CCRE CEMR

Local & Regional Europe

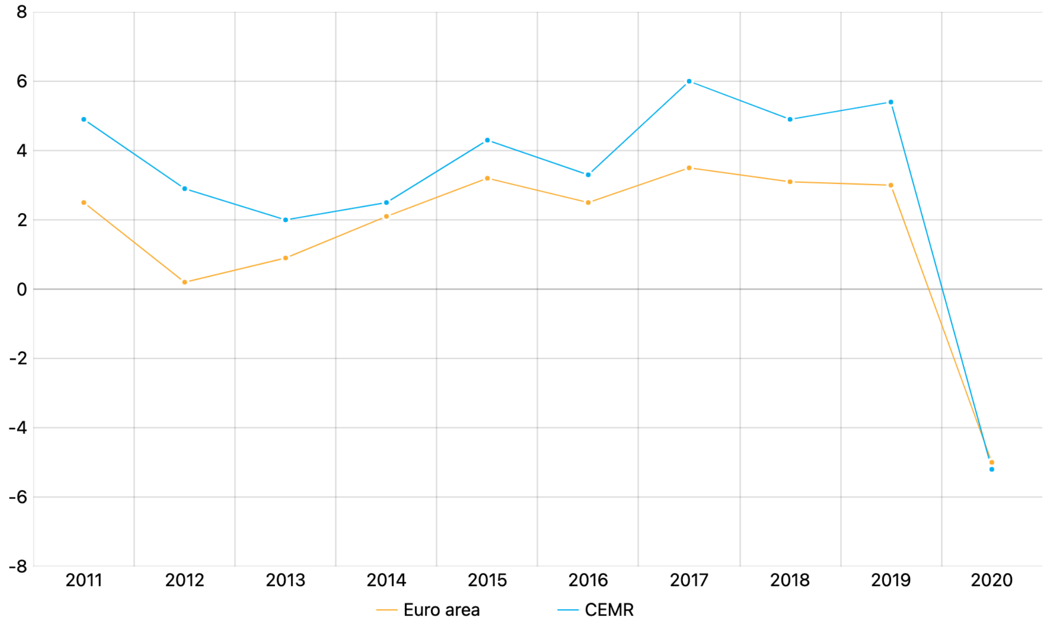
Local Finances and the Green Transition

Managing Emergencies and Boosting Local Investments for a Sustainable Recovery in CEMR member countries

Co-funded by the European Union

1. Macroeconomic environment and public finances

FIGURE 1 ECONOMIC DEVELOPMENT STAGES, CEMR COUNTRIES, EURO AREA
GDP PER CAPITA CURRENT PRICES, ANNUAL CHANGE



Economic growth – measured by annual changes in GDP per capita – fluctuated in the past decade (Figure 1). In both the CEMR countries and the euro area, the first stage of economic development and recovery started after 2013. At the end of the period under study, there was a severe economic downturn in 2020 with a 5% fall in GDP per capita. During the intervening years, growth was stable and averaged around 3 to 4%, although there was a relative slowdown in 2016. Annual economic growth was highest in 2017, with an average of 6% in the CEMR countries.[2]

The level of economic growth showed diverse regional patterns. Some of the smaller CEMR countries were the leaders in high annual growth during the recovery period, including several of the transition and Balkan countries, plus Israel and Ukraine. Interestingly, it was the same group of countries that were the worst affected by the first year of the pandemic in 2020, although large economies like Spain (-10.3%) and Turkey (-8.6%) were also among those the most severely affected.

Unemployment increased until 2014 in the 33 CEMR member countries with comparable data. The annual average unemployment rate then was above 11%. Countries in southern Europe, such as Greece, Spain, Portugal, and some of the Western Balkan countries, were hit the hardest by high unemployment. By the last half of the decade, increased economic growth had led to more jobs and the unemployment rate in the CEMR countries fell to an average of 7% by 2019.

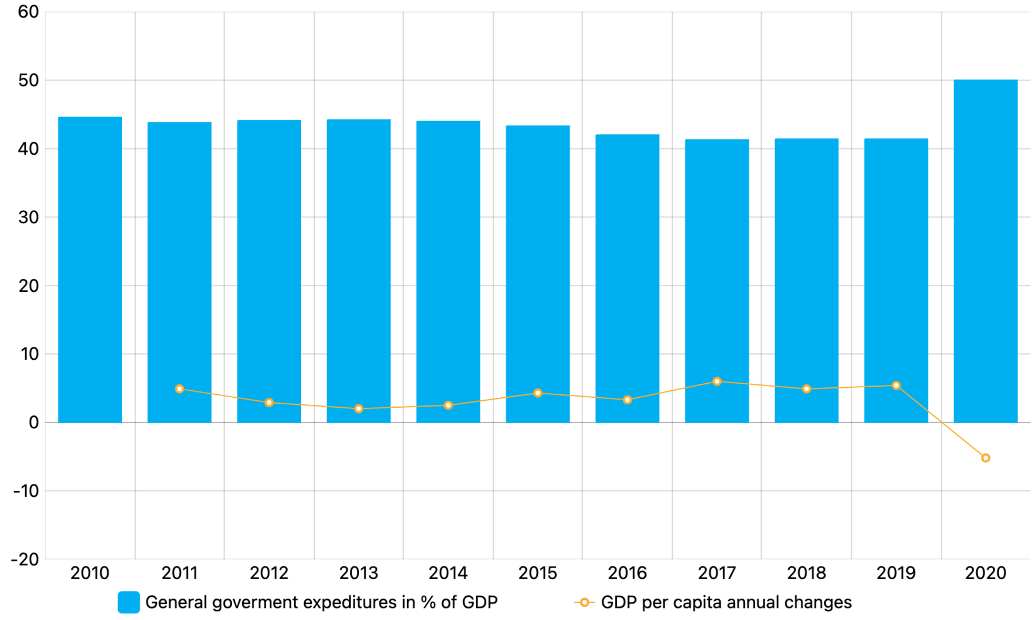
Economic growth was constrained by the deflationary environment. Even the typically low inflation (EU country average of 2-3%) gradually vanished by the middle of the decade. From 2014 to 2016, the average inflation rate dropped close to zero in the EU countries.

The European welfare states provide a broad range of public services and manage numerous governmental functions (Figure 2). The GGE ratio came close to 45% of GDP in 2010. Owing to restrictions and the economic growth rate, this indicator steadily dropped to 41% by 2017-2019. In the first year of the pandemic, government expenditure again increased to 50% of GDP due to high government spending programmes and a shrinking economic base.

2 These are simple arithmetic averages and do not measure the size (weight) of the national economies.

With respect to government expenditure, there are significant differences among the CEMR countries. In 2010, public spending in the Scandinavian countries, France, Belgium, Austria, Greece and Portugal exceeded 50% of GDP, whereas in North Macedonia, Turkey, Albania, Kosovo and Georgia, it did not even reach 35% of GDP. This huge gap, which reflects a high diversification of overall government functions in the first group, can be telling of a country's potential scope of decentralisation since countries with a larger public sector can more easily devolve services to subnational governments.

FIGURE 2 HIGH GENERAL GOVERNMENT EXPENDITURE IN THE EUROPEAN WELFARE STATES



Government expenditure (in GDP ratio) was lower in 2020 than in 2010 only in countries with extended public budgets (e.g. Denmark, Latvia, Portugal).[3] Yet, all governments found it necessary to increase their expenditure from the previous year by an average rate of 7%. The biggest increases in the ratio of government spending to GDP, all above 10%, were found in Greece, the UK and Spain. In many countries, local governments suddenly had to cope with random and unjustified budget cuts (see the case of Serbia in Box 1).

Box 1 – Fiscal policy changes hit local budgets in Serbia

Implementing financial consolidation in Serbia entailed frequent changes to its Law on Local Self-government Finance. In 2009, an ad hoc governmental decision resulted in local self-governments being stripped of RSD 15 billion (EUR 158 million). Although this measure could be justified, its implementation was very hasty, reducing transfers in the middle of the budget year. There was an absence of any objective or measurable criteria for determining the reduction of municipal funds. This led to financial problems and political turbulence between the central and local levels of government. Political pressure brought about a new law in 2011 and the allocation of RSD 40 billion (EUR 420 million) to the local level, but again without any proper rationale given. This amendment set off an implosion of the national public finances and was subsequently revised twice (in 2013 and in 2016).

Portugal, as one of the countries hit the hardest by the economic crisis, was subject to a coordinated stabilisation programme set up by the major international organisations, which had an impact on local governments as well (see Annex 2).

The economic crisis of 2008-2009 was managed in part through active government borrowing. By 2010, high government indebtedness was a by-product of the efforts to subsidise failing businesses and help domestic

3 The impact of the pandemic on government expenditure could only be studied in thirty CEMR member countries on account of the absence of data on general government spending for some Balkan countries, Turkey and Ukraine.

banks. Among the EU Member States, where comparative data is available, 11 economies were burdened with both general government debt above 60% of GDP and net borrowing amounting to more than 3% of GDP. There were several countries, mostly from the group of new EU Member States, whose annual net borrowing exceeded the Maastricht threshold of 3%.

Box 2 – The Austrian Stability Pact

In 2012, the "Austrian Stability Pact" was set up in agreement with the territorial authorities, whereby the European fiscal rules (mainly the Stability and Growth Pact) were transposed into national law. Its aim is to maintain sustainable, orderly budgets and in particular to avoid over-indebtedness. The most important fiscal rules concern the government deficit (borrowing) and the debt ratios.

1) Maastricht Balance: this was the main focus of the regulations until it was replaced by the structural balance in 2017. For the states (Länder) and local governments, the balance was -0.54% in 2012 and increased to +0.01% of GDP by 2016.

2) Debt brake: structural balance differs from the Maastricht balance in that cyclical effects and one-off measures are neutralised. Since 2017, the overall benchmark has been -0.45% of GDP. The distribution among the central federal government and the Länder plus municipalities falls within the ratio of -0.35% to -0.1%. Also since 2017, municipalities have committed to keeping a structurally balanced budget. Any differences between the actual structural budget balance and the permissible balance limit are to be entered in the control account, as a debit or credit, and netted over the years. Public-Private Partnership agreements declined to limit public debt towards the private sector. The "general escape clause" – analogous to the EU's – has been activated for the years from 2020 to 2022.

3) Spending brake: under the permissible growth in spending, the annual primary expenditure growth may not exceed the medium-term potential GDP growth rate. Exceptions are possible in cases where the medium-term budgetary objective has been easily surpassed or when any excess spending has been compensated by discretionary revenue-side measures.

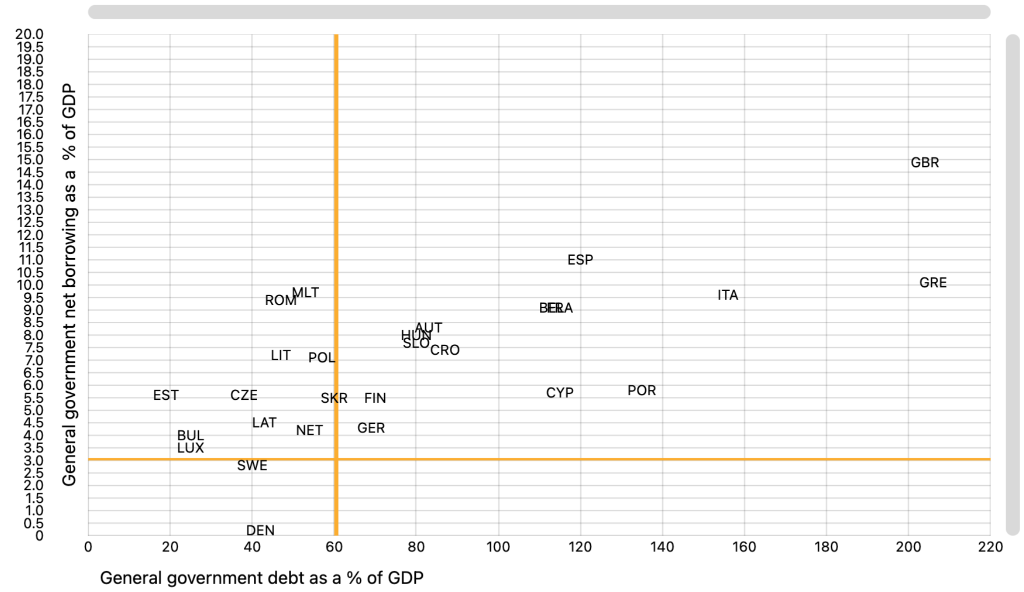
4) Debt ratio adjustment: reduction in government debt is to remain below the reference value of 60% of nominal GDP and kept at that level. It is also deemed sufficient if the difference between 60% and the actual debt ratio has been reduced by 1/20 per year on average for the past three years. The share of the federal government, the Länder and the municipalities in the reduction will be in line with the ratio of their debt levels (as of 2011).

5) Medium-term budget planning must be submitted by all territorial authorities to the Austrian Coordination Committee.

6) Liability caps: the upper liability limit is calculated as a percentage of the assessment base (taking into account revenues and public levies), which amounts to 175% for the federal government, 175% for the Länder (including Vienna), and 75 % for local governments. The consequences of excess borrowing are regulated, although no sanctions have been imposed to date.

Government indebtedness continued to increase over the last decade until 2017. Then, following three years of decline, general government debt rose once again, reaching 80% of GDP in 2020. This amounts to a steep 18% increase from the year before the pandemic (CEMR country average). This means that 15 countries, from both the group of large, developed economies and the smaller ones, are currently well above the Maastricht limits. Only Denmark and Sweden have been able to maintain their status through low debt and limited annual borrowing (Figure 3).

FIGURE 3 GENERAL GOVERNMENT DEBT AND NET BORROWING, 2020



In short, this economic environment was a clear determinant of the local scope of manoeuvre. Public spending was confined by hard budget constraints in the first few years of the past decade. High general government debt limited local spending and subnational borrowing. Slow economic growth reduced municipal revenue-raising options. Then, beginning in the middle of the decade, budget conditions gradually normalised, although there were striking differences among the CEMR member countries. Nevertheless, in the first year of the pandemic, all economies contracted. These losses were partially compensated by fiscal policy measures: wage subsidies, special spending programmes, reduced taxes. In contrast to the earlier economic crisis, these active fiscal instruments created a more favourable economic environment for the government sector. However, the economic decline was more severe at the beginning of the pandemic – and in the subsequent years.

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