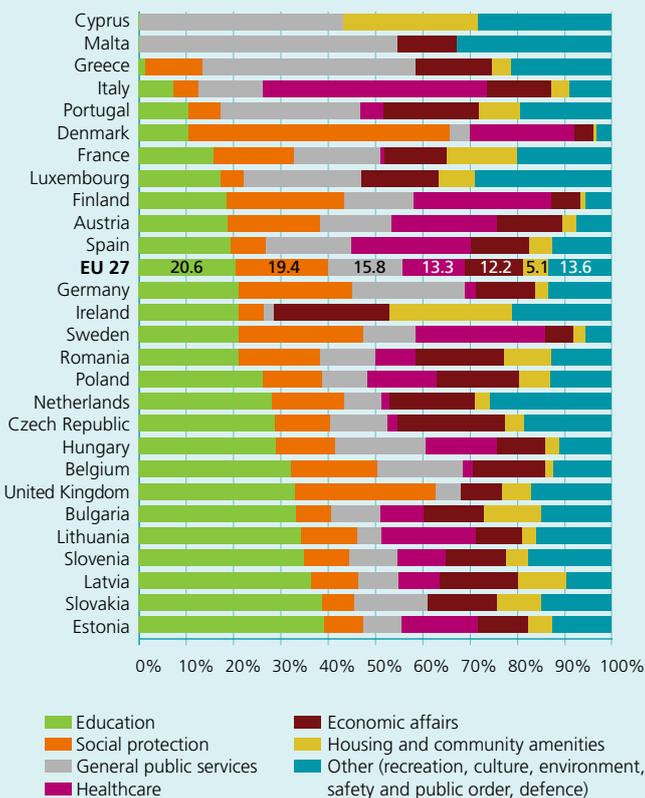
Economic affairs mobilised €255bn in 2010, i.e. 12.2% of subnational budgets but nearly 45% of public economic intervention spending (transport, communications, development of companies active in industry, agriculture, fishing, mining, energy, construction, etc.). They account for more than 20% of local expenditure in *Ireland*, *Portugal* and the *Czech Republic*.

Lastly, although expenditure in **housing and community amenities** (water distribution network, public lighting, building of housing) occupy a relatively minor percentage of subnational budgets (5.1%), the subnational public sector plays as big a role as other public sectors. Their expenditure accounts, in fact, for nearly 86% of public spending in this area.

This can be said about spending on **recreation, culture and religion** (sporting equipment and activities, libraries, museums, up-keep of heritage sites, municipal culture centres and theatres, etc.) and **environmental expenditure** (waste collection and treatment, parks, environmental protection), which accounts for 5.0% and 4.1% of subnational budgets, respectively but 72% and 80% of public spending in these areas.

Lastly, subnational expenditure on **public order and safety** (regional and municipal police, fire brigades and emergency responders) reached 4.5% of budgets and 40% of public spending in this sector. This item is the most developed in countries where functions are partly decentralised such as in the *United Kingdom* (9%), *Germany* (7%), the *Netherlands*, *Belgium* and *Spain*. Modifications are expected in this area, namely in the *Netherlands* (recentralisation) and *Romania* (decentralisation).

Breakdown of subnational expenditure by economic function in the EU 27 in 2010



Return to an increase for financial charges in 2011

Interest charges are particularly volatile, reflecting the fluctuation of interest rates, mainly. However, over a longer period (2000 – 2010), financial charges have had a tendency to decrease an average of 1% per year by volume. Over an 11-year period, they have gone from 3.3% of total spending in 2000 to 2.3 % in 2011 (and by 2.6% to 1.5 % for the local public sector alone). This change attests to the overall drop in interest rates combined with active debt management and, in certain countries, help from oversight authorities on refinancing the debt (e.g. the federated entities in *Germany* and *Belgium*).

In the past few years, this trend has slowed. After a peak in 2007 (+8% by volume), financial charges dropped considerably when the crisis struck (-15% in 2009 and -5% in 2010). In 2011, they started

to increase again in seven out of ten countries, which represents an average increase of +5.7% across the EU (and +7.6% for the local sector alone). The strongest increases occurred in *Finland*, *Sweden*, *Hungary* and *Spain*.

The increase was brought on by a **volume effect** (rising debt stock) as well as a **price effect**. In fact, for local authorities in several countries, the intensification of the economic, financial and public finance crisis has resulted in an increase, since 2010, of indexed interest rates on outstanding debt and in making new issuance more expensive. This is mostly linked to an increase in long-term interest rates and intermediation margins as the banks incorporate higher refinancing and liquidity costs.

The weight of subnational expenditure in the European economy

In 2011, subnational public sector expenditure accounted for 16.7% of GDP and 34.0% of EU public spending (11.9% and 24.3%, respectively, for the local public sector alone). **These averages mask, however, different situations in different countries**, which vary depending on each country's geography, territorial organisation, level of decentralisation as well as the nature of competencies carried out by the local authorities.

One country stands out considerably from the others for its particularly high local spending: *Denmark* (37.5% of GDP and 64.6% of public spending, respectively).

At the other end of the spectrum, there are countries whose local authorities have limited competencies because of their small size (*Malta*, *Cyprus*) or because they have historically been highly centralised countries (*Greece*).

The countries between these two extremes can be divided into **four groups**:

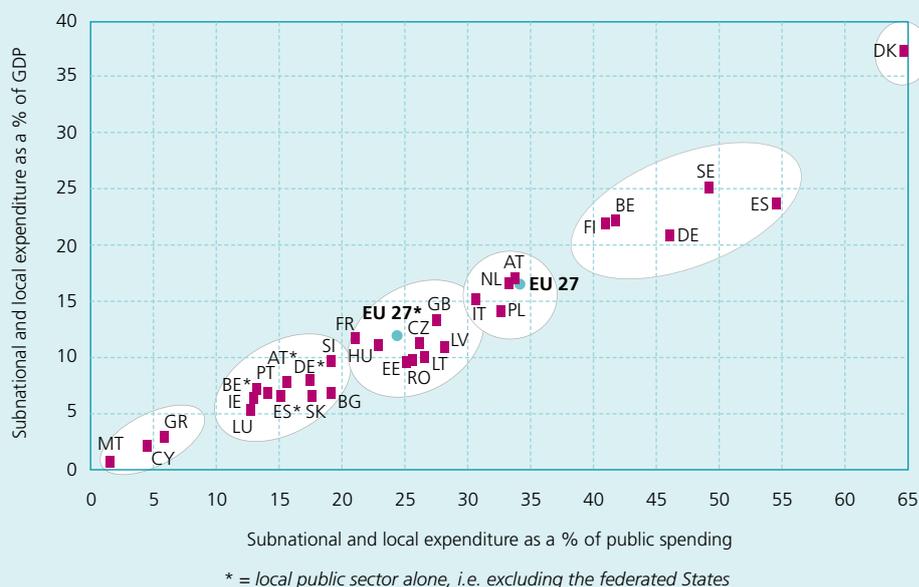
- One group for which the weight of subnational expenditure as part of the national economy is significant. These countries include the other two Nordic countries with highly-decentralised forms of government (*Sweden* and *Finland*) as well as federal countries (except *Austria*) and *Spain*. This high level comes from the fact that the ratio combines spending by the federated States with spending by the local public sector. Excluding the

federated or quasi-federated entities, the weight of local expenditure is, indeed, lighter and is even below the European average for "the local public sector alone".

- A group of countries comprised of *Italy*, *Austria*, the *Netherlands* and *Poland*, which have ratios that are close to the European average.
- In the third group, ratios are lower than the European average. This group includes *France* and the *United Kingdom*, which are close to the three Baltic countries, *Romania*, the *Czech Republic* and *Hungary*. A majority of these countries are transitioning towards decentralisation.
- The last group includes several countries that are relatively centralised with ratios that are markedly below the European average (*Ireland*, *Luxembourg*, *Portugal*, etc.). It also includes the local level of federal entities (See above).

It is important to note that this macro-economic viewpoint is imperfect. It does not always assess the real degree of decision-making power and action that local authorities have in terms of expenditure. Although local government in several countries manage a significant sum of money, they often, in reality, have limited autonomy regarding the choice of how expenses are allocated, a choice merely steered or dictated by the State or are restricted by regulatory and budget standards.

Subnational and local public sector expenditure as a % of GDP and as a % of public spending in 2011



Steep drop in investment for the 2nd consecutive year

The substantial contraction in direct and indirect investment in the subnational public sector (total of €272bn in 2011 in the EU, i.e. 12.9% of subnational expenditure – See inset), which began in 2010, continued in 2011. After a 7.9% drop in volume in 2010, investment was down again by 7.0% in 2011. The fall was even greater for **indirect investment**, i.e. capital transfers (-8.3%), than for **direct investment** (-6.6%).

Until 2009, subnational direct investment was buoyant

Despite a degree of volatility, subnational direct investment was robust over the decade 2000 – 2010, particularly in the countries of Central and Eastern Europe, where it financed decentralisation and urbanisation as well as the development of metropolises, including renovation, construction and efforts to upgrade infrastructure and public equipment (transport, water, waste, etc.) to EU standards. It was also boosted by looser lending conditions for local authorities as well as by European Cohesion policy. In fact, injections from European Structural and Cohesion funds, alongside domestic co-financing,

had a powerful leverage effect on local investment in many Member States.

Likewise, subnational direct investment was particularly robust in the last two years of counter-cyclical stimulus in 2008 and 2009 (average of +4.9% per year) due to the heavy involvement of local authorities in stimulus plans. Many financial and regulatory measures, adopted at different European, national and sometimes regional levels, contributed to propping up local subnational direct investment.

Sharp decline in subnational direct investment in 2010 and 2011 in two-thirds of countries

Subnational direct investment contracted in 2010 (-7.0%) then again in 2011 (-6.6%, to €204bn) and was all the more severe because it affected two out of every three countries. The most marked decline came in *Spain*, where subnational direct investment, by volume, fell more than 30% and the local sector alone dropped by 37%. *Spain* was followed by *Hungary*, *Greece*, *Portugal*, *Bulgaria* and *Slovenia* on the list of countries where local investment lost between 18% and 30%. For the most part, these countries are receiving aid packages and were in a recession or recorded low growth in 2011.

The subnational public sector, driving public investment

The subnational public sector invested a total of €272.2bn in 2011, i.e. 12.9% of subnational expenditure. Three-quarters of this sum consisted of **direct investment** and the remaining quarter consisted of **indirect investment** (capital transfers).

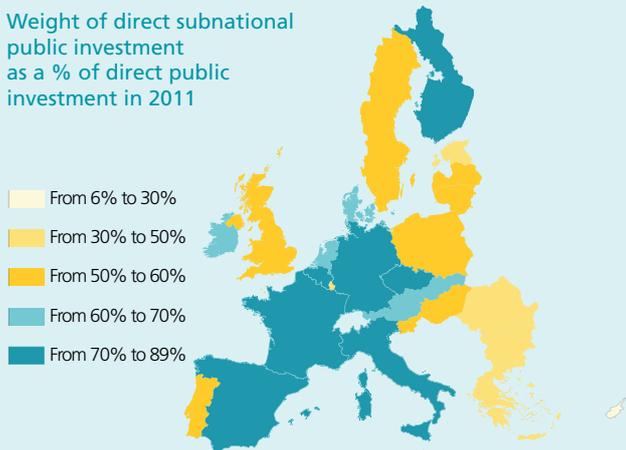
Subnational direct investment reached €204bn in 2011, i.e. an average of 1.6% of European GDP. This ratio ranged from 0.1% in *Malta* to 2.9% in *Poland*.

Despite a steep drop in subnational direct investment in the past two years, the subnational public sector continues to be an engine for public investment: it was responsible for 66.5% of the direct investments made by the entire public sector in 2011, and has been relatively stable for over ten years (fluctuating between 65% and 72% depending on the year). In 2011, this ratio surpassed 70% in seven European countries and even higher than 73% in *France*, *Germany*, *Italy*, *Belgium* (See map). In these two federal countries, the local public sector plays a major role in public investment.

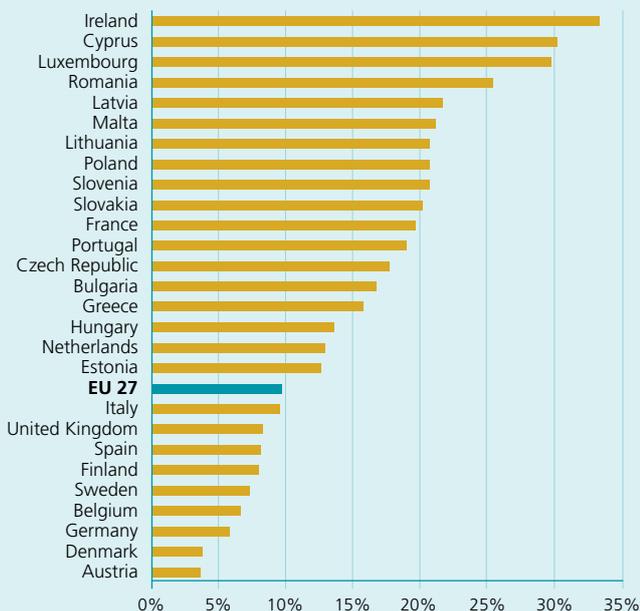
In *Germany*, local direct investment accounted for 64.9% of subnational direct investment and 49.3% of public investment in 2011. In *Belgium*, these numbers were 52.9% and 47.1%, respectively in 2011. On the other end of the spectrum, the local public sector plays a more limited role in *Malta* and *Cyprus*.

On average, direct investment accounts for 9.7% of subnational budgets. But this ratio fluctuates between 3.7% in *Austria* and 33.4% in *Ireland* (See graph). It was generally higher in the least-decentralised countries in which the public sector plays, relatively speaking, a bigger investment than management role in public services.

Weight of direct subnational public investment as a % of direct public investment in 2011

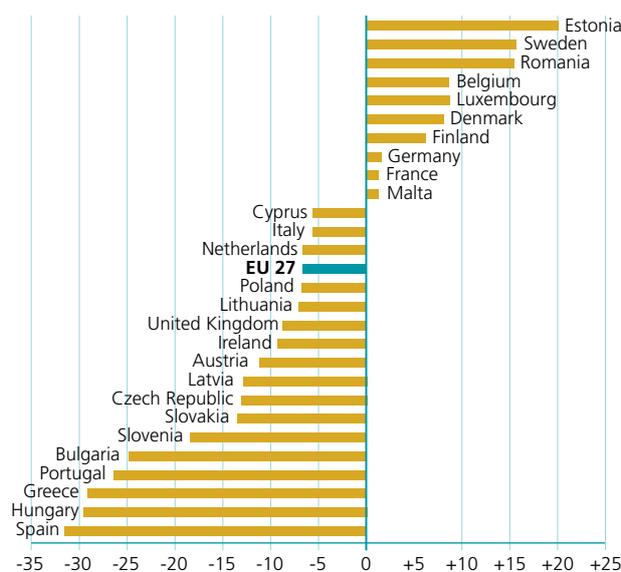


Direct investment as a % of subnational expenditure in 2011



In contrast, in countries with economic growth, pressure on local budgets eased due to an increase in revenue and restoring gross savings. Local authorities were given some room for manoeuvre, which boosted subnational investment in countries such as *Estonia, Sweden, Belgium, Germany, Luxembourg and Denmark*. In *Sweden*, for instance, local authorities drafted highly ambitious investment plans for improving transport, urban infrastructure and health facilities.

Change in subnational public sector direct investment in 2011 (% by volume vs. 2010)



The economic situation was not the only determining factor in subnational investment. In fact, it stands to recall that investment tends to fluctuate greatly from one year to the next depending on various exogenous and endogenous factors that are more or less tangible. Several conclusions can be drawn from an analysis of 2011.

It appears clear that when **national austerity plans were tightened** it often led to the cancellation of major national programmes in which the local authorities were involved. In the *United Kingdom*, for example, the programme for reconstructing schools set in motion by the previous government was cancelled along with several other major infrastructure projects.

The ramping up of austerity plans in 2011 also resulted in the **freeze or reduction in operating grants**, thus reducing local authorities' self-financing capacities. In addition, **the reduction**, which in some countries has been severe, in **investment grants** had a direct effect on investment in *Spain, Greece, Slovenia, the Czech Republic and Latvia* (See Revenue section p. 16).

However, it is important to note that austerity did not prevent investment grants from being maintained or expanded in some countries (*Romania, Estonia, Poland, Germany, Finland, etc.*). In fact, several governments have extended existing counter-cyclical stimulus measures or launched new ones with boosting local investment as their cornerstone. For example, in *Germany*, the federal plan for stimulating investment in the federated States and municipalities, which was adopted under the *Germany* stimulus package (*Konjunkturpaket II*,

i.e. legislation on future investments), continued to produce results in 2011, albeit less effective ones, as the programme expired. In all, this support contributed to financing 43,000 projects (municipal hospitals, rural and urban equipment, education infrastructure) for a total of €15.6bn, 78.5% of which were allocated to municipalities.

Stiffening austerity plans also imposed stricter budget consolidation rules applicable to local authorities, including **spending limits and budget deficit/surplus thresholds** and sometimes **stricter prudential rules about indebtedness** (*Spain, Poland, Slovakia, Slovenia, Latvia, Italy, Bulgaria, etc.*). For example, in *Poland*, local investment declined 6.8% by volume after a very dynamic investment cycle that ended in 2010 amid a favourable economic backdrop (preparation for the Euro 2012 football championships, local elections in 2010, catch-up efforts on infrastructure and European funds contribution). Local authorities in *Poland* seem to be anticipating the prudential standards that will go into effect in 2014, which have already begun to oblige them to reduce their debt levels. The new standards could outsource certain investment operations to local public companies and use public-private partnerships and asset-backed financing vehicles on a more active basis.

Priority sectors for local investments in 2010

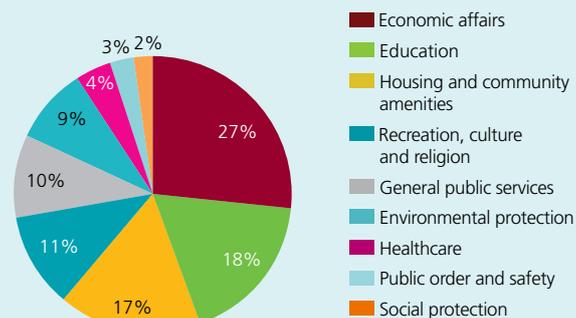
In 2010, the primary sector for local investments (excluding federated and quasi-federated States) was **economic affairs** (transport, communications, development of companies in industry, agriculture, fishing, mining, energy, construction, etc.): 27% of gross capital formation expenditure were allocated to this sector in Europe, and over 40% in *Portugal, Poland, Austria, Greece* and the *Czech Republic*.

In addition, nearly 18% of 2011 local investments were made in **education** (reaching 45% in the *United Kingdom*) and nearly 17% in **housing and community amenities** (40% in *Ireland* and over one-third in *Bulgaria, France* and *Spain*).

Healthcare accounted for 24% of fixed-capital formation expenditure in *Denmark*, 21% in *Sweden*, 18% in *Finland* and 12% in *Italy*, thus underscoring the key role of the local public sector in financing health infrastructure in those countries.

Lastly, the **environment** (waste, waste and water treatment, etc.) mobilised 20% of gross capital formation expenditure of the local public sector in the *Czech Republic*, 18% in the *Netherlands* and 15% in *Hungary*.

Breakdown of gross capital formation expenditure by the local public sector by economic function in 2010



In addition to these prudential rules, the **use of external funding** seems to have become more difficult in some countries. In 2011, other factors including the financial crisis and the less favourable funding conditions vs. 2010 (access to loans, interest in intermediation margins and interest rates, bond market tension) and the shrinking offer of bank finance for long-term investment (impact of the future Basel III capital requirements and liquidity ratio rules) had a negative impact on subnational investments in countries such as *Spain* and to a lesser extent *France*, *Germany* and *Slovakia*.

Continued **competency transfers** have also played a role in some of these changes, like in *Romania* where the healthcare sector was decentralised in 2011, which thus transferred the responsibility of hospital investments.

The **cycle of local and regional elections** also seemed to play a role in 2011 in some countries by either boosting local investment or by slowing it. In fact, subnational investment was relatively strong in countries for which 2011 was a pre-electoral period as teams were set up to finish projects before elections. Local elections at end-2011 and in 2012 (or early 2013) in *Romania*, *Luxembourg*, *Finland*, *Estonia*, *Belgium* and *Denmark* are partly responsible for ballooning investment in these countries. On the contrary, investment tended to point down in countries where local elections had already taken place. Often newly-elected teams tend to favour preparing projects for the coming terms, limiting themselves to making the bare minimum investments (e.g. upgrading facilities) before moving on to bigger projects. This was the case for many countries in 2011, particularly

Lithuania, *Slovenia*, *Poland*, the *Netherlands*, *Hungary*, *Greece*, the *Czech Republic* and *Slovakia* with local elections being held in 2010 or in early 2011.

The **leverage effect of European Structural and Cohesion funds** was more marked in 2011 than in 2010. The rate at which countries absorbed European funds picked up in several countries (See inset). In the Central and Eastern European countries, European funds were sometimes used to compensate lower investment grants from central governments, which allowed them to meet the needs of building, modernising and upgrading infrastructure and public facilities to satisfy European standards. Works included roadways, urban infrastructure, energy and public transport networks, water, waste, schools, health and social facilities (retirement homes, nursery schools, housing, etc.). In addition, European funds also supported local projects aimed at investing in the future (R&D, renewable energies, IT, etc.) in line with the strategic goals of Europe 2020.

European and national regulations applying new norms on **quality, safety, environmental stewardship and sustainable development** that are compliant with European standards, have put additional constraints on local authorities. Financial implications are particularly substantial in countries that are lagging in these areas. Currently, many local governments, notably in Central and Eastern Europe, have stepped up investments in water treatment (quality drinking water, treatment of waste water, sludge, etc.) and treating and recovering waste (See new waste framework directive from 2008). Other topics have emerged in the last few years that have pushed

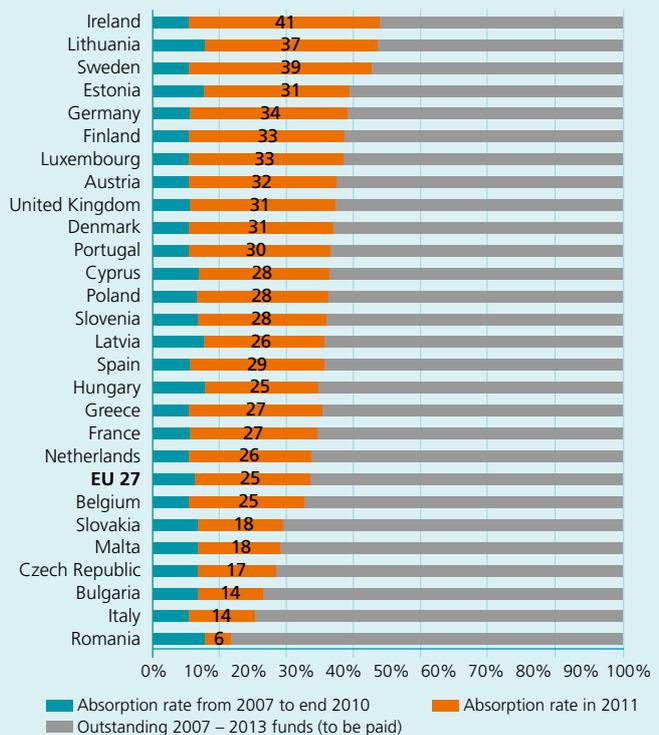
Absorption of European Structural and Cohesion funds

European funds have a **leverage effect** on subnational investment due to co-financing and partnership rules. This multiplier effect is a determining factor for countries that receive substantial amounts of European funds (Objective 1, notably) and countries in which public investment is mainly provided by local authorities. However, they often struggle to prepare and present projects that are compliant with European requirements or even mobilise the local financial resources to match European funds. Some countries have loosened restrictions on local authority borrowing under the condition that the projects receive European funding (*Poland*, *Latvia*, etc.).

As of end-2011, European Commission data published in May 2012 indicated that **the absorption rate of Structural and Cohesion funds was a mere 33.4% in the EU** (payments/allocations). Countries were able to close the gap in 2011, however, which had been growing since 2007 (24.7% of 2007 – 2013 funds were paid out in 2011 alone, versus 8.7% from 2007 to 2010), especially in countries such as *Ireland* (41% of funds paid out in 2011), *Sweden* (39%), *Lithuania* (37.2%), *Germany* and *Finland*. **Funds have been taken up at a faster pace in 2011**, and this is expected to continue as 2013 approaches.

In the end, the absorption rate of European funds varied tremendously from one country to the next in 2011. Several countries had low absorption rates even though, given the weight of EU funds as a percentage of their GDP, they have much to gain from the funds (*Romania*, *Bulgaria*, *Czech Republic*, *Slovakia* and *Malta*). However, countries that do not receive a great deal of funding tend to have high absorption rates (*Sweden*, *Luxembourg*, *Germany*, *Finland*). Lastly, the countries with high rates (over 30% as of 31 December 2011) that receive substantial EU funding (2007 – 2013 funds of over 20% of national GDP in 2007) include the three *Baltic* countries, *Hungary* and *Poland*.

Absorption rate of 2007– 2013 Structural funds by Member State payments/allocations as a % at 31 December 2011



Source: European Commission - "Analysis of the budgetary implementation of Structural and Cohesion funds in 2011" - May 2012

local investing higher: combating noise pollution, improving air quality, reducing greenhouse gas emissions, boosting the energy efficiency of public buildings, encouraging "sustainable mobility" (particularly in metropolises) and more recently updating public lighting systems. The European directive on energy efficiency, which obliges authorities to take high pressure mercury vapour lamps off the market by April 2015, has already driven substantial investments in *Finland*, for example.

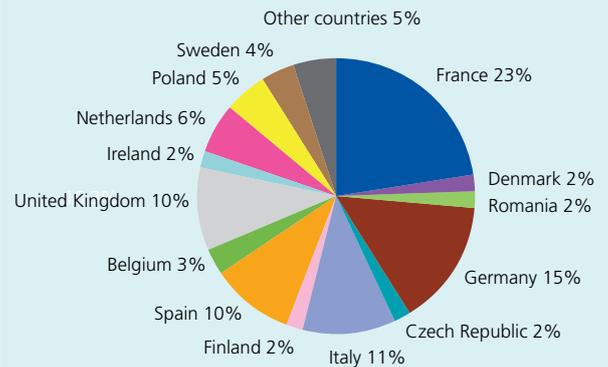
In addition, local investment was stimulated through **temporary events**. For example, in *Estonia*, costs from the "Tallinn, European capital of culture" project and a particularly cold winter in 2010 contributed to exploding local investment levels. The country had Europe's highest growth rate in 2011 (+20%) while the record for a fall in investment was set last year (-40%). Obviously, the tremendous fluctuation in local investment from one year to the next also comes from adjustment effects compared with the previous year. Like *Estonia*, some countries, in 2011, were catching up for an off year in 2010 while others saw their investments tumble in 2011, counteracting strong investment in 2010.

Lastly, **psychological factors** have contributed to investment decisions by local policy-makers in some countries. Uncertainty over the economic and financial backdrop and the many reforms underway since the start of the crisis (affecting territories, institutions, local finance, budget control, etc.) undoubtedly discouraged an investment rebound in 2011.

The French local public sector: #1 subnational public investor in Europe

In 2011, *France* held the top spot in Europe for direct subnational investment (€46bn, i.e. 23%). Far behind *France* are *Germany*, *Italy*, *Spain* and the *United Kingdom*. These five countries accounted for 69% of the EU's subnational investment in 2011.

Breakdown of subnational direct investment in the EU in 2011 by country



Budget balance and debt

Budget balance and debt - Subnational and local public sector in the EU – Year 2011						
	€bn	€ per capita	% GDP	% Public sector	Annual average change 2000 - 2011 (% volume)	Change 2010 - 2011 (% volume)
Budget balance	-93	-	-0.7	16.5	-	-
... Local level alone	-26	-	-0.2	4.6	-	-
Debt	1,563	3,110	12.4	15.0	+3.7%	+3.1%
... Local level alone	743	1,480	5.9	7.1	+2.6%	+2.6%

Changes in subnational budget balance

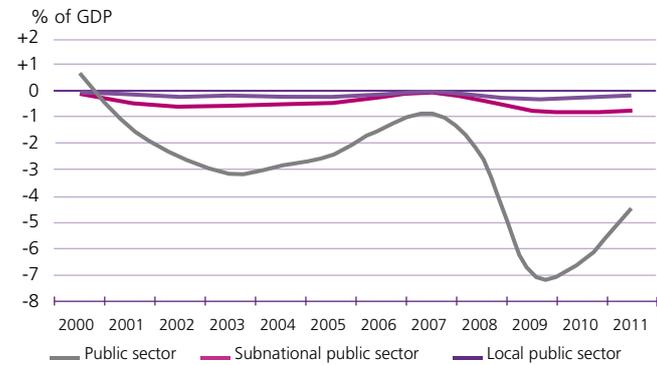
Drop in the deficit of the subnational public sector in 2011 in the EU 27

After steadily increasing since the 2008 crisis, the subnational public sector **deficit** in Europe stopped increasing in 2011. In fact, the stabilisation of revenue combined with slightly lower spending contributed to reducing the subnational deficit slightly, decreasing from **0.8% of GDP** in 2010 to **0.7% in 2011**. The €93bn deficit accounted for 16.5% of the total public deficit in Europe in 2011.

For the local public sector alone, i.e. excluding the federated entities and the Autonomous Communities, the deficit also shrunk from 0.3% of GDP in 2010 to 0.2% in 2011, which corresponds to €26bn and 4.6% of the total public deficit.

However, running a "public deficit" does not necessarily mean that the local public sector's financial situation is imbalanced. **The use of debt** by local government, necessary because of the deficit, is entirely **allocated to investment** in the majority of European countries – without it posing a macro-economic risk.

Change in public budget balance as % of GDP in the EU 27 (2000 – 2011)

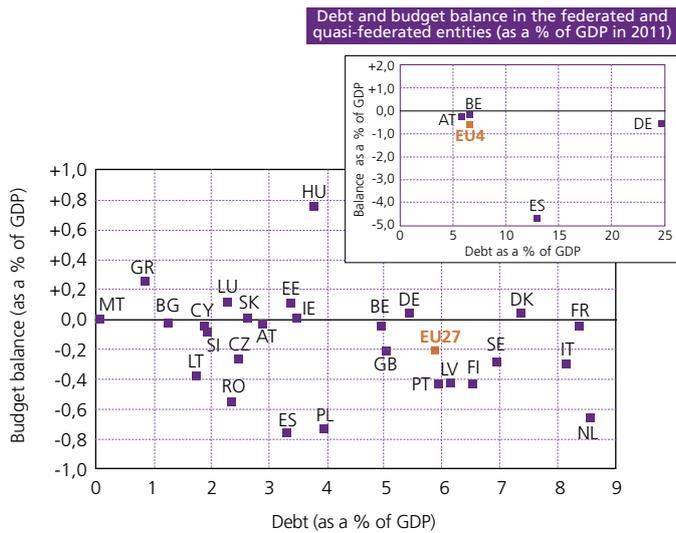


Although the improvement in the budget balance has resulted from the brightening economic backdrop in many countries – which has boosted tax revenue – as well as budget consolidation efforts by subnational authorities (optimisation of own-source revenue and cost controls), it is also due to strengthening management and oversight of local government finances under national fiscal improvement measures (See inset).

Reduction of budget imbalances in over half of the EU 27

The subnational deficit was brought down in around fifteen countries in 2011. The budget balance/GDP ratios improved markedly in *Hungary* (deficit fell 1.6 GDP point), *Slovakia* and *Austria* (0.9pt), *Germany* (0.6pt) and in *Greece* and *Poland* (0.5pt).

Debt and budget balance in the local public sector (as a % of GDP in 2011)



A few countries, however, saw their local public sector budget situation worsen slightly in 2011, including *Sweden*, *Romania*, *Lithuania* and, to a lesser extent, the *United Kingdom* and *Finland*. In *Spain*, the situation for the local public sector has also deteriorated (deficit of a bit less than -0.8% of GDP) but pales in comparison to the deficit of the Autonomous Communities. The real estate crisis in 2007 then the economic and financial crisis in 2008 – 2009 combined with regional stimulus measures have had an enormous impact on the Spanish regions. Their budgets went from being nearly balanced in 2006 to a deficit of 3.5% of GDP in 2010 then 4.7% in 2011, exceeding €50bn in 2011, which was more than half of the subnational sector's deficit in Europe. In all, Spain's subnational deficit (local and quasi-federated) reached 5.5% in 2011, i.e. nearly two-thirds of the country's public deficit (8.5%). This deterioration led the new government to take robust measures in 2012 to bring regional accounts under control through a new law on budgetary stability and financial viability (See inset).

In total, fourteen countries' local public accounts were in surplus or quasi-balanced in 2011. They include *France, Hungary, Greece, Denmark*, local levels in three Federal countries, etc. (See graph). The

largest local deficits were in *Spain, Poland* and the *Netherlands* (lower than 0.8% of GDP, however).

Improved budgetary discipline and public finance governance at the subnational and national levels

At the national level, most governments were forced to strengthen their internal budgetary framework by adopting or reinforcing financial stability pacts, implementing quantitative budgetary rules, creating new independent bodies to oversee budgets (Stability Council in *Germany*, Office for Budget Responsibility in the *United Kingdom*, etc.), setting up warning systems aimed at quickly alerting officials of difficult fiscal situations and establishing a system of sanctions in the event limits are breached. Certain States (*Spain, Italy, France*, etc.) have recently gone a step further by proposing to inscribe the "golden rule" in their constitution, following Germany's implementation of the "debt brake" rule just prior to the crisis. In fact, the "golden rule" has become a part of the constitution in *Spain* (September 2011) and *Italy* (May 2012).

At the subnational level, Member States are trying to improve the coordination of budget policies between the central level and the subnational levels in order to include local governments in national targets that are compliant with the Maastricht criteria.

In countries where there were **internal stability pacts** already in place (*Germany, Italy, Spain, Austria*), there is a willingness to strengthen conso-

lidation standards as well as control and sanction procedures that apply to other levels of administration (federated States and/or local authorities).

Elsewhere in Europe, many States wish to extend or reinforce budgetary discipline beyond the central government. This could take several forms including finance laws or annual or multi-year budget programmes (e.g. the 2011 – 2014 law outlining public finance adopted in *France* in December 2010), negotiated agreements (e.g. the Agreement on budgetary consolidation signed in May 2010 in *Denmark* or the Cooperation agreement from January 2010 in *Belgium*) or special laws (e.g. the law on fiscal and financial responsibility passed in April 2010 in *Romania* or the Framework budget act from December 2010 in *Portugal*).

At the end of the day, these new initiatives have tightened **fiscal discipline rules** for local authorities (ceiling on local deficits, surplus targets, rules limiting expenditure) **and borrowing oversight** (prudential rules). These rules had sometimes been loosened under stimulus plans in 2009 or in order to co-finance projects subsidised by European Structural and Cohesion funds (authorisation of exceptional deficits, raising debt ceilings, etc.)..

Examples of measures adopted or planned in Member States

Fiscal policy

- Setting growth standards for current expenses and/or investment of varying degrees of severity for local authorities that have either gone into effect or have been planned (e.g. *Spain, Italy, Poland, Denmark, Romania*, etc.);
- Setting or reinforcing budget balance standards: deficit threshold, annual balance or surplus targets (*Poland, Austria, Spain, Italy, Czech Republic*, etc.) or over several consecutive years (*Czech Republic*, etc.);
- Making it mandatory for local authorities to prepare multi-year fiscal strategies (*Estonia* for example);
- Establishing or strengthening sanction systems when rules are broken (*Austria, Germany, Spain, Czech Republic*, etc.).

Borrowing policy

- Re-asserting the "golden rule" for local authorities (borrowing exclusively reserved for financing tangible investments). Exceptions can still be made, however, particularly for projects that benefit from European co-financing or to cope with natural disasters (*Czech Republic*, for example);
- Restoring or re-asserting prior approval by the oversight authority for borrowing (*Latvia, Slovenia*, etc.);
- "Constitutionalisation" of local debt limits (e.g., in the new constitution from 2012 in *Hungary*);
- Debt limits: lowering debt limits (outstandings or debt servicing) e.g. halving the limit being planned in *Portugal*; change in calculation methods for debt ratios that seek to lower it (e.g. in *Poland*, from 2014, a debt limit – outstandings and debt service – which will no longer be set based on revenue but rather on gross savings calculated over a three-year period); definition of debt/GDP ratio for the local sector (e.g., in *Slovenia* where a cap of 2% of GDP has been discussed);
- Reinforcement of local debt controls (*Slovakia*, for example) and more broadly on the financial management of local authorities (e.g. *Czech Republic* where the central auditor's remit will be extended to supervision of regional and municipal accounts);
- Establishing additional prudential rules or "best practices" charters (derivatives, choice of lender, currencies, debt refinancing, etc.), which have been put in place in *Italy*, in *Spain* or in *France*;
- Temporary borrowing freeze (*Spain*) or volume limits on borrowing (*Latvia*);
- Implementation or reinforcement of sanctions when debt ceilings are overrun (*Slovakia, Spain*, etc.).

Strengthening internal stability pacts

- **Germany:** Germany's fundamental law (*Grundgesetz*) already included fiscal stability measures in its original version dating back to 1949. Since then, it has been amended three times (1969, 2006 and 2009). The 2009 reform, which was part of the 2nd reform of federalism (*Föderalismusreform II*), added a new measure called the "debt brake" (*Schuldenbremse*). According to this amendment, the federal government must reduce its structural deficit to 0.35% of GDP before 2016 while *Länder* will no longer be allowed to run a structural deficit of any kind starting in 2020. Although, they will be allowed to run a temporary deficit. The rule could also be suspended in the event of a natural disaster, an economic crisis or other exceptional circumstances. The consolidation phase will span from 2011 to 2019. *Länder* encountering financial problems will receive financial aid on an extraordinary basis from 2011 to 2019, particularly *Berlin, Bremen, Saarland, Saxony-Anhalt* and *Schleswig-Holstein*. In the future, the *Länder* will also need to adopt similar rules for including the "debt brake" in their regional constitution or in a fiscal framework law.

- **Spain:** in 2001, Spain passed its first fiscal stability law applying to all levels of government. Revised several times and loosened in 2009 under the Spanish stimulus package, this law was again modified on 1 May 2012 in response to the deterioration of the country's fiscal situation, particularly in the Autonomous Communities. In addition to the balanced budget rule from September 2011 (Article 135 of the Spanish constitution, the new "Organic Law on Budgetary Stability and Financial Sustainability" contributes to stricter control on regional accounts (e.g. debt and spending limits set up, transparency requirements and monthly, quarterly and full-year reporting to the central government) and budget oversight e.g. correction mechanisms, or even sanctions, when targets are not met (fiscal belt-tightening, especially in education and healthcare, implementing fiscal recovery measures, prior permission to borrow, enforcement measures, dissolution as a last resort, etc.). In addition, the central State set up a "supplier payment fund" for Autonomous Communities and municipalities. These financing lines, heavily regulated and controlled by the Finance Ministry, are granted to the Autonomous Communities under the condition that they implement particularly strict economic/financial consolidation programmes. These measures also apply to towns and provinces. Given this fiscal rigor, all Autonomous Communities approved fiscal restoration plans. They are expected to result in lowering the regional deficit in 2012, bearing in mind that the deficit ceiling was written into law at 1.5% of GDP for 2012.

- **Austria:** national fiscal coordination between the federal government, the federated States and municipalities has been regulated by the Austrian Stability Pact (*Österreichischer Stabilitätspakt – ÖStP*). The 2011 – 2014 Pact introduced several new elements, notably stricter sanctions, improved fiscal coordination and greater transparency. The Pact also integrates the new "debt brake" rule, inspired by the German model, and passed in December 2011 by *Austria*. The rule will therefore apply to subnational entities, as well. For 2011 – 2014, the Pact set a cap on the *Länder's* deficit and for Vienna (0.75% of GDP in 2011 and 0.5% in 2013 and 2014). It also includes the budget balance provision for municipalities. There are plans to revise the Pact in 2012 in order to integrate more precise rules on expenditure and debt. From 2017, it sets a limit of 0.35% for the structural deficit at the federal level and an aggregate for the *Länder* and municipalities of 0.1%.

- **Italy:** an Internal Stability Pact (*Patto di Stabilità Interno*) was set out in 1998 in the Italian legal system via law no. 448. Compliance with the Pact by all levels of government is based on the constitutional principle of coordinating public finances (Art. 117 and 119 of the Italian constitution). These rules are redefined every year when the finance law (*Manovra d'Estate*) is drafted. Broken down into two sub-pacts, one for the regions and the other for local entities, the Pact, depending on the year, sets targets on expenditure, deficit, debt or a combination of rules, which are spelled out in the finance laws. It also sets requirements on communication, information and certification as well as a sanctions system in the event of a default. Since 2007, the use of debt has been particularly constrained by the Pact. In 2011 and 2012, the various finance and stability laws have defined new budget balancing targets, current-spending constraints and have tightened access to borrowing for subnational entities. Finally, the constitutional reform introducing the budget stability rule in the Italian constitution was passed in May 2012. This "golden rule" will guarantee Italy's compliance with fiscal equilibrium, which should be reached in 2013 thanks to the new austerity plan. It will result in a ban on the use of debt to finance the deficit and will affect the public administration's fiscal discipline as a whole, including the territorial entities (regions, provinces, municipalities and cities).

Change in subnational public sector debt

Expansion of subnational debt slows in 2011

In 2011, the growth of the outstanding subnational debt slowed: +3.1% by volume versus +5.8% in 2010 and especially compared with +10.8% in 2009, when stimulus plans required a strong increase in investment. In 2011, subnational public sector debt reached €1,563bn in the EU 27, i.e. 12.4% of GDP (versus 9.7% prior to the crisis). For the local public sector alone, debt reached €743bn after increasing by 2.6% by volume in 2011 compared with 2010.

The slowdown in 2011 was due in large part to **lower financing needs, falling investment**, measures taken by several governments to **restrict borrowing** under national fiscal consolidation plans (See inset) and more difficult and expensive access to **external finance** in some countries.

Subnational outstanding debt even fell by volume in ten countries (See graph). Several among them reduced their financing needs in 2011 and/or had a balanced budget or surplus. In certain countries like *Slovakia* or the *Czech Republic*, lower local debt outstandings came as a result of central governments tightening prudential rules. It should be pointed out, however, that local authority debt in these countries remains very moderate (less than 3.5% of GDP).

In addition, there were several specific cases. In *Hungary* for example, local debt outstandings plummeted faster than any other country in Europe in 2011 (-16.8% by volume) and was partly due to a move to recentralise the competencies of the counties, which resulted in the central government taking over their debt. In *Italy*, subnational debt, among Europe's highest (8.1% of GDP and 6.8% of public debt) has fluctuated between stagnation and slower growth in the past five years (-0.7% in 2011), under the effects of strengthening the Internal Stability Pact: first in 2007 (limitation of local spending and budget balance targets), then in 2009 with the 133/2008 law that set new budget and debt targets, then again in 2011.

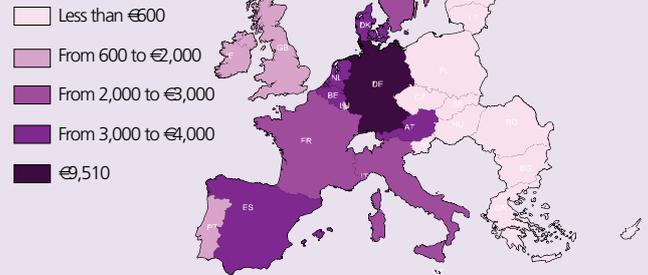
Subnational public debt is unevenly distributed in Europe

Out of the €1,563bn of subnational debt outstandings, **Germany**, especially the *Länder*, **hold half** (nearly €778bn) followed by **Spain** and **France** (11% each), **Italy** (8%) and the **United Kingdom** (6%). Aggregate local debt outstandings of the 12 new Member States do not exceed 2% of European subnational debt (of which 1% for *Poland* alone, i.e. outstandings of around €15bn). Excluding the federated and quasi-federated entities (Autonomous Communities in *Spain*), **France** has the highest debt (22% of local public debt in Europe), followed by **Germany** (19%), **Italy** (17%), the **United Kingdom** (12%), the **Netherlands** (7%), **Spain** (5%) and lastly **Sweden** (4%).

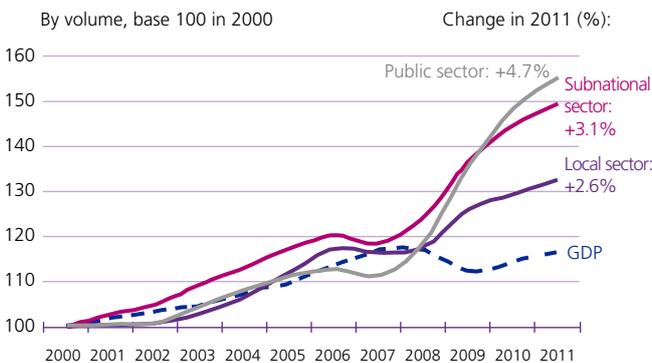
Subnational debt per capita totals an average of €3,110 in the EU (€1,480 for the local level alone). There are sizeable discrepancies between countries (€10 per capita in *Malta* to €9,510 in *Germany*, where the total combines debt from federated entities and the local public sector. They reach €3,000 and €4,000 per capita in the two other federal countries, in *Spain*, in the *Netherlands* and in *Denmark* (See map).

However, debt per capita is less than €600 in Greece and Central and Eastern European countries, despite local debt growth in the last ten years.

Amount of subnational public sector debt per capita in 2011



Change in public debt by sector in the EU 27 (2000 – 2011)



While subnational debt slowed on average in the EU, **it continued to grow in nearly two of three countries**. In some countries, this growth was very robust: it was greater than 5% by volume in six countries, exceeding 10% in *Spain*, *Lithuania* and *Sweden* (+23% by volume).

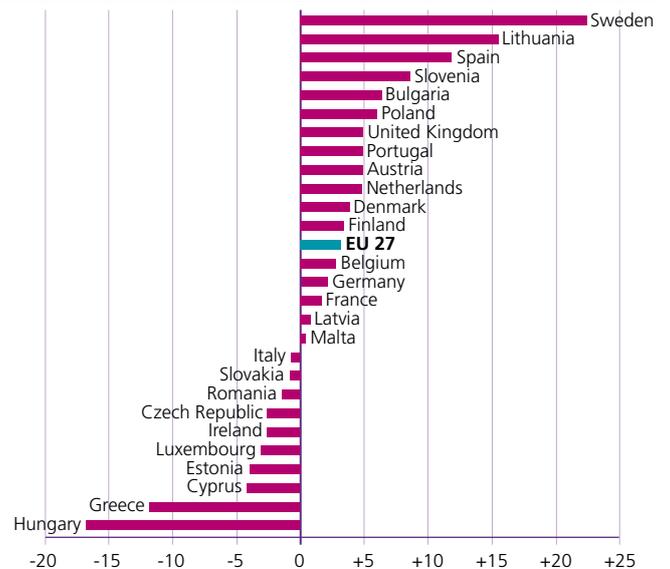
There are **many explanations** for this, including falling revenue, growth in investment expenditure, looser prudential rules (*Lithuania* for example), borrowing exceptions made for projects financed by European funds (several countries in Central and Eastern Europe) or interest rates, which remained attractive in 2011 in some countries, etc.

In *Sweden* notably, the local public sector's borrowing needs were determined essentially by investment expenditure, which gained nearly 16% by volume in 2011 (See previous section). Against this backdrop, the local public sector in that country tapped into the bond markets, for the most part (See below).

In *Spain*, the debt of Autonomous Communities continued to grow rapidly (+16% by volume), while the debt of the local public sector in *Spain* actually dipped 1.4% under the effect of exceptional measures taken in 2011 by the Spanish government to limit the use of debt by provinces and municipalities (local authorities with a debt/current revenue of over 75% are forbidden from borrowing money and have restrictions on refinancing). Regarding Spanish regions, this strong drop is notable

in that they are bound – like other European local authorities but unlike Federated States – by the golden rule pursuant to law 8/1980. But, since the crisis, their deficits and debt have worsened. In addition, in 2010, the government granted them exceptional authorisation to use long-term debt (for less than five years however) to finance current spending. Lastly, the Spanish regions sharply increased their short-term debt (less than one year) in 2011 in order to cover operating expenses and their cash flow needs. As such, the short-term debt outstandings of the Autonomous Communities ballooned 146% in value terms between 2010 and 2011, and even 252% for bonds maturing in less than one year. This type of debt as a percentage of total outstandings in the Autonomous Communities increased from 7% to 15% in one year.

Change in subnational public sector debt in the EU 27 in 2011 (% by volume vs. 2010)



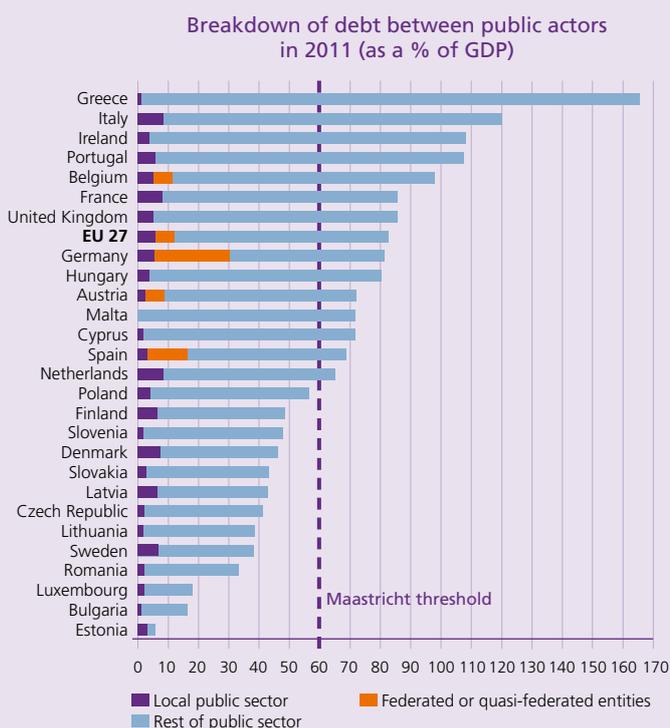
The growth of short-term debt is also worrisome in *Germany*, where short-term local debt outstandings as a percentage of total outstandings went from 15% in 2003 to 26% in 2008 and 34% in 2011 (the EU average was 13% in 2011 for the local sector alone and 8% for the subnational level). Several *Länder* implemented measures to help

Subnational and local public debt in the EU 27 in 2011

At end-2011, outstanding debt of the subnational public sector totalled €1,563bn in the EU 27. It accounted for 12.4% of GDP and 15.0% of public debt. It is split between the federated and quasi-federated entities (52%) and the local public sector (48%). Local debt outstandings dropped €743bn, i.e. 5.9% of GDP and 7.1% of public debt. These ratios are lower for the local sector and mostly come from the fact that the lion's share of local debt is allocated to financing investment ("golden rule") and that it is governed by strict prudential rules.

Subnational debt/GDP varies from 0.1% in *Malta* to 30.2% in *Germany* (of which 24.8% for the *Länder* alone). Its weight in public debt ranges from 0.1% also in *Malta* to 55.8% in *Estonia*, whose total public debt is the lowest in Europe, however (6% of GDP).

The graph on the opposite page illustrates the weight of local debt and federated entities and quasi-federated in proportion to GDP and compared with total public debt. The debt borne by other public bodies (central government and public satellites and social security bodies) is predominant in all European countries.



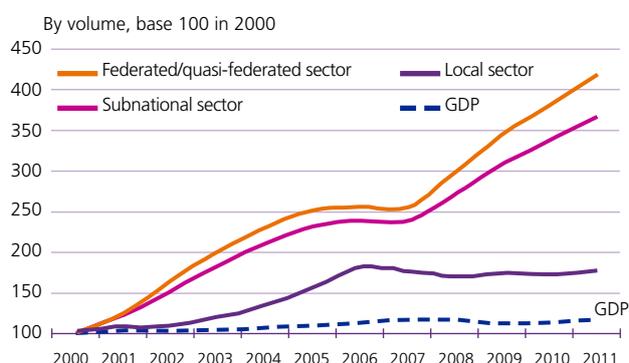
towns pay back the *Kassenkredite* or created reserve funds to meet local authorities' future needs, in addition to equalisation mechanisms that already exist at the municipal level. One such example is *Saxony-Anhalt* and the STARK II programme or *North Rhine-Westphalia* which created a "Strengthening municipal finances" fund in 2011; and in 2012 several other *Länder* implemented measures: *Hesse* (plan entitled "protective shield for municipalities"), *Lower-Saxony* ("Contract for the future – debt relief fund"), *Mecklenburg-Vorpommern* ("Municipal consolidation fund") or the *Rhineland-Palatinate*.

Outstanding subnational debt in the form of loans or bonds

In the last 11 years, the percentage of bonds to subnational public sector debt has risen in Europe: it went from 12.9% in 2000 to 31.3% at end-2011. Currently, bond outstandings stand at nearly €500bn, including 95% long-term (maturity of greater than one year). By volume, it has jumped markedly (an average of 12.6% by volume per year since 2000).

However, it is especially the **Federated States** (particularly, the German *Länder* and the Belgian regions) that increased their bond outstandings in the last few years, particularly since the crisis. The bonds/outstandings at the federated level, which was 21.8% in 2000, reached 46.0% in 2007 then 52.6% in 2011. By volume, growth was an average of 13.9% reaching a total of nearly €449bn. In *Spain* however, the percentage of bond outstandings in the Autonomous Communities fell sharply between 2000 and 2011, and especially since the onset of the crisis.

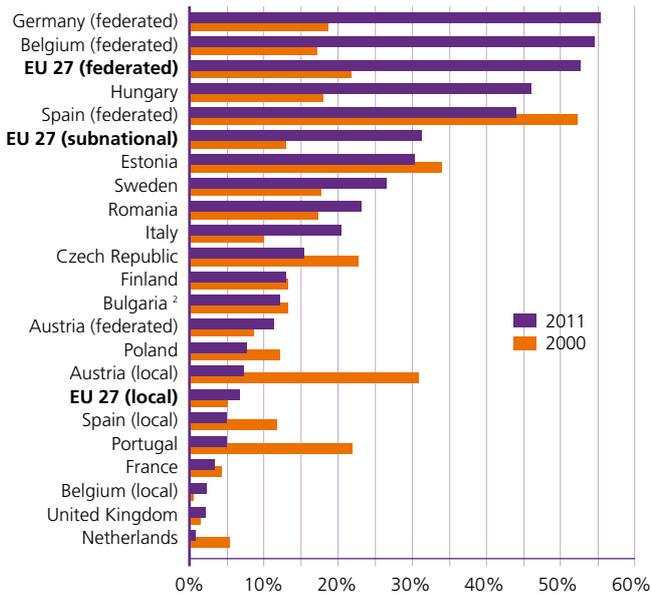
Change in bond debt outstandings from 2000 to 2011 – subnational, federated and local public sector



For the local public sector alone, the increase in the ratio of bonds to total debt was considerably **more moderate** (5.1% in 2000 to only 6.9% in 2011, i.e. bonds totalling €51bn). This percentage was even higher in 2007, just before the crisis (7.7%). In reality, bond debt increased on average 5.3% by volume per year over the whole period, the strongest increases were recorded before 2007 (See graph); Since then, growth has appeared more stable (+0.3% by volume per year). However, *Sweden* was a particular case with the percentage of bonds/total local debt outstandings increasing 6 points between 2010 and 2011, increasing from 21% to 27% (See below).

For European local authorities, **the use of loans remains therefore very much predominant**. The "banking" offer is varied, whether public or private: multilateral public banks (*European Investment Bank, EBRD, Council of Europe Development Bank, Nordic Investment Bank, World Bank*, etc.), Public Treasury and its different branches (*Ireland, Latvia, Public Works Loan Board* in the UK, etc.), State public banks (development banks in the Central and Eastern Europe, *Cassa Depositi e Prestiti*

Bonds as a percentage of subnational and local public sector debt in the EU 27¹ (2000 and 2011)



¹ Germany (local), Cyprus, Denmark, Greece, Ireland, Latvia, Lithuania, Luxembourg, Malta, Slovakia, Slovenia: bonds non-existent or insignificant in 2011
² Bulgaria: data 2002–2011

in Italy and *Caisse des Dépôts et Consignations* in France, *Belfius* in Belgium, *Kommunalkredit* in Austria), regions (Germany), municipalities (*KommuneKredit* in Denmark, *Kommuninvest* in Sweden) or public banks State-local authorities (*KfW-Kommunalbank* in Germany, *Municipality Finance* in Finland, *BNG* and *NWB* in the Netherlands), savings banks and private commercial banks.

In the future, as they are confronted by the difficulties and growing concerns of the banking sector, notably private, to grant long-term finance to local authorities (liquidity crisis and bank refinancing, anticipation of Basel III regulations, increase in the risk local authorities will default as late payments start to accumulate, for example in Spain, Portugal and France), local authorities will undoubtedly make more use of international, national and local **public institutions** and the **bond markets**.

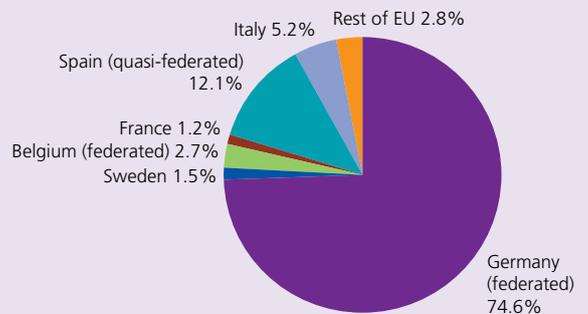
Tensions have surfaced in some countries regarding subnational municipalities' use of external finance (for example, the credit crunch in France, the banking crisis and more difficult access to the bond markets for the Autonomous Communities in Spain), have encouraged several central governments to take **emergency measures** to facilitate subnational public sector finance, for example, in France, via the *Caisse des Dépôts et Consignations* and in Spain, via the creation of temporary line of finance to the *Instituto Credito Oficial* to help local authorities meet their debt repayment obligations and supplier invoices.

Against this backdrop, pooling mechanisms have emerged recently under the aegis of local authority associations (France, England). Inspired by the municipal agencies model in Scandinavia (See above), these projects aim to create **local investment agencies**. The goal is to provide participating municipalities the possibility of tapping into the bond markets through the agency in exchange for an initial capital contribution.

Subnational bond debt concentrated in a few countries

German *Länder* are the most active issuers: their bond outstandings account for 74.6% of subnational public sector bonds outstandings (around €373bn). They are followed by the Autonomous Communities in Spain (€60bn), the Italian local and regional public sector (€26bn), the federated entities in Belgium (€13bn) and the local public sectors in Sweden and France.

Breakdown of EU 27 subnational public sector bond debt outstandings by country in 2011



Change in funding local investment from 2000 to 2011

From 2000 to 2011, local investment finance (excluding the Federated States and Autonomous Communities) was provided, for the most part, by self-financing sources and investment revenue, even though debt (borrowing minus annual amortisation) has regularly been used to meet financing needs.

Until 2003, the overall coverage rate of local investment by self-financing and investment revenue exceeded 90%. From 2004, it contracted amid a slowing economy before rebounding in 2007. Just before the crisis, the coverage rate had returned to 94%: split between self-financing (54%) and capital transfers (40%), which meant that only 6% of investments needed to be financed through debt that year.

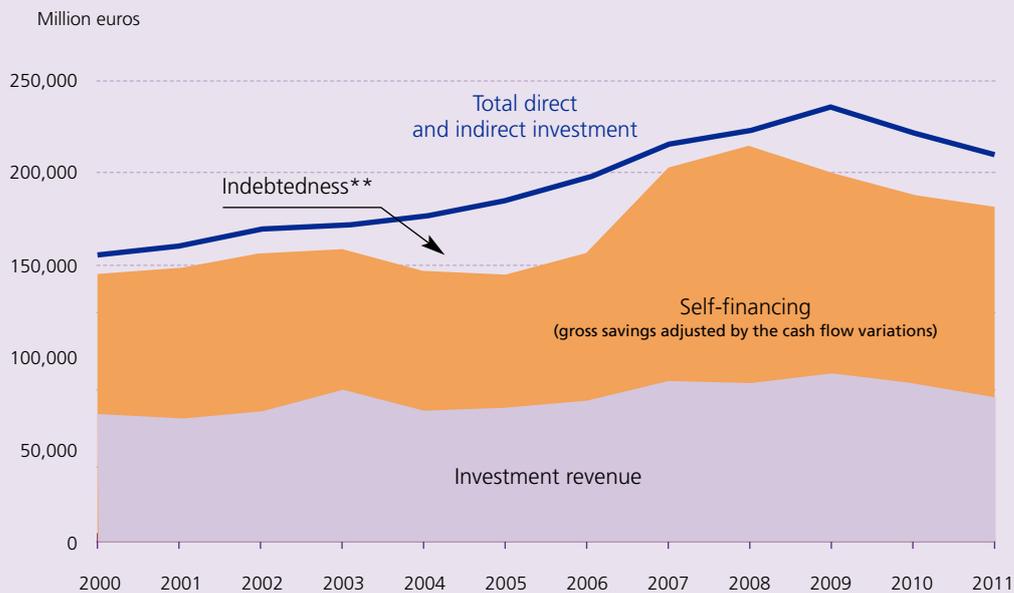
In 2008, self-financing persevered despite the crisis and, combined with capital transfer growth granted under stimulus plans, enabled the investment coverage rate to reach its highest point in the past decade (96%). In 2009, however, the coverage rate fell

back to 85%, investment revenue's resiliency was not quite enough to compensate lower self-finance.

In 2010, self-finance and investment revenue both dropped. The overall coverage rate was, however, maintained at 2009 levels, while local investment fell to the same extent. In all, savings allowed 46% of financing needs to be covered and investment revenue 39% (i.e. 85% of the total).

Lastly, **in 2011**, capital transfers continued to fall but improving self-financing, this time around, helped improve the coverage of local investment very slightly, especially given that the latter continued to fall. In the end, 49% of local investment was funded through self-financing and 37% through investment revenue, i.e. **a coverage rate by own resources of 86%. Debt was used in 14% of cases in 2011**, therefore.

Funding investment in the local public sector* in the EU (2000 – 2011)



* Local public sector, i.e. excluding federated entities (federal countries) and quasi-federated entities (Spain)

**Indebtedness (fluctuation of debt outstandings): total new borrowings - total redemptions

Macro-economic weight of the national, subnational* and local public sectors in the EU 27 in 2011

	Amount (€bn)	As a % of GDP		As a % of total public sector		Change (in volume)	
	2011	2000	2011	2000	2011	Between 2000 - 2011 (annual average)	Between 2010 - 2011
GDP	12,629	-	-	-	-	+1.4%	+1.5%
Public expenditure	6,201	44.8	49.1	100.0	100.0	+2.2%	-1.5%
... Subnational level	2,109	15.2	16.7	33.9	34.0	+2.3%	-0.2%
... Local level only	1,506	10.8	11.9	24.2	24.3	+2.3%	-1.0%
of which direct public investment	306	2.4	2.4	100.0	100.0	-	-7.4%
... Subnational level	204	1.6	1.6	68.5	66.5	+1.2%	-6.6%
... Local level only	179	1.4	1.4	59.8	58.3	+1.2%	-6.0%
Public revenue	5,637	45.3	44.6	100.0	100.0	+1.3%	+2.9%
... Subnational level	2,016	15.0	16.0	33.2	35.8	+1.9%	+0.2%
... Local level only	1,480	10.8	11.7	23.9	26.3	+2.1%	-0.2%
of which tax revenue	3,283	27.2	26.0	100.0	100.0	+1.0%	+3.2%
... Subnational level	838	6.2	6.6	22.7	25.5	+2.1%	+5.5%
... Local level only	529	3.8	4.2	35.5	16.1	+2.2%	+3.5%
of which non-tax revenue	2,354	18.1	18.6	100.0	100.0	+1.7%	+2.4%
... Subnational level	1,178	8.9	9.3	48.9	50.0	+1.9%	-3.3%
... Local level only	951	7.0	7.5	38.4	40.4	+2.1%	-2.2%
Public balance	-565	0.6	-4.5	100.0	100.0	-	-
... Subnational level	-93	-0.1	-0.7	-	16.5	-	-
... Local level only	-26	0.0	-0.2	-	4.6	-	-
Public debt	10,422	61.9	82.5	100.0	100.0	+4.1%	+4.7%
... Subnational level	1,563	9.7	12.4	15.6	15.0	+3.7%	+3.1%
... Local level only	743	5.2	5.9	8.3	7.1	+2.6%	+2.6%

*Subnational: federated and local (see "Methodology")

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