Sub-national public finance in the European Union

December 2008

THE EUROPEAN SUB-NATIONAL PUBLIC SECTOR IN 2007: CONFRONTING THE COMING ECONOMIC CRISIS ON SOLID FINANCIAL FOOTING

In brief...

At the start of 2008, there were nearly 92 600 local, regional and federated governments in the European Union. In recent years, the process of decentralisation and reorganisation of the municipal and regional levels has continued in many countries.

In a macroeconomic environment that remained favourable in 2007 (+2.9% growth), we observed that:

– The pace of sub-national public expenditure growth slowed slightly (+2.0% in volume) to reach €1 912bn or 15.5% of GDP and 33.9% of total public expenditure. Sub-national public sector capital expenditure was not as affected and growth remained vigorous at +4.5% in volume. Rising to €209bn in 2007, sub-national investment made up two-thirds of public investment;

– Revenues from the sub-national public sector (+3.8% in volume in 2007) increased at a faster rate than spending, taking advantage of good economic conditions, finance reforms as well as European funds inflows, especially in the new Member States.

Because of these factors, the sub-national public sector recorded a slight budgetary surplus in 2007 leading to a decrease in outstanding debt, which stood at €1 205bn or 9.8% of GDP and 16.6% of overall public debt.

At a time when sub-national governments are facing the economic crisis forecast for 2009, sub-national governments are in a rather positive financial position, despite strong disparities among countries.

Highlights…

- ***Municipal reorganisations*** *in Denmark, Latvia, Finland, the United Kingdom, etc.*
- ***Regional reforms*** *in Germany, Spain, Denmark, Latvia, etc.*
- *Education and social protection: two top sectors for intervention.*
- ***Numerous reforms of local finances*** *are underway or planned in Denmark, Bulgaria, Slovenia, Germany, Spain, Italy, Belgium, etc.*
- *Budget stability programmes could be in jeopardy because of* ***the financial and economic crisis*** *of September 2008.*

MACROECONOMIC WEIGHT OF THE SUB-NATIONAL PUBLIC SECTOR IN THE EU27

	Amounts (€bn)	% of GDP		% total public sector		Average growth in volume	
	2007	2002	2007	2002	2007	2002-2007	2006-2007
PUBLIC EXPENDITURE							
Sub-national	**1 912**	15.5	15.5	33.2	33.9	+2.4%	+2.0%
Local	**1 547**	12.0	12.5	25.7	27.4	+3.2%	+2.5%
PUBLIC INVESTMENT							
Sub-national	**209**	1.7	1.7	71.8	66.6	+2.8%	+4.5%
Local	**200**	1.6	1.6	67.4	63.7	+3.2%	+4.5%
PUBLIC REVENUE							
Sub-national	**1 916**	14.9	15.5	33.8	34.5	+3.2%	+3.8%
Local	**1 546**	11.7	12.5	26.6	27.9	+3.7%	+3.8%
PUBLIC BUDGET BALANCE							
Sub-national	**+5**	-0.6	+0.0	-	-	-	-
Local	**+0**	-0.3	+0.0	-	-	-	-
PUBLIC DEBT (as of December 31)							
Sub-national	**1 205**	9.8	9.8	16.3	16.6	+2.2%	-1.8%
Local	**691**	5.5	5.1	9.2	9.5	+2.6%	-1.4%

DEXIA

Methodology

Data

The main source of statistical data is Eurostat, completed by the national statistical systems of the EU Member States. Classifications and data are based on the European System of National and Regional Accounts (ESA95), the common reference in matters of national accountancy for EU Member States. All statistical data in this study was extracted in October 2008. Figures may still be modified until national accounts are deemed final, i.e. three years after their reference date.

Please note that:

- in Ireland, the Health Boards were reassigned to the central State accounts on January 1, 2005. For comparison purposes, data for the local public sector (expenditure, revenue and investment) has been estimated for previous years.
- investment expenditure of the British public sector has also been re-evaluated for 2005 in order to neutralise an exceptional measure having negatively affected the country's central administration investment (and thus total public investment) for that year.

Definition of entities

- **Public sector:** classified as S13 under ESA95, it comprises central administrations (S1311), Federated States (S1312), the local public sector (S1313) and social security funds (S1314). Public sector data is consolidated.
- **Sub-national public sector:** it refers to the conjunction of the Federated States and their related entities (S1312) with the local public sector (S1313). Data between both sub-sectors is not consolidated.
- **Local public sector:** classified as S1313 under ESA95, it comprises local and regional governments as well as other entities included in local public administration. Data on the local public sector is consolidated. Data concerning the Spanish autonomous communities, which are classified by ESA95 as federated entities (S1312), was filed under the heading of the local public sector in this study.

Indicators

- **Public expenditure:** current and capital expenditure.
- **Expenditure by economic function:** according to the ten sectors of the Classification of Functions of Government (COFOG).
- **Staff expenditure:** employee compensation (D1).
- **Investment / capital expenditure:** gross fixed capital formation (P51).
- **Tax revenue:** taxes on production and imports (D2), income and property taxes (D5) and capital taxes (D91).
- **Public budget balance:** according to the Protocol on the excessive deficit procedure annexed to the EC Treaty, the government deficit/surplus is the net borrowing/lending of the whole general government sector.
- **Public debt:** gross debt consolidated in nominal value at the end of the year. Other payable accounts and derivative financial products are not included in the definition.

Period under review

The data under review covers the 2002-2007 period. Data on certain countries' public debt were reconstituted for the beginning of the period.

Currencies

Eurostat data was extracted in euros. Data from national statistical systems of countries outside the euro zone was converted into euros using the average annual exchange rate.

Changes

Growth rates represent changes which do not take into account inflation measured in terms of the GDP deflator (base 2000= 100).

For the 2002-2007 period, yearly averages are measured in constant euros. ■

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MACROECONOMIC ENVIRONMENT

In 2007, GDP growth in the world stood at +3.8%, which was relatively stable compared to 2006 (+3.9%). China reinforced its role as a driver of the global economy (+11.9%) while the U.S. economy slowed slightly (+2.2% in 2007 compared to +2.9% in 2006). Economic growth in the European Union went from +3.1% in 2006 to +2.9% in 2007.

Disparate economic growth

In 2007, GDP in most EU15 countries slowed compared to 2006. In a large portion of the EU12 countries, growth surpassed that of EU15 countries. Hungary is the exception with growth of barely +1.1%, Europe's lowest, followed by Italy with GDP rising +1.5%. Slovakia, which will enter the euro zone at the start of 2009, led the European Union with growth of +10.4% along with Latvia (+10.2%).

Inflation creeps higher

In the European Union, average inflation remained stable (2.3%). However, in the closing months of 2007, inflation picked up as a result of soaring oil and food prices. The rise of the euro against the US dollar kept inflation in check, however. Core inflation rose from 1.4% in 2006 to 1.9% in 2007.

POPULATION AND ECONOMIC ACTIVITY IN 2007

	GDP (€bn)	Pop. (Mio Inhab.)	GDP/EU27 GDP (%)	2006/2007 (%)
Germany	2 423	82.26	19.6	+2.5
United Kingdom	2 047	60.78	16.6	+3.0
France	1 892	63.57	15.3	+2.2
Italy	1 536	59.32	12.4	+1.5
Spain	1 051	44.87	8.5	+3.7
Netherlands	567	16.38	4.6	+3.5
Belgium	335	10.62	2.7	+2.8
Sweden	332	9.15	2.7	+2.7
Poland	309	38.12	2.5	+6.6
Austria	271	8.32	2.2	+3.1
Greece	228	11.19	1.8	+4.0
Denmark	228	5.46	1.8	+1.7
Ireland	191	4.36	1.5	+6.0
Finland	180	5.29	1.5	+4.5
Portugal	163	10.61	1.3	+1.9
Czech Republic	127	10.32	1.0	+6.0
Romania	121	21.52	1.0	+6.0
Hungary	101	10.06	0.8	+1.1
Slovakia	55	5.40	0.4	+10.4
Luxembourg	36	0.48	0.3	+5.2
Slovenia	34	2.02	0.3	+6.8
Bulgaria	29	7.70	0.2	+6.2
Lithuania	28	3.38	0.2	+8.9
Latvia	20	2.28	0.2	+10.2
Cyprus	16	0.79	0.1	+4.4
Estonia	15	1.34	0.1	+6.3
Malta	5	0.41	0.0	+3.7
EU27	**12 340**	**495.98**	**100.0**	**+2.9**

In the euro zone, average inflation slightly dropped from 2.2% in 2006 to 2.1% in 2007. Inflation in the European Union was higher than in the euro zone as the twelve new Member States experienced a stronger rise in consumer prices. Inflation in the three countries of the EU15 that are not part of the euro zone was modest: 1.7% in Denmark and Sweden, and 2.3% in the United Kingdom.

In 2007, Malta recorded the lowest inflation rate of the EU (0.7%), followed by the Netherlands, Finland and France (1.6%). Latvia (10.1%), Hungary (7.9%) and Bulgaria (7.6%) recorded the highest inflation rates.

Unemployment sharply down

Thanks to a favourable economic climate, unemployment in the European Union dropped markedly. Average unemployment rate went from 8.2% in 2006 to 7.1% in 2007, results varied greatly from country to country. In the euro zone, it reached, on average, 7.4% against 5.3% in the United Kingdom. Poland and Slovakia recorded the biggest drops in unemployment rates in 2007 but they remain, nevertheless, Europe's highest at 9.6% and 11.2%, respectively.

In 2008, economic growth in sharp decline

During the first quarter of 2008, EU GDP rose +0.6% on a quarterly basis and +2.3% on an annual basis. Over the second quarter, it slid slightly compared to the previous quarter, as growth expanded at an annualised rate of +1.7%.

Individual consumption, investments, exports and imports shrunk during the second quarter of 2008 compared to the first quarter. Consumers were hit by rising petrol prices, which pushed inflation higher and affected purchasing power. Moreover, unemployment started to steadily climb making consumers more pessimistic. Companies were confronted with sagging growth in their markets and had to cope with a rise in commodity prices and the euro, which put pressure on their order books and production and export outlooks. They limited investments for this reason.

In the second half of 2008, the financial crises burst onto the scene in Europe. Economic growth is set to be very weak in 2008 and especially so in 2009. On account of exploding petrol prices in the first quarter of 2008, inflation peaked in July at 4.5% in the EU. However, since August, inflation has once again cooled largely, partly as a result of the collapse of petrol prices. In 2008, economic growth in the European Union should reach +1.4% and average inflation 3.9%.

PUBLIC FINANCES

EU27 KEY PUBLIC FINANCE INDICATORS

In %	2002	2003	2004	2005	2006	2007
Public expenditure / GDP	46.7	47.3	46.9	46.9	46.3	45.8
Public investment / GDP	2.3	2.4	2.4	2.4	2.5	2.5
Public investment / public expenditure	4.9	5.1	5.1	5.2	5.4	5.6
Public investment / total investment	11.8	12.4	12.2	12.1	12.0	11.9
Public revenue / GDP	44.2	44.2	44.0	44.4	44.9	45.0
Budget balance / GDP	-2.5	-3.1	-2.9	-2.4	-1.4	-0.9
Public debt / GDP	60.3	61.8	62.2	62.7	61.3	58.7

Decreasing weight of public expenditure as part of GDP

In 2007, public expenditure in EU27 countries reached €5 650bn or nearly €11 400 per capita and 45.8% of GDP. These averages do not reflect the diversity of the public sector's role in European countries. In nine countries, public expenditure as part of GDP is above the European average. In Sweden, France and Denmark, it is even above 50%. By contrast, it is below 40% in Spain, Luxembourg, the Baltic countries, Romania, Ireland and Slovakia.

Since 2002, the weight of public expenditure in GDP has tended to fall slightly (-0.9 point). The drop was particularly marked in 2007 (-0.5 point). In all, 19 countries recorded a drop in 2007, sometimes significant, as was the case in Slovakia, Slovenia and Hungary (more than 2 points). Only eight countries saw public expenditure to GDP expand, in particular, Greece, Lithuania and Ireland (between 1.5 and 1.7 additional point), Romania (2 additional points) and Bulgaria (nearly 5 additional points).

Strengthening weight of public capital expenditure as part of GDP and of public expenditure

Public investment spending in the countries of the EU27 rose to €314bn in 2007 or €630 per capita. Public investment to total investment in the EU27, all economic actors combined (households, companies, governments) was 11.9%. Public investment as a proportion of GDP was 2.5%. This has been rising slightly since 2002. While the weight of investment in total public expenditure is relatively low (5.6% in 2007), it has been steadily climbing in the last several years, notably in 2007.

Slight increase in public revenue as part of GDP

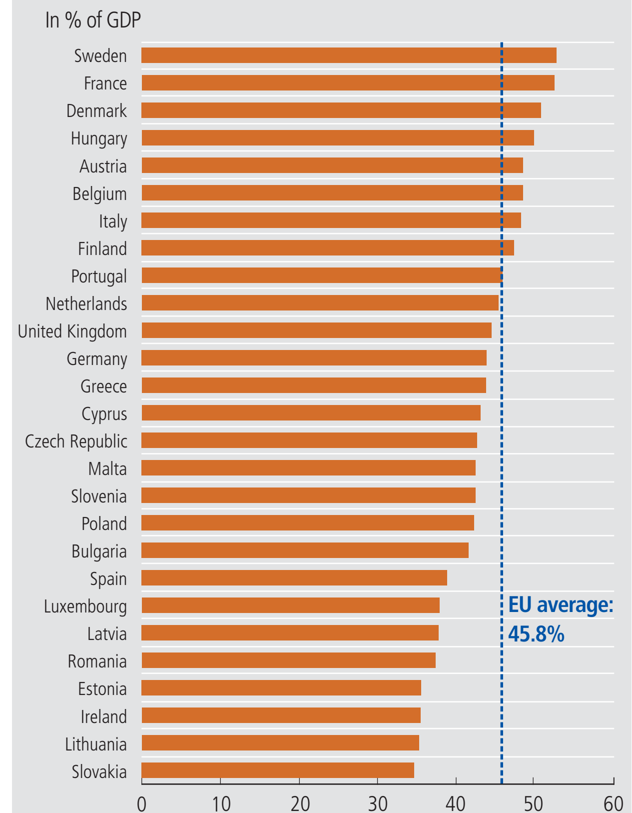
Public administration revenues in the EU27 reached some €5 550bn in 2007 or 45.0% of GDP. This percentage is particularly high in the Nordic countries where it surpasses 50%. In contrast, it is below 35% in Lithuania, Romania and Slovakia. It increased slightly between 2002 and 2007 (+0.8 point of which 0.1 point this past year). In 2007, however, public revenues as a percentage of GDP went down in ten countries, most notably in Ireland, Denmark and Slovakia.

New drop in the public deficit

Begun in 2004, the reduction of the public deficit of the EU27 was particularly strong in 2007. The deficit reached €106bn in 2007, which represents levels one-third of where they were in 2003 (€312bn). This came as a junction of increasing public revenues and better control of expenses, notably in 2006 and 2007.

For the first time, the weight of the deficit as a part of GDP is less than 1% (0.9%), while, in 2006, it rose to 1.4% and even

PUBLIC EXPENDITURE/GDP IN 2007



3.1% in 2003. Between 2006 and 2007, 16 countries improved their budget balances, three such countries turned their deficits into surpluses (Cyprus, Latvia and Slovenia). Of the 11 countries whose budget balance worsened, only Belgium slipped from a surplus in 2006 to a deficit in 2007 (-0.3 point). Five other countries had increasing deficits: France, Lithuania, Romania, the United Kingdom and Greece.

In all, 12 countries were in the black in 2007 including the three Nordic countries, Cyprus, and Luxembourg which recorded a surplus of over 3% of GDP. Greece and Hungary are the lone countries that did not respect the 3% limit set by the Maastricht Treaty with negative balances of -3.5% and -5%, respectively.

Significant drop in the weight of public debt

In 2007, public debt in the EU27 reached nearly €7 250bn. Between 2002 and 2005, this debt as a proportion of GDP increased, ever since it has dropped significantly and, in 2007, it stood at 58.7%, which meant that the EU taken as a whole was under the 60% bar set by the Maastricht Treaty.

Between 2006 and 2007, 21 countries experienced a decrease in their debt/GDP ratio; the strongest drops were recorded in the three Nordic countries, Cyprus and Bulgaria (between -4 and -5.5 points) as well as in Belgium and Spain. Debt as a proportion of GDP climbed in six countries including (from lowest to highest) Ireland, Hungary, France, Luxembourg, Romania and the United Kingdom (from 0.1 to 0.8 GDP point)

In all, eight Member States had public debt levels above 60% of GDP in 2007. Belgium, Greece and Italy greatly exceeded this limit, with debt levels of 84%, 95% and 104%, respectively. While Malta and Hungary are included in this group, most of the other new Member States have a low public debt ratio (less than or equal to 30% of GDP for 8 among them).

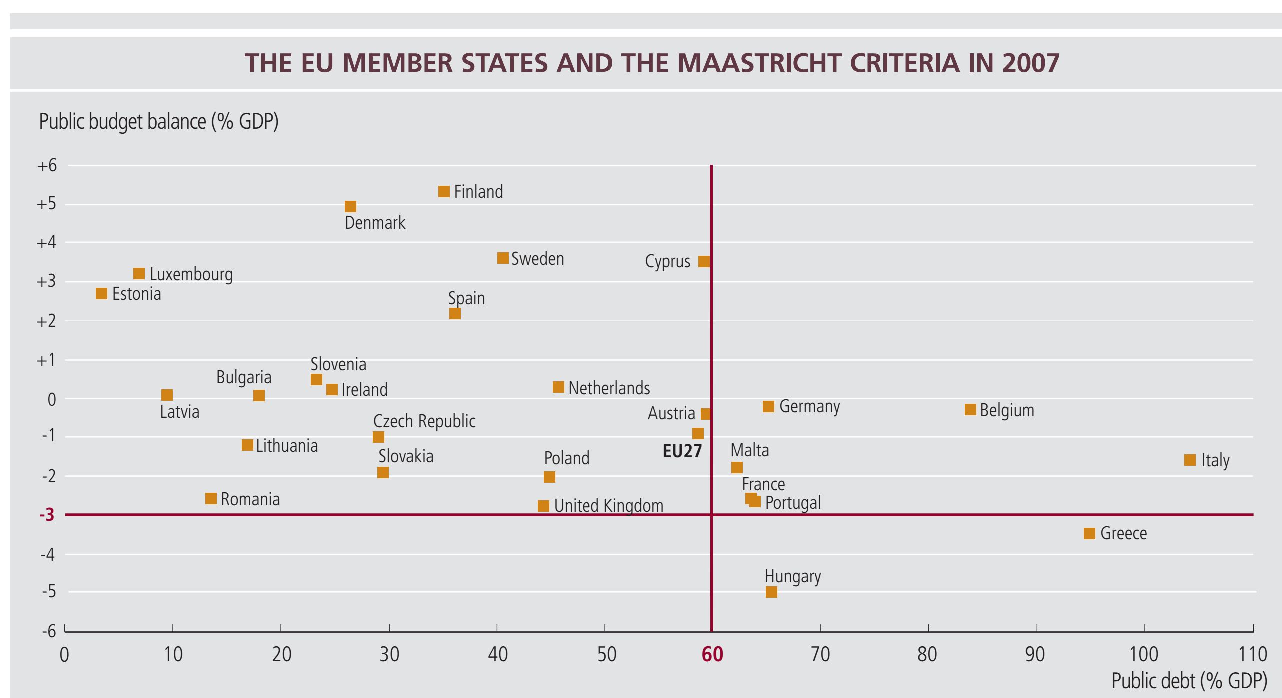
Deteriorating public finances in 2008...and beyond

In 2008, the poor economic outlook is likely to affect the public finances of the EU27.

According to the European Commission's autumn economic forecasts, and assuming policies remain in place, the public deficit is expected to rise steadily at the EU level moving from 0.9% of GDP in 2007 to 1.6% in 2008, 2.3% in 2009 and 2.6% in 2010. Public debt is also expected to grow from 59.8% of GDP in 2008 to 60.9% in 2009 reaching 61.8% in 2010. This deterioration of public finances is predicted to be the consequence of expanding public spending combined with the expected drop in revenues, particularly in tax revenues.

The negative consequences of the economic and financial crisis on public finances are likely to affect all European countries. While trends in the last few years have allowed for several Member States to put an end to the excessive deficit procedures in 2007 and 2008 (in 2008, Hungary and the United Kingdom were the only remaining countries to which this procedure applied), at least five other countries are expected to be subjected to the procedure in 2009: France, Ireland, Latvia, Lithuania and Romania.

Because of the "extraordinary circumstances" created by the financial and economic crisis the Commission has pledged to be more flexible with Member States by giving them time to improve their economic situation. ■



TERRITORIAL ORGANISATION

Nearly 92 600 sub-national governments in the European Union in 2008

The European Union is comprised of 27 Member States including three with a federal structure (Germany, Austria, Belgium), two regionalised States with a quasi-federal structure (Spain and Italy) and 22 unitary States, some of which do not have a homogenous territorial organisation (Portugal, United Kingdom, etc.). In 2008, sub-national governments numbered 92 564 and were broken down, depending on the country, into one, two or three levels. In all, eight countries have just one level, twelve have two levels and the remaining seven have all three.

The lowest level, corresponding to the municipal level, includes some 91 316 municipalities that are unevenly distributed throughout the European Union. Nearly 80% of them are located in just five countries: France (40% of European municipalities), Germany (14%), Spain and Italy (both at 9%) and the Czech Republic (7%).

The second level includes 1 144 authorities, which are either at the "intermediary" level in the large countries with three levels (Spain, France, Poland, etc.) or at the "regional" level in the countries with two levels that have smaller populations (the Netherlands, Sweden, Hungary, Slovakia, the Czech Republic, etc.). In Austria, this corresponds to the Federated States.

The third level includes 104 very diverse authorities: regions in the large unitary States (France and Poland), Federated States in the federal countries (Germany and Belgium), regions with a relatively strong autonomy and their own or a delegated legislative power in the regionalised or unitary countries, whose structure is becoming more and more like countries with a federal structure (Spain, Italy, United Kingdom).

A heterogeneous municipal level

The average European municipality has 5 430 inhabitants in 2008 over a surface area of nearly 50km². These averages hide significant disparities, however. The average size of municipalities ranges from 5km² in Malta to 1 550km² in Sweden. Demographic size of municipalities varies from 1 500 inhabitants in Cyprus to 140 000 in the United Kingdom. With fewer than 2 000 inhabitants on average, municipalities in Cyprus, the Czech Republic, France and Slovakia are the least populated in Europe.

On the other end of the spectrum, seven countries have municipalities of over 30 000 inhabitants. In Denmark, Lithuania and in the United Kingdom, populations even reach 55 000. The United Kingdom is, however, a separate case as its 434 local authorities, which have statutes that vary tremendously depending on their geographic location and on the nation, are, for the most part, "mega-municipalities". They are themselves subdivided into 11 200 parishes or communities. This type of municipal sub-division is common in other countries, often those that have large municipalities such as in Lithuania, Portugal, Bulgaria, Slovenia and Italy. These "localities", which are sometimes given a legal statute, can play an important role with regards to local democracy and the management of certain local public services.

EIGHT COUNTRIES WITH ONE LEVEL OF SUB-NATIONAL GOVERNMENT

Country	Municipal level
Bulgaria	264 municipalities
Cyprus	524 (378) local governments: 33 (24) municipalities & 491 (354) rural communities[1]
Estonia	227 municipalities (194 rural municipalities & 33 cities)
Finland	415 municipalities
Lithuania	60 municipalities (48 districts, 6 towns & 6 municipalities)
Luxembourg	116 municipalities, including 12 cities
Malta	68 local councils
Slovenia	210 municipalities, including 11 urban municipalities

(1) Data in parentheses does not include the northern part of Cyprus

Municipal organisation in perpetual movement

The number of municipalities changes each year as a result of territorial reforms, the principal goal of which is to compensate for the small demographic size of municipalities and to improve management of local public services. In Europe, reforms take shape in two different ways.

• **Encouraging the merger of municipalities**: in several countries, the merger process is mostly progressive with only a small number of municipalities merging each year e.g. the Netherlands.

TWELVE COUNTRIES WITH TWO LEVELS OF SUB-NATIONAL GOVERNMENT

Country	Municipal level	Regional level
Austria	2 356 municipalities (14 statutory cities, 183 towns, 759 markets & 1 400 villages)	9 Federated States
Czech Republic	6 248 municipalities (24 statutory cities, 535 towns & 5 689 municipalities)	14 regions
Denmark	98 municipalities	5 regions
Greece	1 034 local governments (914 municipalities & 120 communities)	50 departments
Hungary	3 175 municipalities (23 towns with county statute, 274 towns, 2 854 villages, Budapest & 23 city districts)	19 counties
Ireland	114 local councils (29 counties, 5 cities, 75 towns & 5 boroughs)	8 regional authorities
Latvia	524 municipalities (7 republican cities, 52 towns, 37 amalgamated municipalities & 428 rural municipalities)	26 districts
Netherlands	443 municipalities	12 provinces
Portugal	308 municipalities	2 autonomous regions
Romania	3 176 local authorities (2 856 rural municipalities, 320 urban municipalities including 217 towns & 103 municipalities)	42 counties (41 counties & Bucarest)
Slovakia	2 891 municipalities including 138 cities	8 regions
Sweden	290 municipalities	20 (18 county councils & 2 regions)

SEVEN COUNTRIES WITH THREE LEVELS OF SUB-NATIONAL GOVERNMENT			
Belgium	589 municipalities	10 provinces	6 communities and regions
France[2]	36 683 municipalities	100 departments	26 regions
Germany	12 379 municipalities (12 263 municipalities & 116 district-free cities)	313 rural districts	16 Federated States
Italy	8 101 municipalities	107 provinces	20 regions
Poland	2 478 municipalities (307 urban municipalities including 65 with county statute, 1 587 rural municipalities & 584 mixed municipalities)	314 counties	16 regions
Spain	8 111 municipalities	50 provinces	17 autonomous communities
United Kingdom	434 local governments (unitary authorities, metropolitan authorities, district councils, council areas & London boroughs)	34 county councils & the Greater London Authority	3 devolved nations (Scotland, Wales and Northern Ireland)

(2) Including overseas departments and regions

However, mergers can also take place on a wider scale such as in Denmark where, in 2007, a territorial reorganisation cut by nearly 3 the number of municipalities (from 270 to 98). In Latvia, the gradual implementation of "merged municipalities", started in 1998, has shifted into high gear. In fact, by 2009, 112 municipalities will have replaced the 524 that exist today. In Finland, the Act on the Restructuring of Local Government and Services, implemented in 2007, ties certain local services to minimum population levels and provides financial incentives for municipalities to merge. In 2009, they will have been cut down to 348 from 415 in 2008. In Northern Ireland, the regional government decided, in March 2008, to reduce the number of district councils from 26 to 11 and to give them additional competencies. They will be up and running after local elections in May 2011. In England, the White Paper published in October 2006 encouraged replacing the current two levels with one for rural areas. This will lead to the creation of ten unitary authorities and the abolition of 44 county and district councils in 2009.

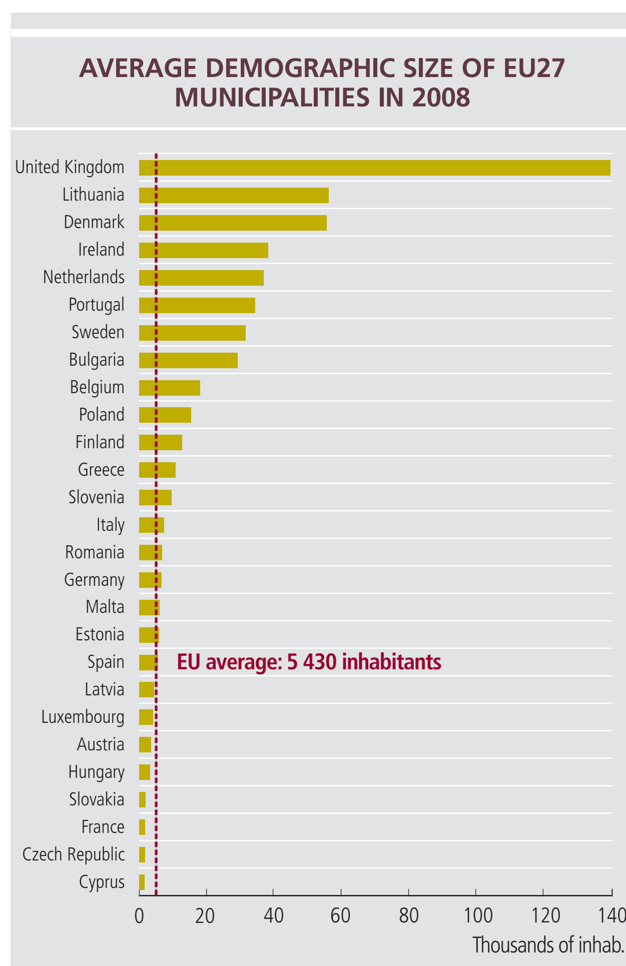
• **Developing inter-municipal cooperation:** in Austria, the Revenue Sharing Act 2008-2013 will put in place financial incentives encouraging inter-municipal cooperation. In Poland, the government is currently preparing a law that would create 12 metropolitan areas, which could notably be responsible for strategic planning of territorial development, transport and environmental protection. In Hungary, the government – as part of its policy to rationalise public services – strengthened the "multi-purpose micro-regional associations of local self-governments" (174 in 2008). In France, almost all municipalities are part of an inter-municipal grouping with own-source tax revenue. The issue of redrawing the inter-municipal map is now, like in Belgium, up for consideration.

Growing regionalisation on the European level

In nearly all Member States, a movement towards greater regionalisation has been underway for the last twenty years but in various ways.

• **Strengthening existing regions**: the majority of Member States that already have regions continue to strengthen their autonomy, competencies and resources. One such example is found in Germany and its reform of federalism that began in 2006 and France as it continues to implement the 2004 Act on decentralisation (new transfers of competencies and staffing in 2007 and 2008). In Spain, reforms of the statutes of autonomy, begun in 2006 with Valencia and Catalonia, expanded in 2007 and 2008 to include five other autonomous communities, which allowed them to increase their responsibilities in matters of taxation, administration and infrastructure management.

• **Reorganising or creating a regional level:** over the last ten years, regions have been created or reorganised in the United Kingdom (devolution in 1998), Poland (1999), the Czech Republic (2000), Slovakia (2002) and, more recently, Denmark where 5 regions replaced the 13 counties on 1 January 2007. Since their



creation, most of these regions have also seen their competencies expand.

• **Experimenting with regionalisation:** experimental regional programmes gave temporary regional status to Västra Götaland and Skåne in Sweden and to Kainuu in Finland by transferring additional competencies to them. Following a report published in May 2008, the Swedish government indicated that regionalisation would be applied to the whole country before 2015 by making the regional status of the two pilot regions permanent and progressively merging what are now counties into new regional entities.

• **Regionalisation planned or debated:** in Latvia, plans have been in the works since 1998 to replace the 26 districts (to be abolished in 2009) with regions (between 5 and 10) that would have a wider range of responsibility. In Slovenia, regionalisation – scheduled for 2009 – has been put off to a later date following the Parliament's refusal of the reform in the spring of 2008 coupled with low voter turnout for a consultative referendum on the subject held in June 2008. In Portugal, an initiative to create eight regions, rejected by referendum in 1998, could be put back on the agenda in 2009, which is an election year both at the local and national levels. In Greece, where the subject has been under review since 2003, the current government has put the item back on the agenda and is considering creating regions that would be indirectly elected by the departmental councils.

In other countries, particularly Hungary, Lithuania and Romania, this issue is also being considered (transforming planning regions or State regional administrations to regional self-governments, merger of level two entities to create larger regions).

The regionalisation process in Europe over the past 10 years

OTHER TERRITORIAL REFORMS UNDER CONSIDERATION

In France, a committee for reforming local authorities was put in place in October 2008 in order to elaborate proposals, to be submitted no later than February 2009, that aim to simplify territorial organisation, to clarify the distribution of competencies and to improve allocation of financial resources.

In Greece, besides creating regions, the government is also considering halving the number of municipalities (from 1 034 to between 400 and 500). Athens and Thessaloniki, as part of this initiative, would implement municipal sub-divisions.

In Ireland, the April 2008 Green Paper on local authorities aims to strengthen local authorities through the provision of directly elected mayors in counties and cities, the promotion of participative democracy and the implementation of specific structures both in large towns (city mayor, unitary authority covering the county and city, etc.) and in Dublin (introduction of a directly elected "regional mayor"). A consultation process has been organised at the local level and will serve as the basis for a White Paper to be published in early 2009.

In Malta, a public hearing on the reform of the local governance system was launched in June 2008. It will examine, among other things, the statute of mayors, the modalities surrounding their re-election, the ways in which local councils are funded as well as the ways to encourage cooperation between councils in order to better carry out public services. Its conclusions are expected before the end of 2008.

In Estonia, discussions on territorial organisation are currently underway. Proposals include trimming municipalities to between 80 and 120 or transforming the 15 counties (State territorial administration) to local authorities. In the latter, the municipal level would be composed of just the 15 former counties and 4 to 10 current large towns.

In Luxembourg, the government introduced its territorial reorganisation project at the end of January 2008 that should redraw the municipal map by 2010 (applicable for the municipal elections in 2017) based, notably, on the creation of urban communities.

EXPENDITURE AND INVESTMENT

EXPENDITURE AND INVESTMENT							
In 2007	€bn	€/inhab.	% of GDP	% of public	% of expenditure	Change 2002/2007	Change 2006/2007
Expenditure							
Sub-national	1 912	3 856	15.5	33.9	-	+2.4%	+2.0%
Local	1 547	3 119	12.5	27.4	-	+3.2%	+2.5%
Investment							
Sub-national	209	421	1.7	66.6	10.9	+2.8%	+4.5%
Local	200	403	1.6	63.7	12.9	+3.2%	+4.5%

Nearly €2 000bn in sub-national public sector spending in 2007

In 2007, expenditure in the European sub-national public sector reached €1 912bn. Excluding the Federated entities (€365bn), expenditure was €1 547bn. Nearly three-quarters of this expenditure occurred in the EU's five biggest countries: Germany (24%), the United Kingdom (14%), Italy and Spain (both at 12%) and France (11%). The twelve new Member States represented nearly 5% of this spending, including 2.2% by Poland.

Economic weight varies from country to country

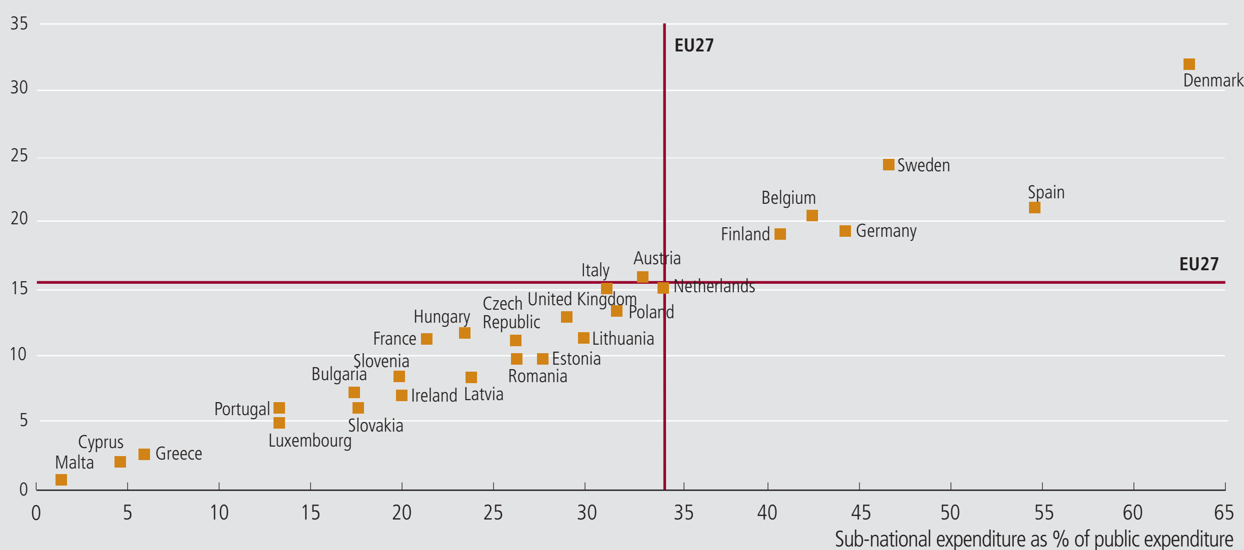
On average, sub-national public expenditure represents 15.5% of EU GDP and 33.9% of all public expenditure (for the local level alone: 12.5% and 27.4%, respectively). This weight varies tremendously from country to country.

Denmark is the country in which the economic weight of the local public sector is the most important: local public spending reached 32.0% of GDP and 63.1% of overall public spending. This weight is also important in Finland and Sweden, in the regionalised countries (Spain and Italy), the three Federal States (Germany, Belgium and Austria) and the Netherlands. In these nine countries, local authorities and/or the Federated States have wide-ranging competencies and the important role played by the sub-national public sector in most of these countries is the result of a long tradition of local autonomy. For Spain and Italy, it is more recent and is due to successive waves of decentralisation over the last thirty years.

At the opposite end of the spectrum, in countries such as Malta, Cyprus, Greece, Luxembourg and Portugal, the economic weight of the local public sector is more modest. In these countries, local public spending represents less than 7% of GDP and 15% of overall public spending. Malta is at the bottom of the list with 0.6% and 1.4%, respectively. Local authorities have fewer responsibilities in these countries, which might be due to their geographic size and/or to the traditionally strong role of the central State.

France, the United Kingdom, Ireland and the new Member States occupy a middle ground with ratios varying from 7% to

ECONOMIC IMPORTANCE OF SUB-NATIONAL PUBLIC SECTOR EXPENDITURE IN 2007



13% of GDP and between 17% and 32% of overall public spending. Poland is singled out with the highest ratios of this group. The position of these countries is changing quickly. Reforms decentralising and reorganising the territory have been underway for several years and have led to a higher local spending/overall public spending ratio (e.g. more than 9 points in Slovakia and Romania between 2002 and 2007).

In 2007, a slight dip in growth of EU27 sub-national public spending

In 2007, sub-national public sector expenditure grew +2.0% in volume, a growth rate slightly higher than that of overall public spending (+1.7%) but which is lower than both GDP growth (+2.9%) and the growth over 2002-2007 (+2.4% in volume per year on average).

This growth was significantly more robust in the new Member States than in the EU15 (+4.3% versus +2.0% in volume in 2007), a trend that confirmed the 2002-2007 evolution (+5.5% in volume per year on average in the new Member States versus +2.3% in the EU15).

Moderate 2007 growth in the EU15

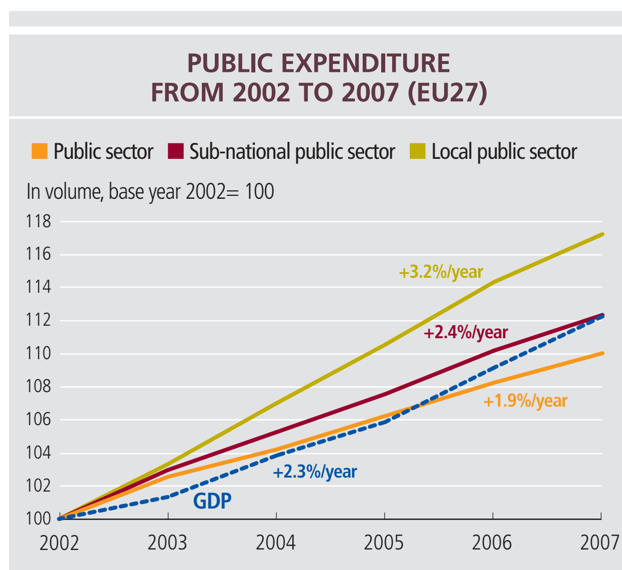
In the countries of the EU15, moderate sub-national expenditure increase (+2.0%) is due to several countries, in particular the three federal countries (drop in spending by the Federated States in Germany and Austria and, for Belgium, a reduction in municipal spending), Denmark (-2.5%) and Italy (-1.9%) where policies restricting expenditure and budget deficits have been implemented. In the majority of countries, the trend in 2007 follows past trends from 2002-2007 with average annual growth rates of between 0 and +1.5%. Moreover, in Denmark, 2007 was the first year that the territorial reform has been up and running. A reallocation of expenditure, particularly of spending on investment (-15.7%) and personnel (-2.9%) has come as a result of the transfer of 15 000 employees from the counties to the State, the implementation of new entities (merged municipalities, five new regions) and, finally, the reorganisation of competencies between these various players.

Elsewhere in the EU15, local public expenditure development was slightly higher, even significantly stronger in such countries as Ireland (+13.6%), Luxembourg (+11.4%) and Spain (+5.4%) – three countries faced with robust demographic growth due to immigration that has subsequently increased demand for childcare centres, schools, family and social programmes, healthcare spending, etc.

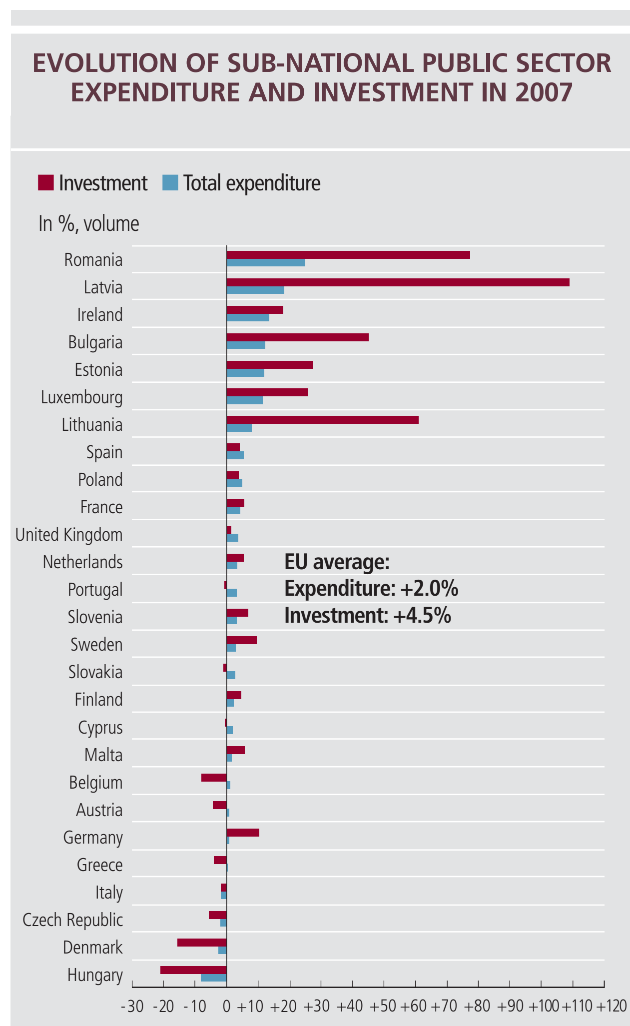
In France, the increase (+4.4%) of local expenditure was mostly the result of continued transfers in social and personnel competencies. Local expenditure for social services climbed +16% per year in volume between 2002 and 2007 while spending on staff grew +5.6% in 2007 (120 000 State jobs were transferred to regions and departments). In Portugal (+3.2%) and the Netherlands (+3.4%), local public expenditure grew in 2007 after several years of stagnation or decline.

In the Netherlands, this is the result of the implementation of a new social aid law that, in 2007, shifted at-home care and financial aid to the elderly, sick and handicapped to municipalities.

PUBLIC EXPENDITURE FROM 2002 TO 2007 (EU27)



EVOLUTION OF SUB-NATIONAL PUBLIC SECTOR EXPENDITURE AND INVESTMENT IN 2007



Stronger growth in new Member States in 2007

Local public expenditure growth remained relatively strong on average in the twelve new Member States over 2007 (+4.3% in volume). However, this was down slightly compared to 2002-2007 (+5.5% in volume per year on average), which was a period when, in some countries local authorities and in some cases newly-created regions, took on greater competencies and technical, human and financial resources. It was also a period of robust economic growth.

In 2007, local expenditure growth was particularly strong in the three Baltic countries and especially so in Bulgaria (+12.2%) and in Romania (+24.9%), which reflects the impact of their entry in the European Union as well as the implementation of decentralisation policies in these two countries. In Romania, for example, the explosion in 2007 of investment expenditure, social services (+28%) and intermediate consumption (+12%) was caused in part by the implementation of the framework law on decentralisation, passed in 2006.

After years of increases, local expenditure slowed down in 2007 in a few countries especially Hungary (-8.2%) and the Czech Republic (-1.9% versus +5.7% over 2002-2007). This was largely the result of budgetary restrictions tied to deteriorating public finances. In Hungary, this came on top of the impact of a recent programme reforming local authorities and reorganising public services at the micro-regional level.

Over €200bn for sub-national public sector capital expenditure

Sub-national public sector capital expenditure reached €209bn in 2007. More than 95% of such spending came from the local public sector (€200bn).

Sub-national players of the five largest countries of the European Union are responsible for approximately 72% of sub-national public investment in Europe. France ranks first at the EU level, with €45bn or 22% of all sub-national investment expenditure in Europe. Spain follows with 14%, Germany and Italy with 13% and the United Kingdom 10%. The weight of the twelve new Member States is greater for investment than for expenditure (€19bn or 9.0% of overall investment) and Poland, Romania and the Czech Republic lead the new Member States with a combined 6.7%.

The disparate weight of capital expenditure in sub-national budgets

While investment in Europe takes up 11% of sub-national budgets on average (13% for the local public sector alone), in more centralised countries it is significantly higher (Ireland 44%, Luxembourg 32%, Portugal 25% while the new Member States average is 20%). These ratios illustrate the fact that, in these countries, local authorities play more the role of an investor rather than a public service manager.

By contrast, in countries such as the Nordic countries, the Federal States or the United Kingdom, countries in which ratios

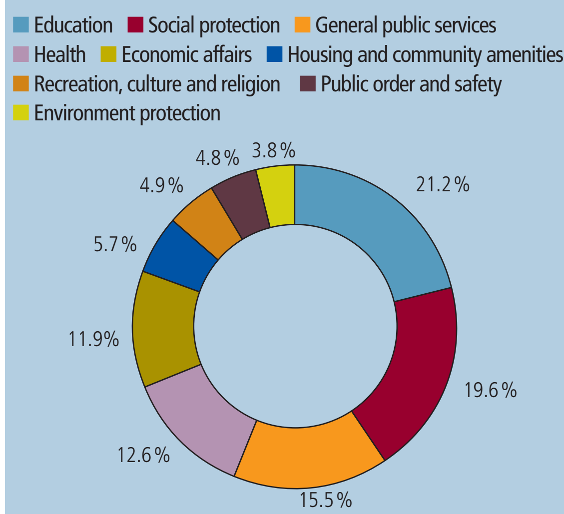
EDUCATION AND SOCIAL PROTECTION ARE THE MAIN SUB-NATIONAL EXPENDITURE POSTS

Education spending (21.2% of sub-national public spending) dominates sub-national budgets in Central and Eastern European countries, ranging from 29% of expenditure in Poland in 2006 to 46% in Estonia. This importance is attributed, in part, to the fact that local authorities are responsible for spending related to both facilities and salaries for primary and secondary school teachers. This expenditure is also significant in the United Kingdom where education is extensively decentralised (32%) and in Belgium, the Netherlands and Luxembourg (between 25% and 32%).

Social welfare spending (19.6%) takes up a sizeable portion of sub-national budgets in countries like the three Nordic countries (51% in Denmark), the United Kingdom (28%) as well as Austria and Germany where their importance has been rising markedly in recent years.

The weight of healthcare expenditure has been on the rise since 2005 growing from 10.4% to 12.6%. It is significantly higher in countries where authorities at the "regional" level are responsible for all, or a part of, managing public hospitals or in countries in which municipalities are heavily involved in healthcare. Examples include Italy, a country in which healthcare spending represents 45% of local public sector spending, Spain (25%), Austria (22%) and in the three Nordic countries (between 21%-29%). In the new Member States, it is not as significant except in Lithuania (21%), Poland (15%) and Hungary (15%) where local authorities manage health services and infrastructure.

BREAKDOWN OF SUB-NATIONAL EXPENDITURE BY ECONOMIC FUNCTION IN 2006



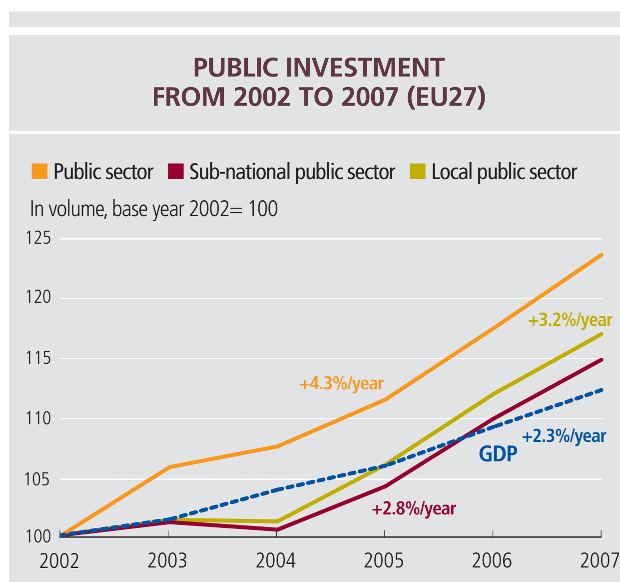
are below 10%, the weight of operating expenses is more significant because of the wider range of competencies in areas such as social protection and education.

Sub-national investment: more than two-thirds of public investments

In 2007, sub-national public sector investment represents, on average, 1.7% of EU GDP. In the new Member States this reached 2.2% of GDP and even 3% in Latvia, 2.8% in Romania and 2.5% in Poland. As a percentage of overall investment, both public and private, it represents 8.0% on average in the EU. This ratio is above 11% in four countries: France, the Netherlands, Poland and Ireland.

On average, 66.6% of public investments in the EU are made by the sub-national public sector (63.7% for the local sector alone). This ratio differs significantly from country to country, varying from 4.2% in Malta to 86.4% in Belgium. It is over 72% in the three Federal States where, in addition, local levels represent the majority of sub-national public investment (Austria 47%, Belgium 48%, Germany 57%). It is also high in strongly decentralised countries such as Italy, Spain, the Netherlands, Denmark and Finland. In these countries, local authorities are in charge of most public infrastructure needs, especially in the areas of education, healthcare and transport. For example, in Italy (77%) and Spain (70%), hospital investments are made by the sub-national public sector.

Sub-national public investment/public investment ratios are also high in the more centralised countries such as Ireland (76.1%), France (73.1%), Portugal (64.6%), which along with the Netherlands are countries in which investing is a fundamental responsibility of local authorities. In Ireland and the Netherlands, local authorities have limited discretionary authority in this area and most often they serve as a relay for the State in the implementation of major national investment projects.



In 2007, growth in sub-national public investments remains high, especially in the new Member States

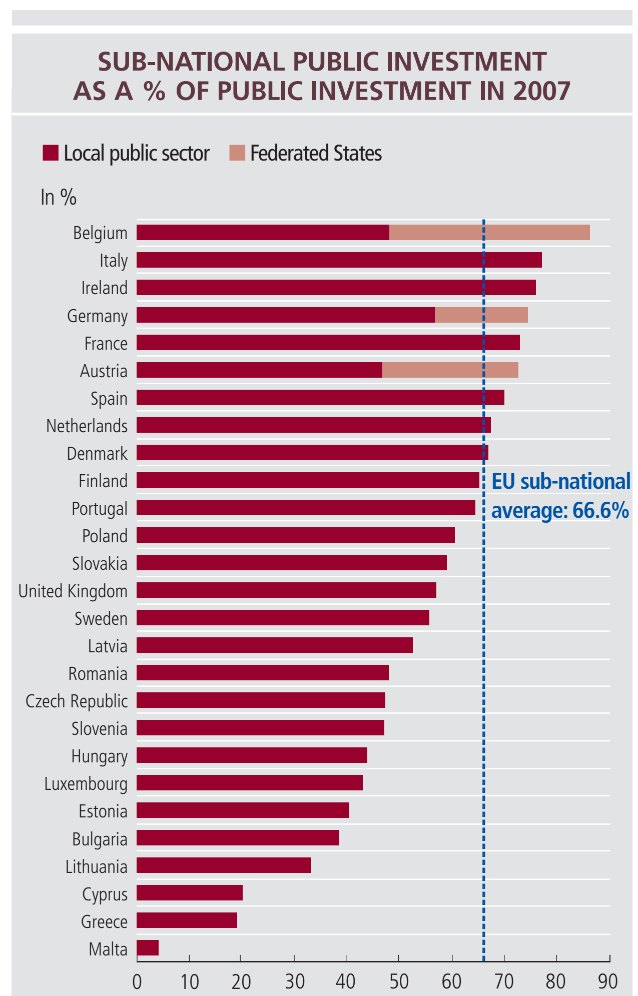
The trend, that was started in 2005, continued in 2007 as the robust sub-national public sector capital expenditure growth of +4.5% in volume (the same as public sector alone). This represented a growth rate far greater than GDP growth (+2.9%) and total sub-national public expenditure (+2.0%) and the annual average from 2002-2007 (+2.8% and +3.2% for just the local public sector), as well.

Differences in trends, however, emerge between countries of the EU15 and the new Member States. In the latter, while local public investment growth was lower than in 2006, it remained very strong for the majority of countries: +11.0% in 2007 whereas in the EU15 it was a mere +3.9%.

Factors affecting investment levels in 2007

At the level of each individual country, overall trends result from the combination of multiple factors, which can converge and grow off each other (especially if they are interdependent) or conversely, oppose one another and negate each other.

Besides structural factors (decentralisation, population needs, etc.) which continued to produce effects in 2007 (see table p.14),



several more cyclical events emerged over the year that had positive or negative consequences on sub-national public sector capital expenditure.

• *Sub-national revenue evolution in 2007*

Increasing revenues allowed sub-national governments to improve their room for manoeuvre and to jump start robust investment policies. In many EU countries and in particular the new Member States, this has been the case, no more so, however, than in Germany as its local authorities are largely dependent on the business cycle. German sub-national public sector investment grew +10% in 2007 whereas, between 2002 and 2005, it contracted. Conversely, slipping local revenues in 2007 helps explain the decrease in other countries.

• *Impact of local and regional electoral cycle*

In 2007, local authorities in several countries scrambled to speed up and finish projects before upcoming elections. Local and regional elections towards the end of 2007 or in 2008 may have contributed to this marked increase in local investment spending in Bulgaria, Finland, France and in Romania.

However, the slower increase or in some cases decrease of sub-national investment, can in part be blamed on post-election effects i.e. the newly-elected teams took advantage of this period to prepare projects for the term to come. This could explain sub-national investment trends in Belgium, Cyprus, the Czech Republic, Greece, Hungary, Poland and in Slovakia.

• *Impact of cohesion policy*

The impact of cohesion policy was quite disparate in 2007. The closure of structural fund 2000-2006 or 2004-2006 programmes accelerated in 2007, the deadline for transfers being the end of 2008. The ten new Member States, for which financing began in March 2004, greatly improved their absorption rates (39% on average at end 2006 to 75% at end 2007). For most of them, community co-financing undoubtedly continued to have a substantial impact on strong local investment rates in 2007.

In the EU15, the impact was perhaps not as pronounced, the average absorption level was already quite high at end 2006 (68%) rising to 84% at year end 2007. Despite 2007 marking the beginning of a new programming cycle (2007-2013), the year got off to a slow start. In fact, the first transfers in 2007 by the European Commission reached approximately €7bn or just 2% of the total allotted for structural and cohesion funds for the new cycle of operating programmes.

• *Stiffening budget measures*

Sub-national governments in several countries were forced, in 2007, to maintain or strengthen budget discipline rules. This might have resulted in tightened investment spending, particularly in Italy, Austria, Belgium, Portugal and, for the first time, Hungary (-21% in 2007 against +21% in 2006) and in the Czech Republic (-6% in 2007 versus +16% in 2006).

• *Exceptional events*

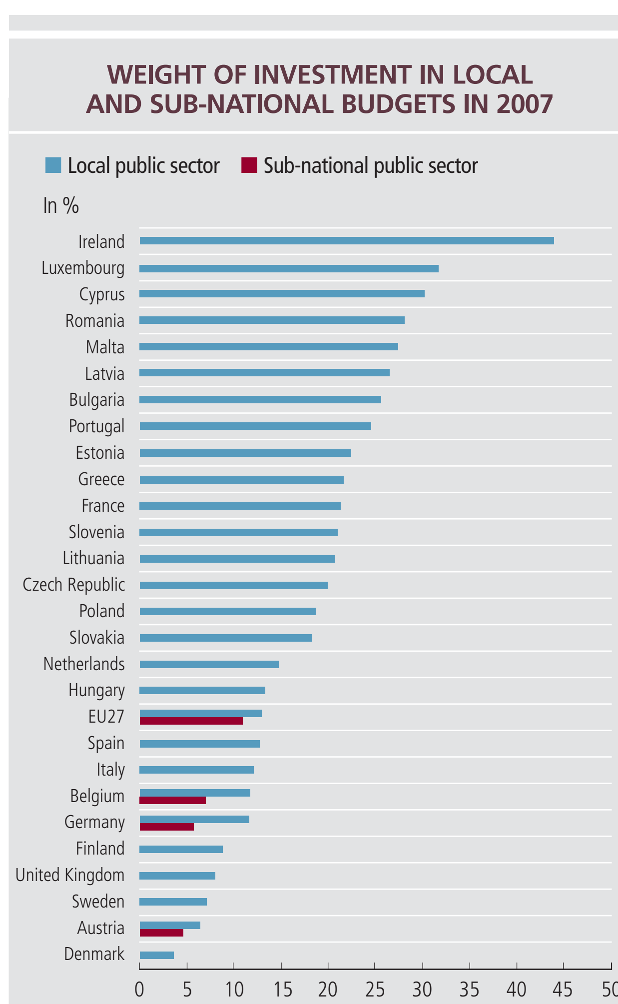
The exceptional rates recorded in Romania (+77%) and in Bulgaria (+45%) in 2007 were due, notably, to their official entry into the European Union on the first of January, which had a particularly positive effect on their economic development and on public finances because of improved access to EU financing.

In Latvia, growth in local public sector investment expenditure has been robust for several years (+41.1% per year in volume between 2002 and 2007) but 2007 was particularly impressive at +108%. This figure resulted from a large-scale construction project, the Riga Southern Bridge, completed by the city, for which the cost was evaluated at 0.4% of 2007 GDP.

• *High prices in the construction sector*

Rising prices in the construction sector in Europe, which can be partly blamed on soaring fuel prices, have contributed to an increase in sub-national public sector investment expenditure. This significant increase in construction prices was several points higher than average prices, GDP or household spending.

WEIGHT OF INVESTMENT IN LOCAL AND SUB-NATIONAL BUDGETS IN 2007



TREMENDOUS VOLATILITY OF SUB-NATIONAL INVESTMENT

Sub-national investment evolutions are varied from one year to the next. In Germany, two years of strong growth have come on the heels of three years of diminishing investment levels. In Spain, after a sour 2004, 2005 was a banner year for investments. In France, growth is strong every year. In the United Kingdom, two particularly robust years were 2003 and 2005.
In the EU12, after two years of decline in 2003 and 2004, the last three years, especially 2006, have been marked by strong growth.

These general fluctuations reflect the discrepancies in a given country and tend to hinge on the organisation of local elections. In addition, they depend on variations in revenue levels and budgetary decisions from a given year, investment being the primary adjustment variable.

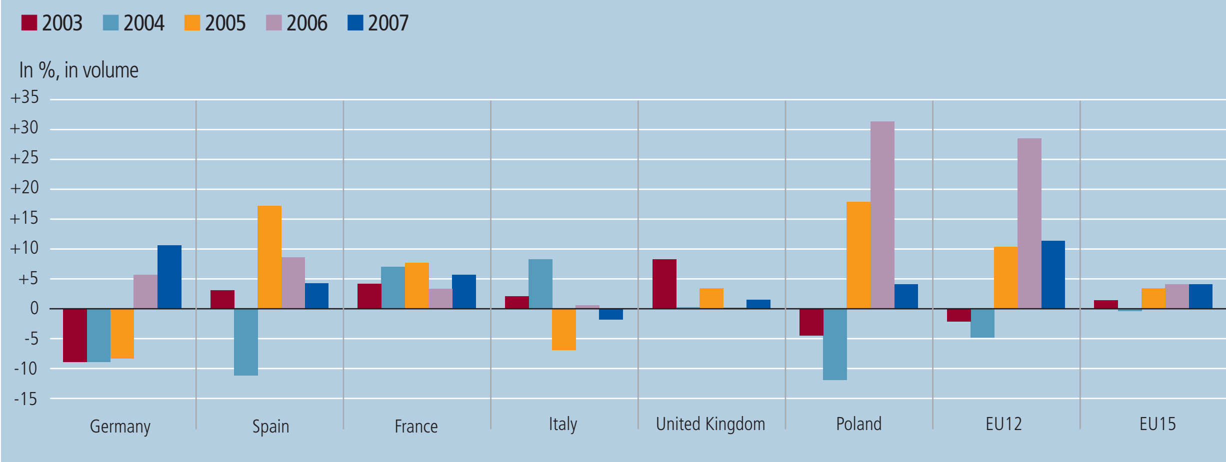
Nonetheless, it is possible to identify several clear trends from the past few years in clusters of countries.

As such, in a number of EU15 countries, the stagnation or decline in sub-national public sector investments can be blamed on the very modest growth or decline in tax revenues, transfers (stagnate economy, tax reforms, drop in investment grants) and tightening budget discipline rules. This was the case between 2002 and 2007 in Portugal (-7.4% in volume per year on average), Austria (-2.6%), Germany (-2.3%) and Italy (+0.3%).
However, at times this drop is more ‘statistical’ than ‘real’ because more and more local investment is being made in the form of public-private partnerships which moves the investments off the public balance sheet.

Several EU15 countries such as Ireland, France, and Spain have followed the opposite path. Growth over this period increased on the whole (+9.3%, +5.4% and +3.8% yearly average in volume, respectively). This may be explained, depending on the country, by various factors including strong demographic and economic growth, EU funds, the role of local authorities in investment matters, greater decentralisation, etc.

In the majority of new Member States, local public sector investment growth has been strong over the last years, which results from the confluence of different factors such as:
• decentralisation and competency transfers, which can spur additional investment (healthcare, education, transport, environment, etc.);
• catch up efforts to respond to considerable demand for public infrastructure and facilities both in terms of renovation (getting up to EU standards) and construction in key areas like transport and environment;
• increasing revenues of local authorities: changes in financing methods (fiscal decentralisation, loosening of local borrowing conditions) and improvement in tax revenues (strong economic growth in the majority of countries);
• structural and cohesion fund’s leverage effect: the injection of European Union funds (approximately €25bn from the EU between 2004 and 2006), which was contingent on domestic co-financing, had the effect of boosting local public sector investment. Marking the theoretical end of 2004-2006 programmes, 2006 translated into an exceptional year for growth rates, which stood at +28.5% in the new Member States.

YEARLY CHANGE RATE OF SUB-NATIONAL PUBLIC SECTOR INVESTMENT BETWEEN 2002 AND 2007



REVENUES AND TAXATION

REVENUES AND TAXATION						
In 2007	€bn	€/inhab.	% of GDP	% of public	Change 2002/2007	Change 2006/2007
Revenue						
Sub-national	1 916	3 863	15.5	34.5	+3.2%	+3.8%
Local	1 546	3 117	12.5	27.9	+3.7%	+3.8%
Tax revenue						
Sub-national	826	1 666	6.7	24.7	+3.7%	+3.2%
Local	594	1 197	4.8	17.7	+4.6%	+2.3%

Sharp increase in sub-national public sector revenues in 2007

In 2007, sub-national public sector revenues reached €1 916bn or 15.5% of GDP and 34.5% of total public revenue. Excluding Federated States, revenues stood at €1 546bn or 12.5% of GDP and 27.9% of total public revenue.

Growth in sub-national public sector revenues (as well as local revenues) reached +3.8% in volume in 2007 or more than GDP growth (+2.9%) and overall public sector revenue growth (+3.1%). Revenues expanded twice as quickly as expenditure (+2.0% in volume). Over the last five years, revenue growth has also been robust (+3.2% in volume per year on average) especially at the local level (+3.7%).

Such an increase was much stronger in the new Member States (+7.4% in 2007) than in the EU15 (although at +3.8% it remains quite high on account of particularly strong growth in Italy +7.4% and Germany +4.7%), which was in line with recent years (+6.3% for the new Member States and +3.1% in the EU15).

Sub-national development in revenues is due, in large part, to an improving economy and healthier central State public finances. Local authorities experienced higher revenues either directly (better revenues from taxes, user fees, and linked to economic activity, etc.) or indirectly (increase in current or capital transfers, particularly from central States).

Moreover, in several countries, and the new Member States in particular (Bulgaria in 2003, Slovakia in 2005, Romania in 2006, Slovenia in 2007, etc.), local authorities benefitted from fiscal decentralisation reforms (creation of own-source local taxes, redistribution of State taxes, steady increase in the share of national taxes allocated to the local sector, financial compensation for transferred competencies) as well as access, since 2004, to European Union structural and cohesion funds.

The increasing weight of taxation in sub-national public sector revenues

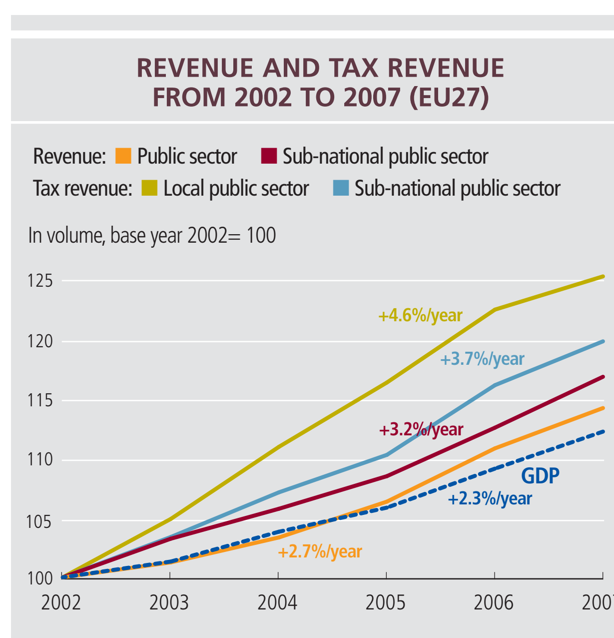
In 2007, sub-national public sector tax revenues reached €826bn or 6.7% of GDP (€594bn and 4.8% of GDP for the local level). Compared to the total public sector, they represent 24.7% of the sector's tax revenues (17.7% for the local level).

Within sub-national public sector budgets, taxation (both own-source taxes and shared tax revenue) provided for approximately 43% of resources in 2007 (38% for the local sector alone), the remainder being provided by grants and subsidies (from the State, from other sub-national levels or from the European Union) as well as revenues from managing assets and public services.

The countries of the EU15 account for 95% of sub-national public sector tax revenues, particularly Germany (36%), Spain (14%), Italy (12%), France (11%) and Sweden (6%).

Rise in sub-national public sector tax revenues slower in 2007

In 2007, the increase in sub-national public sector tax revenues was robust (+3.2% in volume) but slower than in recent years (+3.7% yearly average between 2002 and 2007) and especially compared to 2006, a year of strong growth (+5.3%). This slowdown was more marked for the local level (+2.3%). It was compensated for by a strong jump in capital transfers (+12.5% versus +2.9% yearly average between 2002 and 2007), as was the case in Italy, the United Kingdom, Germany and several new Member States.



Drop off in tax revenues in 2007 concerns EU15 more than EU12

In 2007, sub-national public sector tax revenues grew +2.9% in volume in the EU15 compared to +12.5% in the EU12.

In the EU15, sub-national public sector tax revenues dropped significantly in 2007 in several countries or, grew at a slower pace than 2006, particularly in Spain (+1.7% in 2007 compared to +7.5% yearly average between 2002 and 2007), Ireland (-1.1% in 2007 compared to +9.5% in 2006, which was due to a lowering of commercial rates) and especially in Denmark where local tax revenues plummeted -27.9% in 2007 from cuts to the corporate income tax (which is a shared tax in Denmark) decided at the central level as well as from the territorial reform (see table). Despite the strong increase in current grants in 2007 (+31.8%), total local revenues of Danish municipalities and new regions fell back -1.8% due, in particular, to this drop in tax revenues.

In a few of the EU15 countries, marked growth in sub-national public sector tax revenues in 2007 contrasted with 2006 results and in some cases with averages from 2002-2007, particularly in Greece (+10.0%), Luxembourg (+9.0%), Germany (+6.2%), Austria (+5.3%), as well as in France, Belgium, the Netherlands and Italy (between +4% and +5%). In Germany notably, the considerable development since 2005 is a result of the 2004 reform on local business tax, improvements in shared taxes yields thanks to the economic recovery (personal income tax, corporate income tax,

SEVERAL REFORMS IN LOCAL FINANCES IN 2007 AND 2008

Denmark

A new financing system was implemented within the framework of the territorial reform of January 1, 2007 abolishing counties and creating regions.
These new regions are not permitted to levy taxes and are mostly financed by State grants and municipal subsidies.
The municipalities inherited the lion's share of taxes from the former counties. The tax brackets of the two main local taxes (the local income tax and the property tax on land) were increased.
Most of the shared tax revenue has been abolished.
Only the corporate income tax is still shared between the State and the municipalities.
Moreover, a new system of tax equalisation has been put in place for the municipalities.

Slovenia

A new law on municipal financing went into effect on January 1, 2007, replacing the 1998 law. Throughout a 5-year transitional period, the law aims to reinforce vertical tax equalisation for the execution of municipalities' statutory tasks and to broaden their financial autonomy.
A poll tax was created to cover the average costs necessary to perform urgent municipal tasks. With regard to municipal investment spending, this law could boost the State's co-financing share (through a form of investment grant) from 70% of project costs in 2005 to 100%.

Bulgaria

Within the framework of a fiscal decentralisation programme started in 2003, the Constitution was changed in January 2007 to give municipalities own-source taxation powers.
Modifications, in 2007, to the Local Tax and Fees Act went into effect on January 1, 2008. They give municipalities the authority to set local tax rates within the limits of the law. The tax on patents was also transferred to the municipalities.

Austria

The new Revenue Sharing Law went into effect in 2008 for a period of six years. It stipulates that negotiations concerning the distribution of tax revenues between the Federal State, the *Länder* and the municipalities are to be held every six years instead of every four (or three) years. It reinforces fiscal decentralisation by transforming the majority of grants into shared taxes. The distribution keys between the three levels remained unchanged but the statistical method for counting the population, principal indicator of revenue sharing, was modified.
The financing allocated to the authorities was increased with an aim to helping them cope with escalating charges. The *Länder* are thereby to receive additional grants from the Federal State for their healthcare spending. Financing from the municipalities for long-term care, healthcare for children, minimum revenues and early childhood schools will be increased. The "consolidation contribution" paid by the *Länder* and municipalities to the central State after the revenue sharing, will progressively be phased out.

Portugal

The 2007 Local Finance Law overhauled the system that redistributes fiscal resources from the State to the municipalities. It notably reduces the annual amount of the "Share of State Taxes" grant (which represents a third of local revenue) from 33% to 25.3% of the average revenue from three major national taxes (personal income tax, corporate income tax and VAT). To compensate for this reduction, municipalities are allowed to keep between 2% and 5% of PIT turned over by their residents. In addition, a "Municipal Social Fund" has been created to finance the transfer of competencies from the State to the local authorities as part of efforts currently underway to further decentralisation in the areas of education and healthcare among others.

Spain

The reforms concerning the statutes of the autonomous communities continued in 2007 bringing about changes in their financing system, including an extension of their fiscal sovereignty, but on a case-to-case basis.

VAT, taxes on dividends, etc.) combined with a VAT rate hike from 16% to 19% since January 1, 2007.

In the new Member States, the average increase in local tax revenues in 2007 was considerable: +12.5% in volume, which was confirmed over the 2002-2007 period (+11.7% yearly average). Substituting for grant financing, local tax revenues enlarged their role in the budget, jumping from 34% of resources in 2002 to 43% in 2007. Of the new Member States where local tax revenue growths were the strongest in 2007, Bulgaria (+29.8%), Slovenia (+25.0%), Poland (+17.4%), the three Baltic States and Romania (+9.3%) were at the top. In exchange, they were sometimes accompanied by a drop in grants, for example in the Baltic States and in Slovenia.

Growth in local revenues was overall robust in the new Member States with the exception of Hungary where a significant fall in local resources (-3.2%) was recorded in 2007 even though during previous years they had remained largely positive (+3.1% in volume, on average per year over 2002-2007). This decline resulted from a combination of a meagre increase in local taxes (+2.6%) and, especially, a sharp reduction in operating and investment grants in 2007 following drastic measures taken by the government to consolidate public finances. ■

A broader reform of the model governing the autonomous communities' financing is currently being considered by the Finance and Tax Policy Council in order to increase their tax autonomy and to improve equalisation mechanisms through the *fondo de suficiencia*.
In addition, the municipalities' financing system, set up in 2003, could be modified in 2009 with the adoption of a new Local Administration and Government Law, based on a White Paper on local sector reform published in 2005.

Belgium

In Wallonia, the reform of the Municipal Fund *(Fonds des communes)*, passed in June 2008, calls for the distribution of the grant based on a smaller and more stable number of criteria. Amounts previously allocated to ad-hoc measures were reintegrated into the fund.
Its annual fluctuation is now indexed to inflation plus 1%. The reform will be implemented over 20 years. Each year, an extra 5% in funding will be distributed on the basis of these new criteria and the remainder will be calculated based on the old criteria. The reform will be joined by measures with guaranteed amounts as well as a debt buy-back and pension charges for certain municipalities.

Germany

The second phase of the federalism reform was launched in March 2007 when a joint parliamentary Commission was established, which will propose solutions for reforming financing relationships between the Federation and the *Länder*.
Furthermore, in order to make Germany more attractive to businesses, a significant tax reform went into effect on January 1, 2008 that lowers the corporate income tax rate (from 25% to 15%) as well as the local business tax in the hope of bringing the overall tax burden on businesses down from 39% (of which 17% on average comes from the local business tax and the rest from the corporate income tax and the solidarity tax) in 2007 to 29.8%. While municipalities continue to fix the level of the multiplier rate (municipal rate) applied to firms' taxable revenue, the calculation of this revenue is very complex and was reviewed, which has allowed for significant deductions. Despite several steps aiming to expand the tax base and to thus compensate for falling tax revenues for municipalities, the loss generated by this reform of municipalities is estimated at €1bn per year.

Italy

In early October 2008, the Italian government adopted a bill on fiscal federalism. Having received approval from the Unified Conference of Regions and the national association of Italian municipalities (ANCI), this project – currently being debated in Parliament – will take two years to implement. Composed of 22 articles modifying, in particular, article 119 of the Constitution, the reform is based on three pillars: a simplification of sub-national taxation (own-source and shared) and local authorities keep a larger part of taxes; the use of "standard cost" methods for calculating State transfers to regions instead of the system based on "past expenditure"; strengthening equalisation via a fund managed by the State which aims to guarantee the provision of basic services (healthcare, education, social welfare) in the poorest regions.

Poland

A new law on public finances is currently being debated in Parliament. It would place individual limits on sub-national governments' debt and deficits, implement long-term financial plans (at least four years) and impose the obligation to submit a balanced budget, including current expenditure.

United Kingdom

Numerous discussions are underway regarding the much-decried council tax. In Scotland, the regional government proposed in March 2008 to replace it with a local income tax at the regional rate of three pence per pound sterling. An outcry emerged from public hearings regarding the implementation of a fixed rate set by the region. Demands called for, instead, a complete freedom for local authorities to set the rate. The government hopes to implement this tax during the current session of the Scottish Parliament (before 2011/2012).

BUDGET BALANCE AND DEBT

BUDGET BALANCE AND DEBT				
In 2007	€bn	% of GDP	Change 2002/2007	Change 2006/2007
Budget balance				
Sub-national	+4.8	+0.04	-	-
Local	+0.1	+0.00	-	-
Public debt				
Sub-national	1 205	9.8	+2.2%	-1.8%
Local	691	5.1	+2.6%	-1.4%

The sub-national public sector recorded a slight surplus in 2007

With a budget surplus totalling €4.8bn, 2007 was the first year since 2002 that the sub-national public sector recorded a positive budgetary balance. In fact, in 2002, the deficit stood at -0.57% of GDP. Since then, it has progressively been reduced, particularly since 2005, when it went from -0.44% of GDP to -0.24% in 2006 before reaching +0.04% of GDP in 2007.

As far as the local public sector is concerned, the budgetary balance also improved from a deficit of €27.2bn in 2005 to a balanced budget in 2007 – even attaining a slight surplus of €109 million.

Most countries follow trend

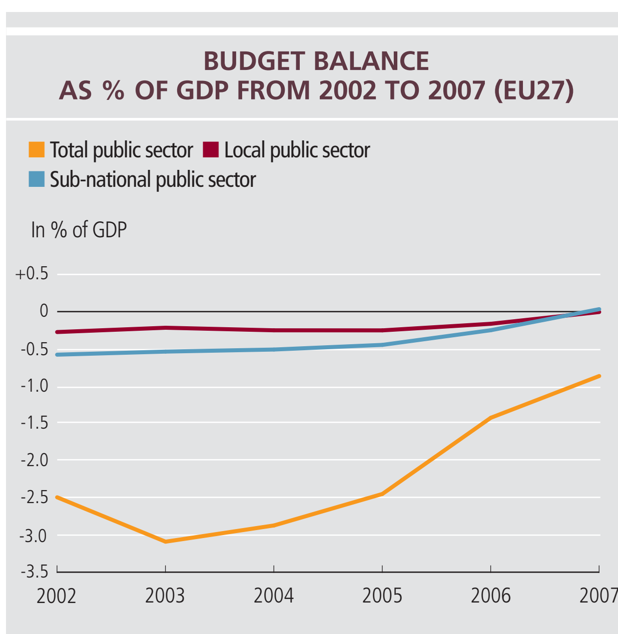
Sub-national public sector budget balances range from -0.61% of GDP in Latvia to +0.51% of GDP in the Czech Republic. In all, while two-thirds of countries reported sub-national public sector deficits in 2007, they were, in most cases, only moderate. Only five countries (the three Baltic States, Spain and France) recorded a local public sector deficit over -0.30% of GDP.

In 2007, sub-national public sector budget balances, expressed in GDP terms, improved in 15 countries. Among them, Austria added to its sub-national public sector surplus, the 14 other countries reduced their deficits of which six (Germany, Belgium, Italy, the Czech Republic, Poland and Denmark) progressed from a deficit in 2006 (and even over the entire period from 2002-2006) to a surplus in 2007. Germany, whose sub-national public sector deficit reached more than €22bn in 2005 (-1% of GDP and 46% of EU27 sub-national public sector deficit), recorded a surplus of nearly €12bn (+0.48% of GDP), split between the local authorities (71%) and the *Länder* (29%). In Italy, the sub-national public sector deficit/GDP ratio, which at -1.13% was by far the highest in the EU27 in 2006, flipped in 2007 to reach +0.23% of GDP. Finally, the Czech Republic performed a turnaround from one of the deepest sub-national public sector deficits in 2006 (-0.41% of GDP) to the largest surplus (+0.51%) in 2007.

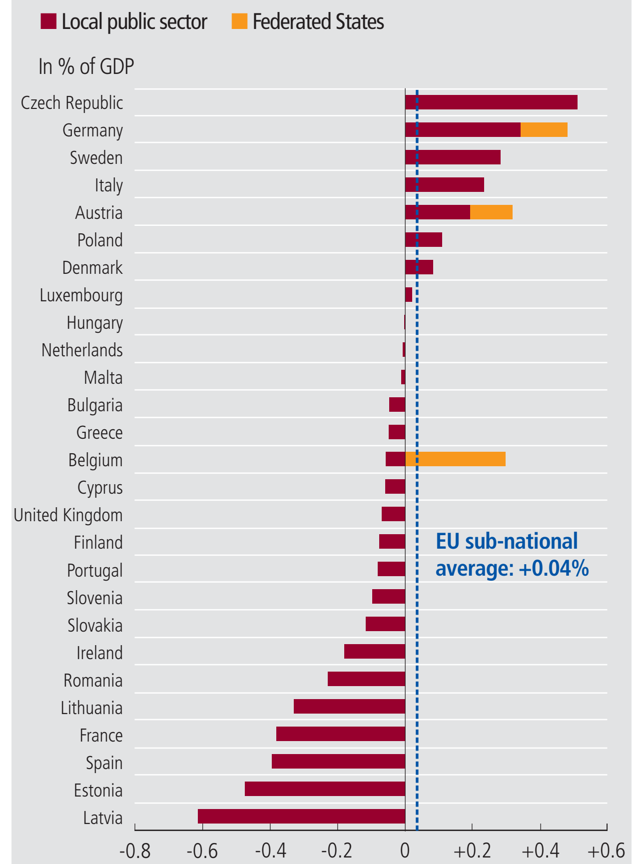
This trend comes as a result of improved economic and employment conditions (drop in unemployment benefits and social services, revenue increases linked to economic activity), injection of European funds, healthier public finances of central governments and improved handling of sub-national budgets (see table). Improved revenues (+3.8% in volume) combined with a more moderate increase in expenditure (+2.0%) over 2007 resulted in a reduction of sub-national deficits in numerous countries.

However, all countries did not experience this positive development as the sub-national public sector budgetary balance

BUDGET BALANCE AS % OF GDP FROM 2002 TO 2007 (EU27)



SUB-NATIONAL PUBLIC BUDGET BALANCE AS % OF GDP IN 2007



deteriorated in 12 Member States. For Luxembourg and Sweden, it resulted only in a surplus reduction. For six other countries, the surplus in 2006 turned into a deficit in 2007, notably in Romania, Bulgaria, Portugal and especially Estonia, Spain and Ireland where the change was particularly drastic. In the four remaining Member States (Malta, France, Latvia and the United Kingdom), the local public sector deficit widened in 2007.

Several factors can explain these movements. One of them is, particularly in the new Member States, the acceleration in capital expenditure spending, which has been boosted by European funds, and has at times affected local budget balances. In addition, transfers of competences were not always accompanied by appropriate financial compensation while certain mandatory public expenditure remained impossible to reduce. Finally, in certain countries including Ireland, Portugal, Spain and Estonia, among others, local authorities were confronted, in 2007, with a substantial reduction in capital grants despite the fact that they represent a significant portion of their budgets.

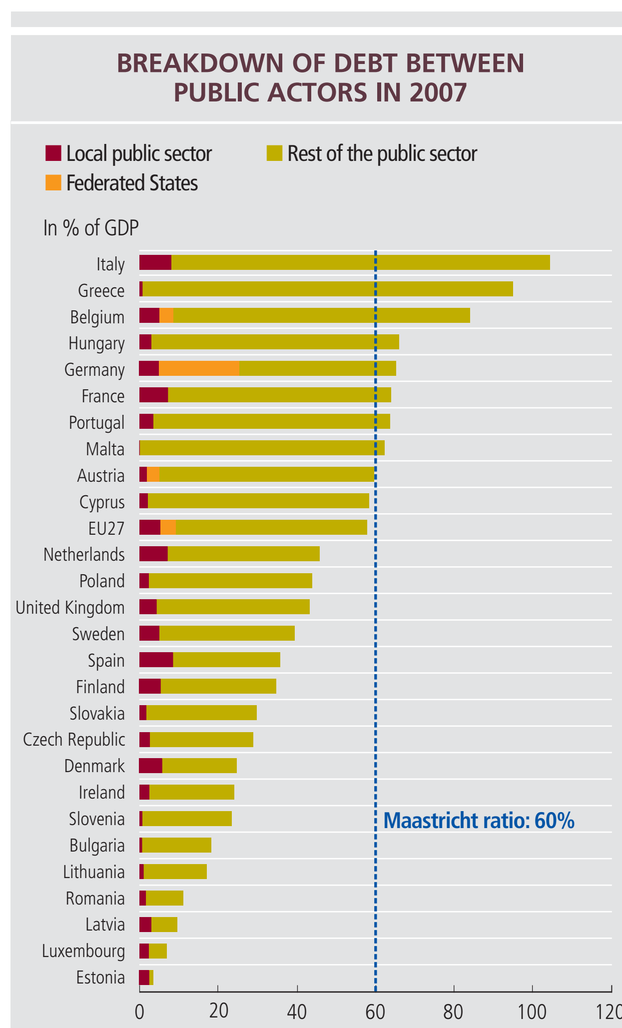
Sub-national public sector debt reaches €1 205bn but €691bn for the local level alone

In 2007, sub-national public sector debt in the EU27 reached €1 205bn or 9.8% of GDP and 16.6% of total public debt. Germany, and in particular its *Länder*, is responsible for half this sub-national public sector debt (€493bn, or 41%).

Excluding the Federated States, local public sector debt drops to €691bn or 5.1% of GDP and 9.5% of total public debt. These relatively moderate ratios come from the fact that debt, at the local level, is attributed in very large part to financing investments and is constrained by strict prudential rules. The vast majority of this local public sector debt is held by the EU15 (97%) and in particular France (20%), Italy (18%), Germany (17%), Spain and the United Kingdom (13% each).

The weight of local public sector debt as a percentage of GDP varies from 0.05% in Malta to 8.5% in Spain. In the new Member States, this ratio is nearly four points less than that of the EU15 (2.2% of GDP compared to 5.9%). Besides Spain, it is above 5% in Italy, France, the Netherlands, the Nordic countries, Germany, Belgium i.e. wherever local authorities have wide-ranging competencies and/or looser borrowing restrictions.

The weight of local public sector debt to total public debt is also very disparate ranging from 0.1% in Malta to nearly 70% in Estonia.



SUB-NATIONAL GOVERNMENTS AND BUDGETARY "CODE OF CONDUCT"

- **In Italy,** the 2007 Finance Law imposes constraints on regions in matters concerning expenditure (operating and capital, except healthcare expenses that are subject to specific rules) as well as, on a trial basis, budget balances. Provinces and municipalities must also better balance their budgets; however, no method is imposed.
- **In Austria,** the Stability Pact 2007-2010 has renewed the balanced budget targets of the 2005 Pact, which imposed a balance or deficit ceiling for municipalities and surplus objectives for *Länder*.
- **In Spain,** the Budgetary Stability Law of 2006, finalised in 2007, imposes budget balance norms that are set depending on regional economic growth levels. New procedures will be implemented in 2008 including individualised balance targets and borrowing restrictions.
- **In Belgium,** the Budget Agreement calls for a return to a balanced budget for municipalities in 2007; in 2006, deficits were tolerated because it was a municipal election year.
- **In Germany,** the Financial Planning Council decided to limit standard increases in public expenditure to +1% on average per year for the years 2007-2009. Cutting staff expenditure is a priority.
- **In Portugal,** the new 2007 Local Finance law strengthened municipal debt limitations that were already in place.
- **In Hungary,** the law on public finances was amended in July 2006 in order to introduce new financial rules and budget austerity measures.
- **In the Czech Republic,** the government has undertaken an important public finance reform.

Sub-national public debt retreats in 2007, except in the new Member States

In 2007, sub-national public sector debt slowed -1.8% in volume, reversing a trend that spanned from 2002 to 2007 (+2.2% per year). At the local level, it continued to drop in 2007 but to a lesser extent (-1.4%).

In 2007, trends varied tremendously from country to country. Sub-national public sector debt grew +9.3% in volume in the new Member States while it dropped -1.6% in the EU15 (-1.3% for local debt alone).

In the EU15, sub-national public sector debt retreated in seven countries, sometimes significantly such as in the United Kingdom (-7.2%), Sweden (-5.4%), Italy (-3.7%), Germany (-3.5% for the local sector alone). This reflected the increase in revenues and self-financing resources, the impact of austerity measures, notably concerning the use of borrowing as well as, in certain countries, the "outsourcing" of part of debt from sub-national public accounts. Only a few countries of the EU15 experienced soaring local debt in 2007. They include France, Luxembourg, Greece and especially Denmark (+9.6%) and Ireland (+18.2%).

In the new Member States, strong local public sector debt growth in 2007 follows a pattern established over 2002-2007 (+14.5% yearly versus +2.5% in the EU15). It is between +22% and +43% in Hungary, Lithuania, Latvia, Romania and Bulgaria, which reflects growth in local investments, the impact of European Union cohesion policies - borrowing provides part of domestic matching funds which are required for obtaining Community financing - and finally, the opening of the borrowing market and the loosening of prudential rules since 2005. ■

THE EFFECTS OF THE CRISIS ON SUB-NATIONAL GOVERNMENTS

Since September 2008, the financial and economic crisis has rapidly spread to all corners of society including households, businesses and public authorities both at the national and sub-national levels.
As an economic player, employer and investor with an important role in providing services and ensuring local solidarity, the sub-national public sector has been affected by the crisis in many ways. All of these different roles must be considered when measuring the impact of the crisis, the effects of which will vary over time and depend on the country.

Impact of the financial crisis

The financial crisis could affect sub-national governments in three ways:
- by increasing their financial charges for loans taken out with variable interest rates;
- by exposing sub-national governments' cash flow and assets to market turbulence if they were invested in non-guaranteed securities, as was the case in Belgium, the United Kingdom or the Netherlands, for example;
- by deteriorating their financial conditions for new loans (higher interest rates and, at times, scarce liquidity).

The scope of the impact will depend on numerous factors such as the sub-national governments' degree of flexibility regarding cash flows deposits, investments, and taking direct participation in private companies' capital as well as national borrowing regulation and use.

Reduced leeway and growing constraints

Resources from taxes, user fees and transfers, which are backed by volatile economic flows – such as business revenues, companies' added value, household revenues, consumption, real estate transactions, property taxes - are likely to slow. The effects will depend on the precise characteristics of sub-national government revenues, on the tax sharing and distribution systems as well as the existence or not of mechanisms able to stabilise or guarantee sub-national revenues.
Sub-national governments will also be confronted with increasing expenditure in several areas, particularly those of a social nature in countries where sub-national authorities are responsible for managing social benefits linked to household revenues or unemployment.

Contrasting impact of national rescue plans on sub-national governments

The stimulus packages that many European countries are planning to implement include measures to lower VAT, provide tax breaks, reduce social security contributions, take budgetary initiatives as well as regulatory reforms. They could have both negative (drop in revenues) and positive effects (support for investment, simplification of public procurement procedures, expediting application appraisal for EU funded projects, loosening of budget constraints, etc.) on sub-national governments.

What role for sub-national governments?

Sub-national governments are not simply condemned to suffer the consequences of the crisis; by acting in an effective manner they can not only minimise these consequences but can also fight against the crisis itself. As a public investment leader, they will be on the frontlines of the stimulus plans targeted at boosting infrastructure. This is the mindset adopted by several Member States including, among others, France and Spain. It is also the strategy the European Commission has taken with its rescue plan, which comprises a 'budget stimulus' scheme, including, in particular, to speed up the payments of European funds.

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French and English versions of this publication are available online: *www.dexia-creditlocal.fr*
Detailed statistics for each country are provided in the set of index cards "EU sub-national governments: 2007 key figures" - 2008 Edition, prepared in association with the CEMR and available online: *www.dexia-creditlocal.fr* and *www.ccre.org*

General Editor: Pascal Poupelle

Designed by Spécifique: SPÉCIFIQUE – *www.specifique.com* – Paris – France