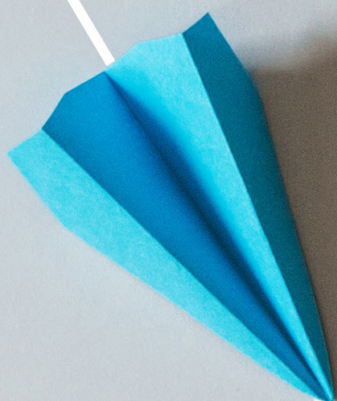


Local Finances and the Green Transition

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



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the European Union

Executive Summary

This report provides an analysis and an explanatory synthesis of the evolution of subnational finances in CEMR member countries during the decade of 2010-2020. It also evaluates climate change-related aspects of local finances, primarily local capital spending on green investments.

The study is based on the comparative fiscal data available for this rather diverse group of countries. Information collected from selected CEMR countries and evaluations of national plans produced for the European Union's Recovery and Resilience Facility supplement the fiscal analysis.

Periods of economic growth and public sector development

Even though the economic crisis was already a reality at the start of the decade, local governments only began to contend with its long-term consequences in 2010-2012. A confluence of contracting economies, high general government debt and increased unemployment all severely affected local budgets.

By the middle of the decade, a gradual recovery was underway amidst a stagnating, deflationary economic environment. During this period, even while private sector involvement in public service provision started to decline, economic consolidation took place through new forms of partnership between government tiers. Moving beyond economic concerns, local policies also began to respond to climate change and to expand local actions for sustainable development.

The year 2020 marked the onset of a third period with the global eruption of the COVID-19 pandemic, which produced a "scissors effect" of higher expenditure and revenue losses for both national and local governments. Unlike their response to the economic crisis a decade earlier, national governments and the international financial institutions promptly initiated coordinated countercyclical policies and launched intensive stimulus programmes.

The macro-economic environment and public finances

This economic environment was a determinant in the local scope for manoeuvre. In the first part of the past decade, public spending was confined by the hard budget constraints. High general government debt limited local spending and subnational borrowing. Slow economic growth reduced municipal revenue-raising options. Gradually, towards the middle of the decade, budget conditions did begin to normalise even if there were striking variances among CEMR countries. During the first year of the pandemic, all economies contracted. These losses were partially offset by countercyclical 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. Nonetheless, the economic decline triggered by the eruption of the pandemic proved to be more severe from the start and in the years that followed.

European welfare states provide a broad range of public services and manage numerous government functions. In 2010, the general government expenditure (GGE) ratio had been close to 45% of GDP but fell under the restrictions and economic growth to 41% by 2017-2019. Owing to high government spending programmes and a shrinking economic base, government expenditure again increased, reaching 50% of GDP in the first year of the pandemic.

Significant differences in the GGE ratio can be seen among CEMR's member countries. In the Scandinavian countries, France, Belgium, Austria, Greece and Portugal, general government expenditure exceeded 50% of GDP, whereas in North Macedonia, Turkey, Albania, Kosovo and Georgia, it did not even reach 35% of GDP.

Government indebtedness increased throughout the decade until 2017, when it declined for a short time, before rising again to 80% of GDP by 2020. Currently, 15 CEMR countries are well above the Maastricht limits.

Decentralisation trends in Europe

After the 2008-2009 economic crisis, subnational governments were in the centre of economic and fiscal policies. They aimed to eliminate public spending inefficiencies, to utilise revenue-raising options and to limit overall government debt. Using an economies-of-scale approach, administrative reforms promoted larger municipalities (or inter-municipal cooperation) in order to lower service unit costs and to create networks of sizable local governments, more manageable from the centre.

As local government structures in CEMR countries are very diverse, the possible ways to carry out these amalgamation reforms ran the gamut as well. Still, several CEMR countries were able to successfully implement administrative territorial reforms (Albania, Austria/Styria, Estonia, Latvia, Ukraine).

Economic growth in the past decade occurred alongside regional differentiation. The distance between the basic (NUTS2) regions with the highest and lowest GDP value per capita increased (from 2.37 (2010) to 2.46 (2020), averages based on 36 countries). In terms of population size, the average weight of capital cities increased slightly (by 1%) in CEMR countries over the past decade. The share of national capitals in countries with more concentrated urban networks further increased (Estonia, North Macedonia, Portugal, Finland).

Budget expenditure and investment patterns

The scope of decentralisation did not change significantly in CEMR countries from 2010 to 2020. Overall, subnational government expenditure amounted to a share of 25% in total general government expenditure.

In terms of finance, however, rather diverse fiscal decentralisation policies were followed in CEMR countries during this period. Subnational governments' share of overall government spending increased in two federal countries (Belgium, Germany), in countries with already extended local services (e.g. Denmark, Sweden), and in those with a relatively low baseline (e.g. Albania, Ukraine). Radical centralisation policies (those lowering subnational governments' share of general government spending by 5% or more) were implemented in Hungary, Georgia, Spain and the UK.

The more decentralised countries experienced an increase or lower cuts in subnational spending than the centralised ones, which lost more of their spending powers. Past public sector characteristics seem to determine future paths.

Local functions and responsibilities

Subnational governments provide a wide range of services with huge variations among CEMR countries. Moreover, the options for rationalising municipal expenditure and crisis management very much depend on the extent and form of decentralisation, i.e. the type of local public services provided.

Education represents the largest expenditure item in the budget of subnational governments; it comprises more than one-fifth of local and regional governments' budgets. In federal countries, social services and health care each represent 19% of regional governments' total expenditure. As they also manage infrastructure network services (e.g. transport), spending on economic affairs is significant (13%).

Locally provided services greatly differ among the CEMR countries. Health care and social service budgets are correlated with the scope of decentralisation. The share of public education, health care and recreational services marginally increased between 2010 and 2019.

After the 2008-2009 economic crisis, subnational governments everywhere operated under a constant pressure to improve the efficiency of their administration and other locally provided services. According to the indicator on standardised costs (current expenditure per capita as percentage of GDP per capita), options for future efficiency savings do exist for the transition countries of Central and Eastern Europe, Italy and the Western Balkan countries and Turkey. However, local service efficiency improvement is generally determined by the prevailing labour costs, which represent an average of 46% of current expenses in the CEMR countries.

Capital expenditure

Subnational governments are responsible for a significant part of all government capital expenditure even though capital investments may only represent 15-18% of total subnational expenditure. In the past decade, this ratio decreased even further in the less decentralised countries (e.g. Montenegro, Serbia, Bosnia and Herzegovina, Slovakia) or where recentralisation reforms were implemented (e.g. in Hungary).

Subnational governments' powers extend to managing capital expenditure on green investments. Most subnational capital investments are currently implemented in infrastructure and communal and utilities sectors. The investment gap to meet the EU's climate mitigation goals, estimated at EUR 350 billion a year plus an additional EUR 130 billion for other environmental objectives, can be bridged by mobilising private and public financial resources, an area where subnational governments can play an important role. Indeed, getting the local and regional levels fully involved in decarbonisation strategies and their financial architecture is the key to achieving national as well as European climate and sustainability objectives.

Revenue assignment and taxation

Subnational governments control a significant part of taxes in the decentralised Scandinavian countries and in federal Germany and Spain (with more than 25% of all government taxes collected). In response to the fiscal challenges of the economic crisis, countries with a higher local tax revenue share increased local taxes further, while the less decentralised countries decreased their local tax share.

Grant dependency, measured by the ratio of intergovernmental transfers and grants in subnational budgets, was calculated at more than 60% of subnational budget revenue on average. No general pattern of change in the grant dependency ratio has been identified over the past decade. The factors behind any specific perceptible changes are country-specific: the overall budget restrictions (e.g. Greece), the radical recentralisation of local functions (e.g. Hungary) or the transformation of tax policies (e.g. France).

Local taxation systems in the CEMR countries are predominantly based on income (personal, profit) or land and building taxes. Local property taxation is used in the less decentralised and smaller countries, where taxes on land and buildings usually constitute the primary source of local tax revenue. Local tax systems only underwent marginal changes during the post-crisis period.

Several trends have been identified. In some countries, the local tax burden on businesses and production decreased and there was a shift towards property taxation; whereas in others, there was a slight move away from property taxation and experimentation with either income-based taxes (income, profits, capital gains) or taxes on products (sales, excise, motor vehicles, etc.). Countries with local income taxation pursued diverse policies. In light of the foregoing, some convergence of local taxation systems can be observed. The level of tax autonomy itself remained stable over the past decade.

Budget balance and debt

In the beginning of the past decade, local governments had to borrow amidst a restrictive fiscal environment. By the end, in the first year of the pandemic, the financial burden had fallen primarily on the national budget and in the federal countries on state governments.

Local governments operate under a balanced budget requirement and borrowing represents a minor source of budget revenue. In the 36 countries where comparative data was available, subnational government debt remained at a manageable level. Due to strict fiscal rules and regulated borrowing procedures, accumulated debt was kept stable and below 4% of GDP at the first tier local level. However, in the federal countries, state government debt reached 15% of GDP and increased even further during the first year of the pandemic (17.5%).

Public financial management

Selected aspects of public financial management (PFM) round out the data analysis on the overall quality of fiscal rules, budget openness and accountability.

Following the 2008-2009 economic crisis, the primary aim of national fiscal policies was the balancing of public budgets and curbing local debt. The country ranking listed in the *Fiscal Rules Index* does not correlate to level of decentralisation or economic development.

Efficiency in municipal service provision is greatly dependent on the degree to which governments manage to align public demand for services with a suitable form and level of taxation. The process of maintaining budget openness is primarily shaped by the general governance practices in place, although it is also linked in part to the scope of decentralisation. It is therefore not surprising that the more economically developed countries score high on the *Open Budget Index*.

Openness in local finances and financial management also helps to curb corruption. Countries with greater decentralisation have better *Corruption Perception Index* scores. CEMR countries usually score high on the *Statistical Performance Indicator*.

The Recovery and Resilience Facility and subnational governments

In the coming years, climate change and digital transition will be central to the European Union's plans and funding policies. The Recovery and Resilience Facility (RRF) is a major EU financing mechanism, made possible through the first large-scale issuance of mutualised European debts, which provides funds for the EU Member States. The total budget of the Recovery and Resilience Facility is EUR 672.5 billion, which is available as a grant (EUR 312.5 billion) and as a loan (EUR 360 billion) over the 2021-2026 period.

Due to the RRF allocation criteria, the grant per capita is higher in the newer less economically developed EU member countries, Italy and Spain being the exceptions (these large countries were hit hard by the crisis and have huge internal regional differences).

The six priorities (pillars) of the RRF represent critical areas for crisis recovery, incorporating responses to climate change as well as promoting solid foundations for future economic development through digitalisation, sustainable growth and increased resilience. Local governments with functions and competences aligned with the RRF's main pillars may be eligible to benefit from these grants.

The primary *green transition* pillar represents the highest share of RRF grants (42%). It accounts for more than 30% of RRF related expenditures in the countries with approved plans. The share of green transition spending is higher in the more decentralised countries, apart from the smaller countries (Luxembourg, Malta). The four countries with strong regional structures have all appropriated more than 40% of their RRF budgets to climate-related actions and policy areas.

Sustainable mobility is the preferred policy area (32% of total planned expenditure) under pillar 1 (green transition). Energy efficiency is a similarly high priority, representing 29% of total expenditure planned on green transition. In comparison, typical local government tasks such as solid waste management and other environmental pollution prevention programmes only represent 2% to 4% of total expenditure under the first pillar.

Territorial infrastructure and services make up the bulk of RRF spending under the *social and territorial cohesion pillar* (66% of total). It is worth noting in this respect that, according to a survey of local government associations in 19 countries, local and regional governments are generally not satisfied with the existing national plans on territorial cohesion.

In the less decentralised countries, national plans spend more on programmes under the *resilience pillar*, where health care and public administration expenditures have been budgeted. Health care services (48%) and effective public administration (30%) in fact represent the main expenditure areas of this pillar encompassing health and economic, social, institutional resilience.

The policy areas predominantly being targeted by the *next generation* grants, namely three different levels of education (74% of total grants), early childhood education and care (14%) and youth employment (12%), ensure that there will necessarily be a local dimension to this pillar.

Including local and regional governments in the national planning process of the Recovery and Resilient Facility programmes is critical. According to our survey, local governments believe that the main goals of the

Recovery and Resilience Facility are reflected in the national plans. However, an overwhelming majority of local government associations (75% of respondents) claim that the national RRF plans respond effectively “*only to a limited extent*” to the key challenges faced by local and regional authorities.

A majority of respondents (40%) characterised their involvement as only being informed about the overall process, while approximately one-third stated that they had been consulted (mostly with limited impact on the outcome). Specific aspects of national programmes were developed without any local government involvement.

It is essential that local and regional governments also have a say in the RRF’s implementation. The financial statistics available in the country reports provide information on the attainment of the original objectives. For monitoring and evaluation purposes, the core data used by the Commission, and not only aggregate ratios, should be made publicly accessible.

Conclusions and recommendations

1. The main lesson to be drawn from the first economic downturn is that all responses to the crisis require new forms of cooperation among various government actors as well as between the public sector and private entities. The interconnected tasks of both crisis management and environmental risk mitigation call for and would highly benefit from new forms of coordination among government tiers, improved service management methods, additional and restructured investments, adjustments to local revenue to meet changing requirements, better administrative capacities, modified planning and improved budgeting practices.
2. Austerity measures should be proportional to the fiscal weight of subnational governments, legislated for all government entities in general and introduced in a straightforward, transparent way. Active fiscal policies that are financed through increased borrowing and higher general government debt impinge on the future of subnational government budgets and local capacities to invest in the green and digital transitions. These overall fiscal conditions should not augment the risk of fiscal recentralisation.
3. Administrative-territorial reforms strengthen the effectiveness of responses to climate change. These highly political administrative-territorial changes are typically initiated under favourable economic conditions, but structural reforms can only be implemented after the abatement of any financial shocks.
4. Countries with more devolved government structures continued with further decentralisation while others with lower subnational spending favoured centralisation policies. Any transfer of decentralisation methods and best practice exchanges should take this path dependency into account.
5. Subnational government capital expenditure is mainly driven by national investment programmes and grant schemes. However, there is a great deal that can be done by local governments to better the environment beyond investments in municipal services and planning.
6. Responses to the economic crisis’ fiscal challenges conform to existing patterns of revenue decentralisation in the CEMR countries. A broad revenue base and a convergence of local tax systems make local budgets more stable and financially resilient to withstand economic fluctuations. Autonomy in raising local revenue is vital in being able to regulate polluting activities. Local taxes, charges, levies and other revenue-raising options all have an indirect impact on the climate. They influence the extent to which water management, forms of transport, land use and urban planning can contribute to minimising disaster risks and reducing pollution.
7. Subnational government loans are essential for financing capital investments. Local debt issue should be regulated by a general control mechanism, which would reflect dynamic local creditworthiness and allow the higher government tier to exercise limited discretion.
8. The share of the principal RRF spending going towards green transition is higher in the decentralised countries. Stronger local and regional governments translate into more support for recovery and resilience programmes and actions. According to CEMR’s member associations, national RRF plans need to respond to key local and regional challenges more effectively. Local and regional governments should also have a say in the monitoring of RRF implementation.



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