TRENDS 2000 / 2005

Sub-national public finance
in the European Union

DEXIA

SUB-NATIONAL GOVERNMENTS: EUROPEAN LEADERS IN PUBLIC INVESTMENT

Our annual Economic Outlook portrays the institutional and financial situation of the sub-national public sector in the 25 Member States of the European Union between 2000 and 2005.

Macroeconomic Environment

The year 2005 confirmed the return of economic growth in Europe, as witnessed by the rebound in household spending, investment and falling unemployment rates. The new Member States proved particularly dynamic.

Public Finances

Public deficits are decreasing on a European level, standing at 2.3% of GDP in 2005. But public debt is still on the rise, weighing 63.2% of GDP in 2005.

Territorial Organisation

The deepening of decentralisation remains on the agenda throughout the European Union, along with institutional reforms concerning its 89,250 sub-national governments (Federated States, regional and local authorities).

Expenditure and Investment

Sub-national public expenditure has been increasing for years, in relation to extended responsibilities transferred by central administrations and a growing demand in local utilities and services. In 2005, sub-national public expenditure in Europe totalled 1,726 billion euros, standing at 15.9% of GDP. Sub-national governments strengthen their position as leaders in public investment: with 176 billion euros invested, they were responsible for two-thirds of all public capital expenditure in 2005.

Fiscal Revenues

Taxation represents an increasing share of the total income of sub-national governments due to fiscal reforms transferring taxes or replacing State grants.

Balance and Debt

Financial fundamentals for the sub-national public sector are sound: debt and deficit remain under control due to improved joint monitoring by the different government tiers as well as a tightening of prudential rules.

MACROECONOMIC WEIGHT OF SUB-NATIONAL AUTHORITIES IN THE EU25

	Amounts (Bn €)	% of GDP		% total public sector		Average yearly growth in volume
	2005	2000	2005	2000	2005	2000-2005
PUBLIC EXPENDITURE						
Sub-national	**1,726**	15.2	15.9	33.4	33.7	+2.6%
Local and regional	**1,374**	11.5	12.7	25.4	26.8	+3.6 %
PUBLIC INVESTMENT						
Sub-national	**176**	1.6	1.6	68.3	66.8	+2.4%
Local and regional	**169**	1.5	1.6	63.4	63.9	+3.0%
TAX REVENUES						
Sub-national	**708**	6.3	6.5	23.0	24.6	+2.3%
Local and regional	**510**	4.1	4.7	14.8	17.7	+4.5%
PUBLIC BUDGET BALANCE						
Sub-national	**-44**	-0.04	-0.41	-	17.4	-
Local and regional	**-25**	0.05	-0.23	-	9.8	-
PUBLIC DEBT						
Sub-national	**1,136**	9.7	10.5	15.8	16.5	+3.1%
Local and regional	**633**	5.6	5.8	9.1	9.2	+2.4%

November 2006

Methodology

Data

The main source of statistical data in this study is Eurostat, completed by the national statistical systems of the Member States. Classifications and data are based on the European System of National and Regional Accounts (ESA 95), the reference in matters of national accountancy. All statistical data in this study was extracted between October and November 2006. Figures may therefore be modified until national accounts are deemed final, i.e. three years after their reference date (for instance until 2008 for data pertaining to 2005).

Some countries have already published their national annual accounts on Base 2000 = 100, while others that still use the Base 1995 will do so in the coming months. At this juncture most countries revise and redefine the bases of all valuations in their accounts. According to the country, the data presented here is thus in Base 1995 or Base 2000.

In Ireland, healthcare budget, previously attributed to territorial authorities accounts, was reassigned to the State on the First of January 2005. For purpose of comparison, data for the local and regional public sector (expenditure, revenue and investment) has been estimated for previous years.

Definition of entities

- **Public sector:** classified as S13 under ESA95, it comprises central administrations, Federated States, local and regional authorities and social security funds.
- **Sub-national public sector:** it refers to the conjunction of the local and regional public sector and local entities (S1313) with the Federated States (S1312).
- **Local and regional public sector:** classified as S1313 under ESA95, it comprises territorial authorities, both local and regional, together with local entities. Data on the local and regional public sector is consolidated. Data concerning the Spanish autonomous communities, although they are classified by ESA95 as federated entities, was filed under the heading of territorial authorities since Spain is a unitary State.

Indicators

- **Public expenditure:** operating and capital expenditure.
- **Public capital expenditure:** gross fixed capital formation (P51), also referred to as investment in the survey.
- **Tax revenue:** it includes taxes on production and imports (D2), income and property taxes (D5), and capital taxes (D91). The ESA95 data on local and regional tax revenues may include the revenue from State taxes shared with local authorities.
- **Public budget balance:** as defined by the Maastricht Treaty.
- **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 concerns the 2000-2005 period for the 25 Member States of the European Union.

Currencies

For countries outside the euro zone, data in local currencies has been converted in euros using the average annual exchange rate for all indicators, except for public debt, for which the exchange rate as of December 31 of each year is used.

Evolutions

Growth rates represent, unless otherwise stated, evolutions in volume: they do not take into account inflation, measured in terms of the GDP deflator. They are given in local currency (euro or otherwise).

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MACROECONOMIC ENVIRONMENT

The return of growth in Europe, first observed in 2004, was confirmed in 2005. Household spending grew and corporate investment went up while unemployment continued to decline. Improvement was, however, not uniform throughout the European Union. The new Member States proved their potential for economic dynamism. The combination of these factors contributes to the convergence of European economies.

Europe in the world from 2000 to 2005

Activity in Europe sagged between 2001 and 2003, contrasting with the strength of the American economy which provided a favorable external environment. In 2004, the strong recovery of global activity (+4.9%) boosted Europe, which reported a higher level of growth (+2.3% versus +1.3% in 2003). The recovery continued in 2005, in spite of a slight slowdown at the beginning of the year. It was, nevertheless, stronger on a global level (+4.4%), in the United States (+3.2%) and Japan (+2.6%) than in the EU25 (+1.7%). The European Union reported a GDP of 10,846 billion euros, slightly higher than that of the United States and almost three times that of Japan. The figures are, however, less flattering on a per capita basis: the GDP per capita in Europe was 30% lower than in the United States and 18% lower than in Japan.

POPULATION AND ECONOMIC ACTIVITY

	GDP (Bn€)	Population (Mio. Inhab.)	GDP/ EU25 GDP (%)	2004/2005 (%)
Germany	2,241	82.46	20.7	+0.9
UK	1,791	60.19	16.5	+1.9
France	1,710	62.70	15.8	+1.2
Italy	1,417	58.53	13.1	0.0
Spain	905	43.40	8.3	+3.5
Netherlands	506	16.32	4.7	+1.5
Belgium	298	10.47	2.7	+1.2
Sweden	288	9.03	2.7	+2.7
Austria	245	8.23	2.3	+2.0
Poland	243	38.16	2.2	+3.2
Denmark	209	5.42	1.9	+3.0
Greece	181	11.08	1.7	+3.7
Ireland	161	4.15	1.5	+5.5
Finland	157	5.25	1.5	+2.9
Portugal	147	10.57	1.4	+0.4
Czech Republic	100	10.23	0.9	+6.1
Hungary	89	10.09	0.8	+4.2
Slovakia	38	5.39	0.4	+3.4
Luxembourg	29	0.46	0.3	+4.0
Slovenia	28	2.00	0.3	+4.0
Lithuania	21	3.41	0.2	+7.6
Cyprus	13	0.76	0.1	+3.8
Latvia	13	2.30	0.1	+10.2
Estonia	11	1.35	0.1	+10.5
Malta	5	0.40	0.0	+2.2
EU25	**10,846**	**462.34**	**100**	**+1,7**

Heterogeneous growth rates in 2005

The average growth rate (+1.7%) recorded in the EU25 masks major discrepancies among Member States. While the new Member States have been enjoying economic growth well above the EU average (growth rates stand above +10% in Estonia and Latvia, at +7.6% in Lithuania and at +6.1% in the Czech Republic), Italy, Portugal and Germany lower the European average with growth rates of less than +1%. Between the extremes, countries such as Ireland, Luxembourg, Greece or Spain reported more encouraging results.

Inflation is under control

In 2005, inflation in the EU (2.2%) remained above the ECB's price stability ceiling of 2%, mainly due to the rise in energy costs, which exercised pressure on consumer prices. On a general level, increased productivity and international price competition help keep inflation under control, but the aggregate figures hide strong disparities: seven out of the ten new Member States report inflation rates largely above the average (6.9% in Latvia and 4.1% in Estonia for example).

Unemployment is gradually receding

In 2005, the European Union enjoyed a noticeable recovery of its labor markets. The average rate of unemployment fell from 9.1% in 2004 to 8.8%.

National differences are still perceptible: unemployment remained below 5% in Ireland, Luxembourg and the United Kingdom, while Germany, France and Greece recorded rates above 9.5%. The highest unemployment figures are those of Poland (17.7%) and the Slovak Republic (16.3%).

Confirmation of economic acceleration in 2006

Economic growth in the EU25 accelerated in 2006. It is expected to reach +2.7% by the end of the year, reflecting a favorable global environment (+5% growth) and strong domestic demand, consumption and private investment. Job creation has been spurred and resulted in a lower unemployment rate (8% in August 2006). The underlying inflation remained under control and is estimated at 2.3% for 2006. ■

OVERVIEW OF PUBLIC FINANCES

2005 confirmed the positive reversal in trend initiated in 2004, after the difficult period of 2000-2003, which had seen a sharp degradation of public finances due to economic slowdown. Between 2004 and 2005, public deficit in the EU25 decreased from 2.7% to 2.3% of GDP. But the public debt-to-GDP ratio continued to rise, from 62.4% to 63.2%.

The weight of public expenditure in 2005 remains stable

Public expenditure in EU25 countries totalled 5,120 billion euros in 2005, representing 11,100 euros per capita and 47.2% of GDP. However, this overall figure does not reflect the diversity of national situations. Indeed, public expenditure weighs more than 50% of GDP in the three Scandinavian countries, France and Belgium, while it stands at about a third of GDP in the Baltic States and Ireland. On a European scale this ratio, which had risen from 45.5% to 47.7% between 2000 and 2003, decreased in 2004 since public expenditure (+1.1%) grew more slowly than GDP (+2.3%).

In 2005, it stabilised at 47.2%, as growth in public expenditure (+1.8%) paralleled that of GDP. Ten countries nevertheless reported a rise in the indicator, especially the United Kingdom, Portugal and Hungary, by one or more percentage points.

Public investment expenditure in EU25 countries totalled 263.6 billion euros in 2005, which corresponds to 570 euros per capita. Public capital expenditure in the EU25 thus represented 12.2% of total investment by all economic players (households, companies, government entities). Public investment amounted to 2.4% of GDP in 2005, remaining relatively stable in the 2000-2005 period. The share of public capital expenditure in total public expenditure was also stable between 2000 and 2005, amounting to 5.1% in 2005, since most public spending was allocated to welfare or redistribution expenditure.

Public revenues increased in 2005

The revenues of government entities in the EU25 totalled 4,870 billion euros in 2005. Compared with GDP, public revenues, which had been declining regularly between 2000 and 2004, rose again and went from 44.4% in 2004 to 44.9% in 2005. This increase in revenue reflected a dynamic economic environment, characterised by a rise in employment rates and private consumption, which boosted tax revenues.

Public deficit is diminishing in 2005

The budgetary situation in 2005 was better than in 2004 and better than had been forecast at the beginning of the year. This is due, on the one hand, to a slower growth in public expenditure and on the other hand, to higher revenues. Altogether, the public deficit of EU25 countries stood at 252.4 billion euros in 2005, representing 2.3% of GDP compared to 2.7% in 2004 and even 3% in 2003. This aggregate result however masks different performance levels in the Member States. Nine of them thus continued to exceed the 3% Maastricht cap, with four of them (Hungary, Portugal, Greece and Italy) exceeding a deficit of 4% of GDP.

EU25 KEY PUBLIC FINANCE INDICATORS

In %	2000	2001	2002	2003	2004	2005
Public expenditure/ GDP	45.5	46.5	47.0	47.7	47.2	47.2
Public investment/ GDP	2.3	2.4	2.3	2.5	2.4	2.4
Public investment/ public expenditure	5.0	5.1	4.9	5.2	5.2	5.1
Public investment/ total investment	11.1	11.7	11.8	12.7	12.4	12.2
Public revenue/ GDP	45.9	45.2	44.6	44.6	44.4	44.9
Budget balance/ GDP	+0.4	-1.3	-2.3	-3.0	-2.7	-2.3
Public debt/ GDP	62.9	62.0	60.4	62.0	62.4	63.2

At the other end of the spectrum, seven countries reported a budget surplus in 2005 (in particular the three Scandinavian countries and Estonia), demonstrating that no simple correlation between the level of public expenditure and the deficit can be established.

Between 2004 and 2005, 15 Member States improved their budget balance, in several cases significantly (more than 1.5 points of GDP in the Netherlands, Malta, Cyprus, Denmark and Greece), while the remaining ten reported an erosion or a serious decline (more than 1.2 points of GDP in Portugal, Hungary and Belgium). Occasionally, the introduction of a new accounting system or a budget-line transfer was the cause of either an improvement in public finances (Poland) or on the contrary, a degradation (in Belgium, allocation of the rail infrastructures fund to the State budget).

For some Member States, exceptional one-off budgetary measures played a significant role in deficit reduction. One may cite partial or total privatisation of public sector companies, real estate sales or occasional payments by public sector companies. Accounts sometimes benefited from transfers earmarked for the payment of future retirement benefits, such as the "soulte" payment that *Électricité de France* made to the State for taking on some of its pension liabilities, which reduced the deficit by some 0.5% of GDP. At times, budgetary improvement was due to gains resulting from tax amnesty programs. In Cyprus, this measure reduced the public deficit by almost 1 point of GDP in 2005.

Public debt is rising in 2005

Public debt in the EU25 totalled approximately 6,900 billion euros in 2005. After a decrease between 2000 and 2002, the public debt-to-GDP ratio increased over the following years. Between 2004 and 2005, it rose from 62.4% to 63.2%. Nine Member States of the European Union went above the Maastricht ceiling, established at 60% of GDP. Three even exceeded 90% (Belgium, Italy and Greece). On the other hand, most of the new Member States reported a low level of public debt compared with GDP.

Between 2000 and 2005, several countries significantly reduced their public debt, by 11 points to 18 points in percentage of GDP: Ireland, the Slovak Republic, Belgium, Denmark and Spain.

Between 2004 and 2005, the countries in which the public debt-to-GDP ratio decreased most were Finland, Spain, Denmark and the Slovak Republic. The greatest increases could be witnessed in the United Kingdom, France, Germany, Italy and Portugal (between 2 points and 5.4 points of GDP in additional debt).

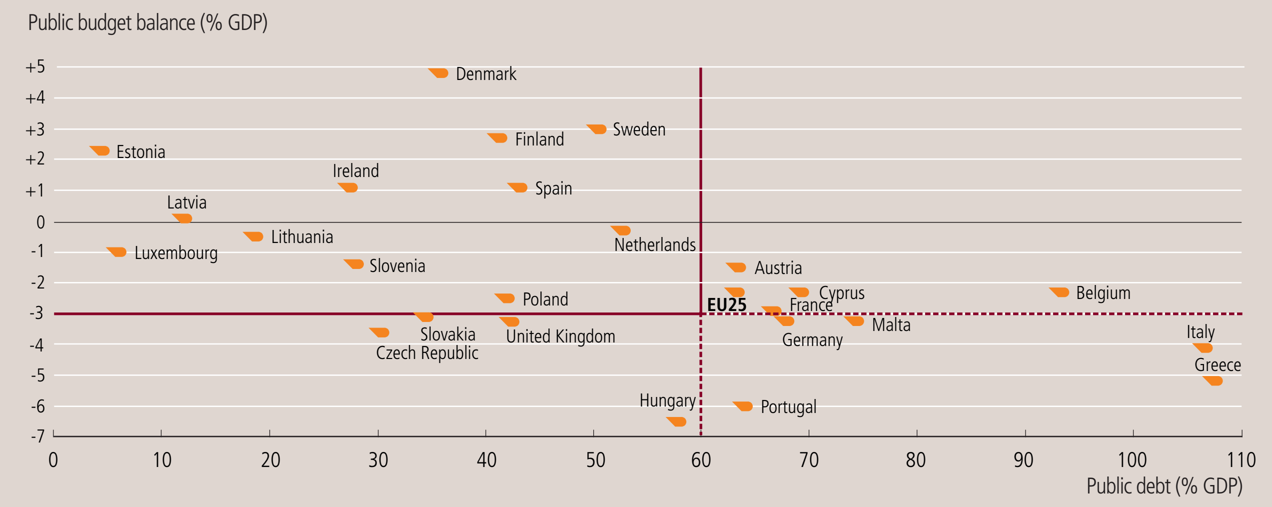
Public finances in 2006… and beyond

In 2006, this positive trend is expected to continue as a result of economic growth and the corresponding tax gains, reinforced by the implementation of restrictive policies in some countries such as the United Kingdom and Italy. In the longer term, there is some uncertainty about the viability and sustainability of public finances in a difficult demographic environment characterised by an ageing population and greater welfare expenditure. The Member States are thus called upon by the European Commission to carry out in-depth reforms of their pension, healthcare and old-age dependency policies.

THE 2005 REFORM OF THE STABILITY AND GROWTH PACT

In March 2005, the European Council decided to revise the European Stability and Growth Pact (SGP) at the request of France and Germany. The aim was to gain in flexibility and to improve the economic relevance of the common European budgetary framework. The two thresholds – 60% of GDP for the debt and 3% of GDP for the deficit – remain unchanged, but a number of rules were rewritten to give Member States more budgetary leeway, in particular by taking into account the impact of the overall state of the economy on public finances. For instance, no excessive deficit procedure will be launched against a Member State with a deficit over 3% if it experiences a recession. That exception used to apply only to countries with severe negative growth (-2% of GDP or worse). They may also be granted temporary exemption from sanctions or benefit from extended deadlines to correct deficit excesses when these are justified by "relevant factors" (low growth rate, structural reforms aimed at spurring potential growth or improving long term sustainability of public finances). Under the revised edition of the Pact, a greater emphasis is laid on the evolution of debt ratios when implementing the excessive deficit procedure. In the case of countries where debt weighs more than 60% of GDP, the rate at which that ratio decreases and comes closer to the threshold will be assessed. There will also be closer monitoring of budgetary practices having an impact on public debt.

THE EU MEMBER STATES AND THE MAASTRICHT CRITERIA IN 2005



TERRITORIAL ORGANISATION

The 89,250 sub-national governments in Europe come in a great variety

Sub-national governments are organised in one, two or three tiers according to the size of the country and the process of decentralisation, which is developing rapidly in the new Member States. The first level, with approximately 88,000 entities, corresponds to the municipalities. Several countries have created distinctions between urban and rural municipalities (e.g. Cyprus, Estonia, Greece and Latvia), but also within urban ones. Some cities are given a special status, and may thereby be a part of both the first and the second level of local government (e.g. the Latvian *republikas pilsetas*). The second level is intermediary in large countries such as Spain, France and Poland, but is the highest geographic level in smaller countries. The third tier corresponds to "regions" in large unitary States, and to Federated States in the three Member States with a federal structure (Germany, Austria and Belgium). Spain and Italy, the "regionalised States", where the organisation of government leans towards that of federal States, have granted specific or delegated legislative power to the majority of their regions.

Municipal reforms promote mergers

To offset the disadvantages due to the small size of municipalities, many countries encourage inter-municipal cooperation and/or provide financial incentives to merge municipalities. In Estonia, a law passed in June 2004 provided that municipalities willing to merge would benefit from grants and financial compensation for merger-induced expenditure: as a consequence, 6% of the country's municipalities merged in 2005. In Finland, a reform of the structure and services of municipalities will be implemented in 2007. It aims at strengthening inter-municipal cooperation and increasing the average size of municipalities through mergers.

EU MEMBER STATES' ADMINISTRATIVE TERRITORIAL STRUCTURE

	1st level	2nd level	3rd level
FEDERAL STATES			
Austria	2,358 *Gemeinden*		9 *Länder*
Belgium	589 *communes*	10 *provinces*	6 *communautés* and *régions*
Germany	12,431 *Gemeinden*	323 *Kreise*	16 *Länder*
UNITARY STATES			
Cyprus	377 (24 *municipalities*/353 *communities*) (1)		
Czech Republic	6,248 *obec*	14 *kraj*	
Denmark	270 *kommuner*	13 *amter*	
Estonia	227 (194 *vallad*/33 *linnad*)		
Finland	432 *kunta*		
France (2)	36,784 *communes*	100 *départements*	26 *régions*
Greece	1,034 (914 *demos*/120 *koinotita*)	50 *nomoi*	
Hungary	3,145 *települések* (3)	19 *megyék*	
Ireland	85 (5 *city councils*/75 *town councils*/ 5 *borough councils*)	29 *county councils*	8 *regional authorities*
Italy	8,101 *comuni*	103 *province*	20 *regioni*
Latvia	527 (7 *republikas pilsetas*/53 *pagats*/ 34 *novads*/433 *pagasti*)	26 *rajoni*	
Lithuania	61 *savivaldybes*		
Luxembourg	116 *communes*		
Malta	68 *municipalities*		
Netherlands	458 *gemeenten*	12 *provinces*	
Poland	2,478 *gminy*	314 *powiaty*	16 *wojewodstwa*
Portugal (4)	308 *municipios*		2 *região autònoma* (Madeira and the Azores)
Slovakia	2,891 *obec* (3)	8 *vyssie uzemne celky*	
Slovenia	210 *občina*		
Spain	8,110 *municipos*	50 *provincias*	17 *communidades autonomas*
Sweden	290 *kommuner*	20 *landsting*	
United Kingdom	404 (239 *districts*/ 165 *unitary authorities*)	34 *counties*	2 *devolved nations* (Scotland and Wales) and 1 *devolved territory* (Northern Ireland)
EU 25	**88,002**	**1,125**	**123**

(1) Excluding the 9 municipalities located in Turkish Republic of Northern Cyprus. (2) Including sub-national authorities of French overseas departments (D.O.M.). (3) Excluding cities' districts. (4) Portugal also has an infra-communal level (4,259 *freguesias*).

The budget allocations for municipalities that agree to merge will be doubled in 2007.

Municipal mergers may also result from a general territorial reorganisation. Thus, in June 2006, Latvia decided to divide by three its number of municipalities, which would drop to 176 by the 2009 local elections. In Denmark, the regional reorganisation planned for January 1, 2007, will reduce the number of municipalities from the current 270 to 98. The average population per municipality will then reach 55,000 inhabitants, versus 20,000 today. Municipalities will see a major increase in the scope of their powers, since they will be responsible for almost all local public services.

The process of regionalisation continues

Regional decentralisation is currently a global trend in Europe, with countries falling into three main types depending on the stage they have reached in this process.

• **Type 1 is characterised by further autonomy and increased powers for regions or Federated States.** In July 2006, Germany adopted a major reform of federalism granting the *Länder* additional powers as of 2007 (in the fields of education, research, housing, environmental policies, management of regional government employees, organisation of the legal system, etc.). Over the last few years, Spain made a strong commitment to strengthen regional autonomy. This led to a reform of the status of the Autonomous Community of Valencia in April 2006, and of Catalonia in June 2006 which entailed increased responsibilities in the areas of taxation, administration and the management of infrastructures. Other Communities should follow (Andalusia, Balearic Islands, Aragon). This process brings Spain closer to a federal organisation, and may pave the way for a constitutional reform in 2008. In Italy, the empowerment of regions continues. However, the constitutional move to a federalisation of the country ("devolution"), supported by the former government, was rejected by referendum at the end of June 2006.

• **Type 2 is characterised by the creation of a regional level.** Within the framework of its territorial reform, Denmark is going to create five regions to replace the current 13 counties. Their former responsibilities will be distributed among the central government, municipalities and regions. The new regions, mainly in charge of healthcare services and regional development, will not be allowed to levy taxes. A reform of the grant system and of the equalisation mechanisms will be introduced to accompany these power transfers. In June 2006, Slovenia adopted the constitutional amendments required to create regions. Their final number, most likely 14, will be settled at the beginning of 2007 and introduced at the beginning of 2009. Slovenian regions will be responsible, in particular, for constructing and managing regional infrastructure (roads, hospitals, schools, cultural and social welfare institutions, etc.).

• **Type 3 corresponds to experimental regionalisation:** in Sweden, two counties (Västra Götaland and Skåne) are experimenting a pilot program. This project, to last until 2010, puts them in charge of regional development, a responsibility formerly managed by the State through its local representatives. In January 2005, Finland set up an experimental region at Kainuu for a period of seven years. Its responsibilities (healthcare, social services, education and economic development) were transferred from the municipalities, which nevertheless continue to control financing.

TERRITORIAL REFORMS UNDER STUDY

In **Sweden**, a report by the parliamentary committee appointed in 2003 is due in February 2007. It studies the division of responsibility between the central government, the counties and the municipalities. No reform of the municipal structure is expected, but the committee may suggest that counties be merged and that their number be reduced from currently 20 to about ten. These structures would still be responsible for healthcare and could acquire additional responsibilities in regional development.

In the **United Kingdom**, a White Paper on the reorganisation of local government in England was published in October 2006. The White Paper invites local authorities to submit consensus-based proposals for unitary authority status and promotes an increase in their number. Reorganisation is also under study in the other constituent countries of the United Kingdom, in particular in Northern Ireland, where the number of local governments could drop from 26 to 7.

In **Luxembourg**, a report on territorial and administrative reorganisation was published in May 2005. In addition to other measures, it advocates an increase in the size of the country's municipalities. This could happen either through mergers of municipalities, an option encouraged and overseen by the State, or through the formation of groups of municipalities. The latter option would require the creation of a new legal basis.

In **Hungary**, the committee for the reform of local authorities set up in June 2006 may propose the creation of regions, which would in particular be in charge of the healthcare system and road maintenance.

The creation of regions is also on the agenda in **Latvia**, within the framework of the territorial reform project voted in June 2006. Such regions (5 to 9 of them) could replace the existing 26 districts.

In **Greece**, a reform of the second tier of local government has been debated for several years. If voted, it could lead to the formation of regions, compromising the existence of the country's departments. A reform of the two metropolitan areas (Athens/Attica and Thessalonica) is also being studied. It may entail the creation of a metropolitan association of municipalities.

Lastly, after having dramatically reduced the number of its municipalities since 1994 (from 581 to 61 today), **Lithuania** now plans to initiate a movement in the opposite direction. In order to enhance relations between the population and local elected officials, the number of municipalities should thus increase to 80 or 90.

EXPENDITURE AND INVESTMENT

LOCAL AND REGIONAL EXPENDITURE

Territorial public expenditure on the rise in Europe

In 2005, public expenditure by the European local and regional governments totalled 1,374 billion euros, roughly 2,970 euros per capita.

Between 2000 et 2005, public spending increased at a rate of +3.6% per year on average, more rapidly than GDP (+1.7%) or than total public expenditure (+2.4%). This upward trend led to a constant and steady increase of the expenditure/GDP ratio – from 11.5% to 12.7% – and of their share of total public expenditure – from 25.4% to 26.8%. These evolutions mirror the growing responsibilities of local and regional authorities and the dynamism of social expenditure.

In 2005, expenditure growth slowed down to +3%, still remaining higher than that of GDP (+1.7%) and that of total public expenditure growth (+1.8%).

Cross-national variations

There are considerable national variations concerning the weight of territorial public expenditure within GDP, which ranges from as low as 0.7% in Malta to as high as 32.9% in Denmark.

The ratio largely depends on the size and the nature of responsibilities entrusted to territorial governments: those are quite extensive in the Nordic countries or in Spain, where local and regional authorities are involved in social welfare, healthcare and education personnel management.

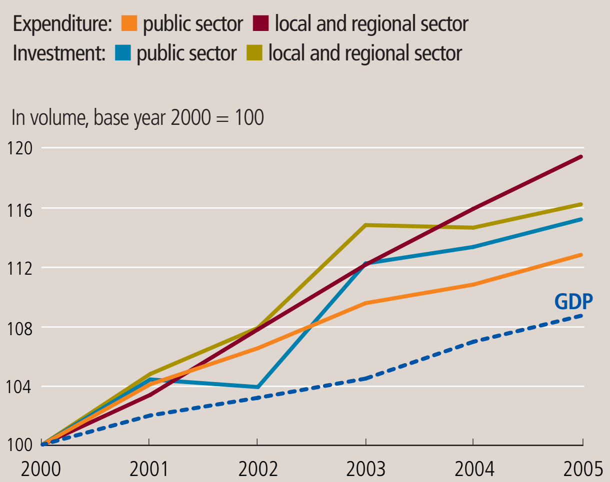
On the contrary, in Malta, Cyprus, Greece or Luxembourg, the responsibilities of territorial governments are limited, and so is the weight of their expenditure.

EXPENDITURE AND INVESTMENT

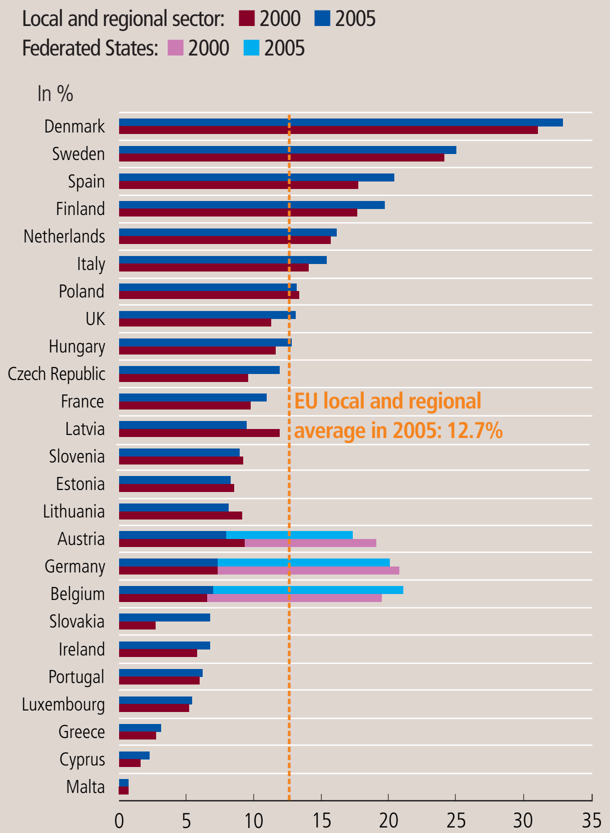
In 2005	Bn €	€/ inhab.	% of GDP	% of public	Evolution 2004/2005
Expenditure					
Sub-national	1,726	3,733	15.9	33.7	+2.0%
Local and regional	1,374	2,972	12.7	26.8	+ 3.0%
Investment					
Sub-national	176	381	1.6	66.8	+2.0%
Local and regional	169	365	1.6	63.9	+1.4%

When analysing the territorial expenditure/total public expenditure ratio, Member States fall into four distinct categories. Denmark and Spain stand out since their local and regional governments are responsible for more than half of their total public expenditure. The ratio is also quite high in Finland, Sweden, Italy (where regions were given large responsibilities), in the Netherlands (which have a long tradition of territorial self-government) and in Poland, where territorial responsibilities were considerably extended in 1999 (education, health, social aid, etc.).

PUBLIC EXPENDITURE AND INVESTMENT FROM 2000 TO 2005 (EU25)



SUB-NATIONAL PUBLIC EXPENDITURE/GDP IN 2000 AND 2005



Expenditure trends between 2000-2005

Between 2000 and 2005, the rise in territorial expenditure was strong in the EU10 (+4.7% per year on average), mostly due to the dynamic process of decentralisation.

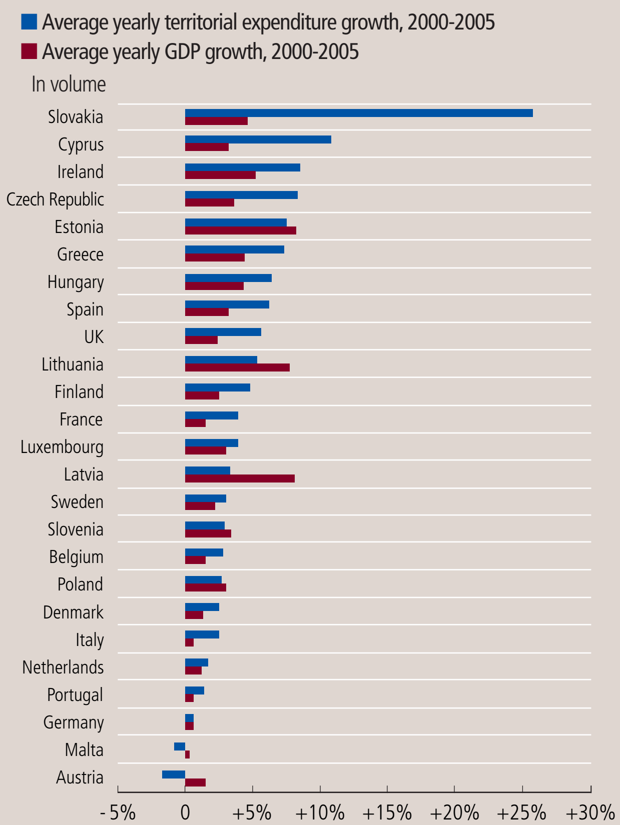
The highest increase was witnessed in Slovakia (+25.7% on yearly average), where municipalities and the new regions created in 2002 now finance most public infrastructure and services (education, hospitals, social aid, public transportation and road infrastructure). The territorial expenditure/total public expenditure ratio went from 5.2% in 2000 to 18.2% in 2005 while the expenditure/GDP ratio rose from 2.7% to 6.8%. The expenditure growth in the Czech Republic (+8.3%) is largely the consequence of a transfer of responsibilities to regions (created in 2000) and to municipalities (social aid, hospitals, retirement homes, cultural policy). In Estonia, education personnel management was transferred to municipalities in 2001, inducing a +27.3% rise that year, and an average growth rate of +7.5% per year over the 2000-2005 period.

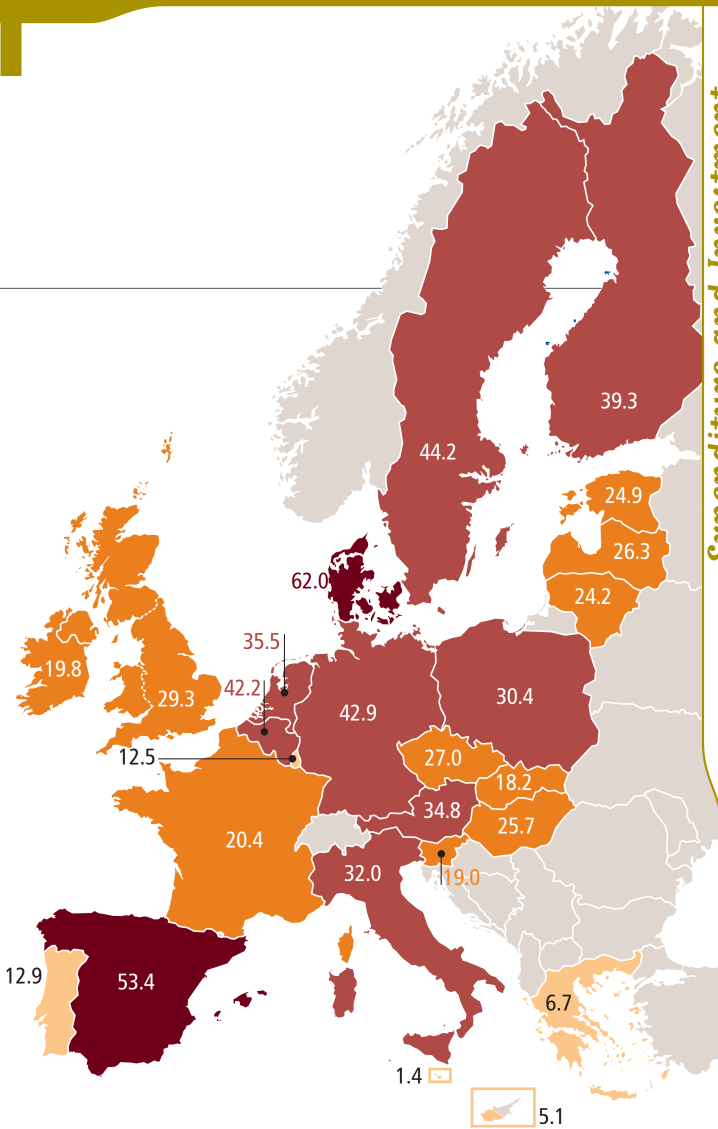
The decentralisation process also gained momentum in several countries of the EU15. In Spain, the autonomous communities received the responsibility for education in 2000 and for healthcare in 2002. This explains the rise of territorial expenditure by +6.2% per year on average, as well as the rise of their share in GDP and in total public expenditure. In Italy, the strong increase in regional public expenditure, direct consequence of decentralisation, took place mostly before 2002.

Other countries, for instance Finland and Sweden, have witnessed steady growth in local and regional expenditure under the influence of rising operating expenditure (especially personnel management, social aid, education and health). In the United Kingdom, after a decade of continuous decline in local and regional spending, then deemed excessive, a reversal of trends intervened in 1997. The UK is now strengthening its collective infrastructure and services, thus raising territorial expenditure (+5.6% per year on average) with large investments in public services and education, one of the main responsibilities of British territorial authorities.

Such strong growth rates are not however ubiquitous. In Germany, the Netherlands and Portugal, expenditure growth remained slow, partly because falling tax incomes (e.g. the decrease in business tax revenue for German municipalities) led local governments to curb their spending to avoid further deficit.

GDP AND TERRITORIAL EXPENDITURE EVOLUTION BETWEEN 2000 AND 2005





Sub-national public expenditure as percentage of public expenditure in 2005

< 15% | 15-30% | 30-45% | > 45%

EU average: 33.7 %

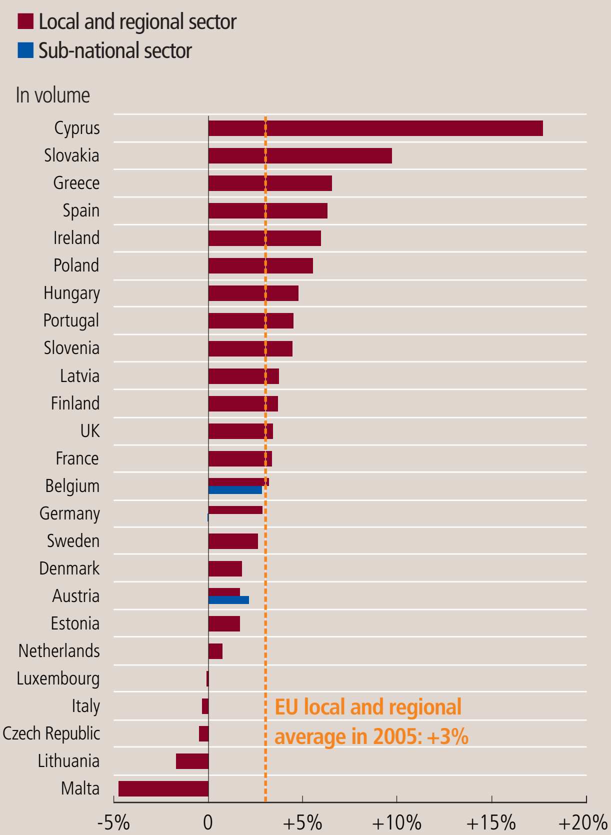
Two countries even experienced negative growth: Malta and Austria. The stark decline in Austrian territorial public expenditure (-1.7%) is due to the contraction of municipal tax revenues (-0.2% over the 2000-2005 period) and tighter budgetary constraints under the internal stability pact, which has been enforced since 1999 and aims at zero deficit. The expenditure/GDP ratio consequently fell by 1.4 point between 2000 and 2005. Decreasing expenditure/GDP ratios over the period in other countries (Poland, Slovenia and the Baltic States) can be explained by the remarkable growth in GDP, more buoyant than territorial expenditure (e.g. respectively +8.2% for GDP and +7.5% for territorial expenditure in Estonia).

Slight slowdown in 2005

Territorial public expenditure growth is most dynamic in the new Member States of the European Union, the EU10 showing a growth rate of +5.3% in 2005 contrasting with +2.9% for the EU15. In Slovakia, local and regional expenditure remains buoyant (+9.7%), partly because the 2002 decentralisation reform has now reached its final stage and partly because of a strong rise in fiscal revenue in 2005.

In most countries of the EU15, territorial public expenditure is still on the increase, especially in Greece (+6.5%), due to the 2005 reform of the status of municipal personnel in charge of social aid, and in Spain, particularly in the fields entrusted to autonomous communities such as healthcare (an area now weighing almost a third of their budget). German territorial expenditures have rebounded in 2005 (+2.8%) after decreasing several years in a row. This is partly due to *Hartz IV*, a reform of the labour market which extended the municipalities' social responsibilities. In France, the *Acte II de la décentralisation* (August 2004) launched a gradual transfer of State responsibilities and personnel to the regions and the departments from 2005 onwards: for instance, regions now monitor vocational training and apprenticeship and departments are in charge of social aid. That law triggered a rise in territorial expenditure by +3.3% in 2005.

EVOLUTION OF SUB-NATIONAL PUBLIC EXPENDITURE IN 2005



SUB-NATIONAL GOVERNMENT PERSONNEL IN THE EU

The 25 Member States of the European Union are home to 32 million public employees who represent 16% of the entire European workforce. Sub-national governments employ 18 million of them, more than half of all public personnel. In the most decentralised countries, a large proportion of public employment falls under the supervision of sub-national governments: in Germany, roughly 9 out of 10 public employees work for local authorities or the *Länder*; this is also the case of 3 out of 4 public employees in the Nordic countries or in Spain. The distribution pattern of sub-national public employment largely depends on the type of responsibilities exercised by sub-national governments, as some fields such as healthcare, education or police require an extensive workforce.

In most countries of the EU15, further decentralisation boosted sub-national public enrolment and depleted central government recruitment. In Spain, over the last decade, the personnel employed by the autonomous communities doubled (now amounting to more than half of all public personnel) while at the same time the Spanish State lost more than 40% of its workforce.

The public sector personnel in Europe is divided across two main theoretical frameworks: the "career type" with a strong emphasis on employment status and a majority of civil servants on the one hand, and the "contract-based type" in which enrolment is based on contracts, generally under common labour laws and with no special status.

These two theoretical models are increasingly overlapping all over Europe. One may observe a shift towards the contract-based type, in particular for sub-national governments. The focus for the sub-national public sector is now on the ability to react rapidly and to adapt its missions, therefore enticing sub-national governments, more than central States, to recruit under common labour laws.

Source: *Local government employment in the 25 countries of the European Union*, Dexia Editions, 2006, 228 pages.

At the opposite end of the spectrum, territorial expenditure growth lagged behind the EU average in six countries, and was even negative in five countries. Strengthened budgetary constraints (definition of objectives of budgetary surplus, policies curbing expenditure, etc.) and diminishing tax revenues (smaller grants, tax freezes in Denmark and Italy) explain this slowdown.

Moreover, a growing number of countries are involved in structural reforms which allow them to outsource spending (through financial dealings with satellite bodies which do not appear as public expenditure), to privatise local public companies or to transfer certain public utilities – like water services, electricity or municipal waste – to the private sector (Austria, Belgium, Denmark, Germany, Portugal, Sweden, Spain).

FEDERATED STATES EXPENDITURE

In 2005, Federated States expenditure amounted to 352 billion euros, 80% of which are borne by the German *Länder*. Sub-national expenditure represents 17.3% of GDP in Austria, 20.1% in Germany and 21.1% in Belgium.

Over the 2000-2005 period, the German Federated States expenditure decreased by -0.4% per year on average, with a sharper decline in 2004 (-2%) and in 2005 (-1.6%), when investment expenditure was curbed down.

The Austrian *Länder* expenditure growth was limited (+0.6%), whereas Belgian regional and community expenditure grew vigorously (+3.2%), mostly because they received added responsibilities and resources (institutional reform in 2001).

LOCAL AND REGIONAL INVESTMENT

Territorial governments remain leaders in public investment

In 2005, public capital expenditure by local and regional governments amounted to 168.5 billion euros (365 euros per capita), representing 1.6% of GDP and 12.3% of local and regional budgets.

The local and regional sector in the UE25 makes up for 7.8% of the entire European investment, public and private. It plays a major role as a public investor: in 2005, 63.9% of public capital expenditure in Europe was made by local and regional governments.

Between 2000 and 2005, local and regional investment expenditure rose by +3% per year on average, more rapidly than GDP (+1.7%). Investment growth proved positive every year except 2004, which was characterised by a slight decrease (-0.2%).

In 2005, local and regional public investment was back on track, but at a slower pace of +1.4%, below the growth of GDP (+1.7%).

Investment depends on the extent of territorial responsibilities

In countries where territorial governments have extended responsibilities, investment usually represents less than 10% of their budget as most of their expenditure relates to operational costs. This is the case in the three Nordic countries as well as the United Kingdom, Lithuania and Estonia. Teaching personnel costs take up the lion's share of the budget in the latter three, since education represents 60% of local expenditure in Lithuania, 45% in Estonia et 38% in the United Kingdom.

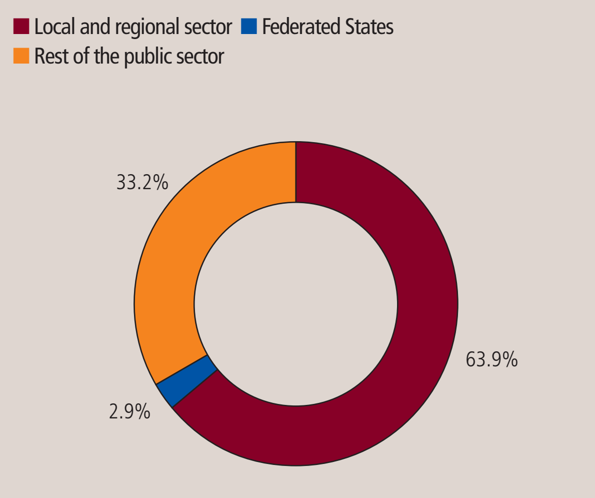
On the contrary, investment represents more than 20% of local and regional public expenditure in France, Malta and Greece, and even more than 30% in Cyprus, Luxembourg, Ireland and Portugal, where the scope of responsibilities falling to local and regional authorities is smaller and where they focus on financing public infrastructures and utilities.

The local and regional public investment/GDP ratio differs greatly from one country to the other, from 0.2% in Malta to 2.5% in Spain. Local/total public investment ratios also span a wide range from 22.5% in Lithuania to 79.6% in Italy (Malta with 2.9% stands out as the exception). Italian municipalities traditionally act as leaders in this field since they are responsible for two-thirds of all local and regional public investment (retirement homes, day care centres for children, schools, municipal road infrastructure).

Moreover, in their capacity as "objective 1 regions", local and regional actors in Italy, Spain, Portugal and Ireland have largely contributed to financing projects profiting from EU structural and cohesion funds.

The weight of local and regional public capital expenditure in Ireland may also be explained by the fact that the investment policies decided by the State under the heading of "Public capital programme" are implemented by territorial governments.

BREAKDOWN OF INVESTMENT BETWEEN PUBLIC ACTORS IN 2005



Investment remained buoyant between 2000 and 2005, especially in the EU10

The majority of new Member States have been implementing very dynamic investment policies throughout the whole period 2000-2005, showing a growth rate of +4.2% per year on average contrasting with +2.9% for the EU15.

Local and regional investment experienced negative growth in six countries, in particular Austria (-6.9%), Germany (-5.7%) and Portugal (-1.4%). Cuts were mostly linked to falling territorial government income and to restrictive budgetary policies, which had an impact on investment decisions. This was the case in Portugal, which restrained municipal debt accumulation.

In 2005, several countries experienced a significant rise in investment (sometimes spectacular at over +50%). This happened mostly in the EU10, where investment progressed on average at +10.2%, in sharp contrast with a +0.8% growth for the EU15.

The implementation of structural funds from 2004 onwards started to have a strong leverage effect on local and regional public investment in the new Member States. That boost was added to the impact of the decentralisation process (which translated into further expenditure) and to the general increase in local and regional revenue.

In Latvia, investment skyrocketed by +58% due to more flexible borrowing protocols for territorial governments: an amendment to the budgetary law of 2005 raised the ceiling on local and regional government borrowing by 45%.

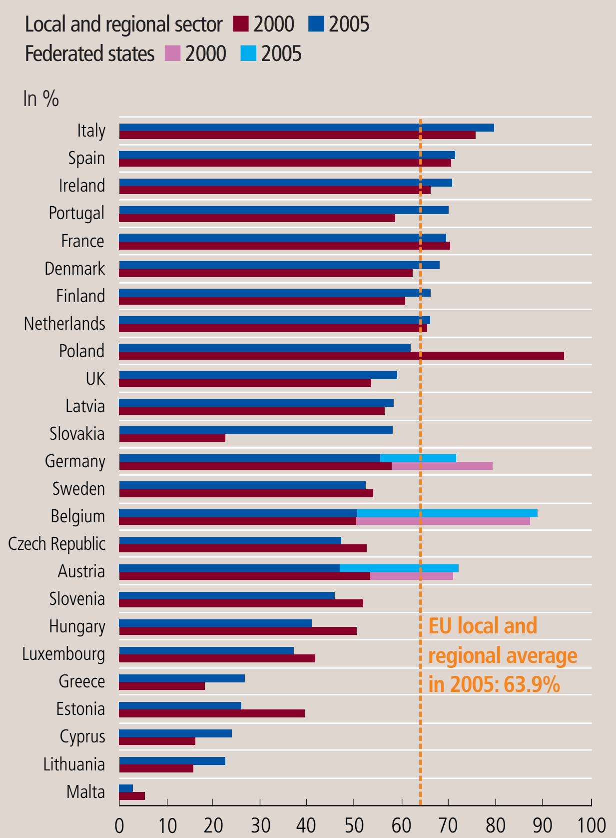
In Slovakia, the trend is also linked to municipal elections being held in December 2006. The same electoral cycle phenomenon is at work in almost all countries where local or regional elections are due in 2006, for instance Belgium (+24.6%), Greece (+18.2%), Poland (+17.2%) and Slovenia (+15.1%).

However one should note that in 2005 local and regional investment regressed, sometimes sharply, in eleven countries. This downfall may be the result of stricter budgetary constraints since the first item to be cut in periods of budgetary restriction is often public capital expenditure.

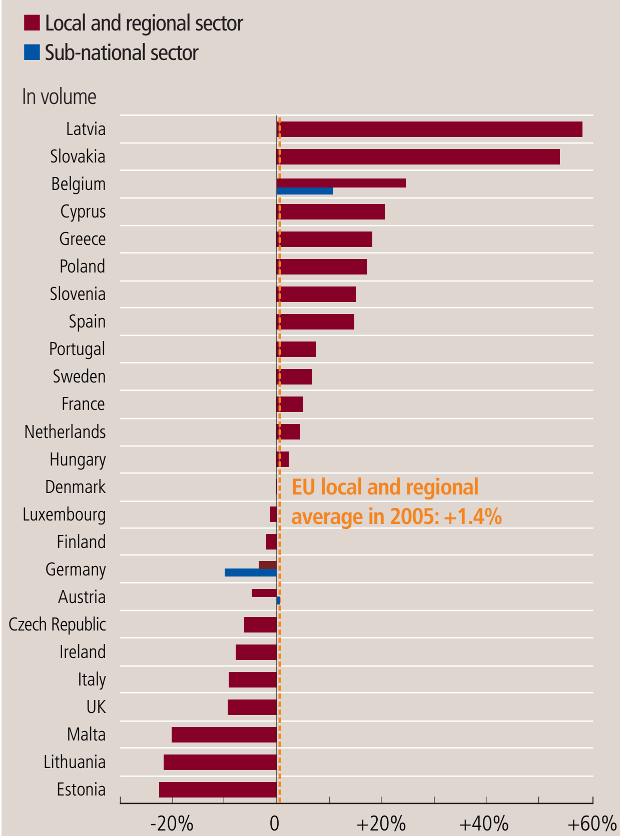
In Italy for example, investment was included in the expenditure budget for the first time in 2005. This had an immediate sobering effect (-9% to be compared with +8.3% in 2004).

Falling investment may also be due to growing education expenditure (Estonia, Lithuania) or social expenditure (Finland), post-election austerity (Lithuania) or an increasing number of Public Private Partnerships projects (United Kingdom, Ireland).

SUB-NATIONAL PUBLIC INVESTMENT/PUBLIC INVESTMENT IN 2000 AND 2005



EVOLUTION OF SUB-NATIONAL PUBLIC INVESTMENT IN 2005



FEDERATED STATES INVESTMENT

Federated States investment expenditure amounted to 7.6 billion euros in 2005. Over the 2000-2005 period, it grew at a moderate rate in Austria and Belgium but fell sharply in the German *Länder*, on average by -10% per year, with an all-time low in 2005 (-26.6%).

The year 2005 also saw a decrease in investment for Belgian communities and regions (-3.6%).

The situation in Austria is more positive in 2005 with the *Länder* public capital expenditure rising by +12.6%.

PUBLIC PRIVATE PARTNERSHIPS IN EUROPE

Using Public Private Partnerships (PPP) to finance public investment is becoming increasingly common in Europe, especially for transportation systems, hospitals, schools and prisons. PPP is a long-term contract (usually covering a period of 20 to 40 years) between a public entity and a private one in charge of designing, building, financing, operating or maintaining an asset in order to provide a service to the public sector. Such a contract enables the public domain to benefit from the technical or financial know-how of the private sector. PPP definition refers to various models which may include concessions (e.g at the European level) or may be limited to projects in which projects revenues come mostly from the public sector under the form of an ongoing fee based on availability or demand risk.

PPP is clearly on top of the agenda of the European institutions: the Commission published a Green Paper in 2004, Eurostat ruled on the accounting status of PPP (2004), the European Parliament published a non legislative resolution (October 2006), the EIB has launched EPEC (European PPP Expertise Centre), and a directive on concessions is due for 2007. However, Community legislation does not currently provide a specific legal framework for PPP, which therefore falls under national legislations. Over two thirds of Member States have adopted a specific legal framework for PPP and have established protocols to coordinate, promote and assess PPP projects, either at national or sub-national levels. The extent to which PPP have developed varies in each country, especially for the projects initiated by local or regional governments.

Countries with a strong PPP culture

- **United Kingdom:** the Private Finance Initiative (PFI) was launched in 1992 and extended in the form of Public Private Partnerships from 1994 onwards. The PPP Task Force, originally monitored by HM Treasury, changed its status in 2000 to become UK Partnership. Since 1992, more than 700 projects have been initiated, both at national and local levels in the fields of healthcare, education and transportation, totalling more than 62 billion euros. PFI amounts to 10 to 15% of total public investment.
- **Spain:** the concept of PPP was introduced through the 2003 law on concessions in the field of transportation. Autonomous communities monitor 50% of all PPP projects, especially in the fields of transport, infrastructure and hospitals.
- **Ireland:** a law was passed in 2002 (revised in 2006) and an Expertise Centre created in 2005. PPP plays a central role in the "National Development Plan". The official aim is to raise the share of PPP in transport investments from 3% to 15% by 2008.
- **Italy:** a legislative framework was established in 2002 and a national Expertise Centre was created in 2000 (*Unita Tecnica Finanza di Progetto*). Some regional PPP units have been set up to promote regional project financing.
- **Portugal:** a law was passed in 2003 (revised in 2006). The programme implementing shadow toll highways proved a success and led to a surge in the number of PPP projects at a sub-national level, especially for hospitals.

Countries where PPP is becoming increasingly common after a slow start

- **France:** France already had a fully developed regime of concessions and from 2002 onwards opened the way for specific PPP programmes in hospitals, prisons and for homeland security. In June 2004, it launched the "Partnership contract" which allows PPP for projects of an urgent or complex nature. It also created the *Mission d'appui à la réalisation des PPP* (MAPPP). In addition to State-driven pilot programmes, 60 projects concerning equipment or infrastructure are under study and 5 partnership contracts have already been signed at a sub-national level. The official aim is to raise the share of PPP in public investments to 10% by 2011.
- **Germany:** a task force was established in July 2004, at the federal level as well as in 6 *Länder*. PPP are quite common at a sub-national level (current estimated weight: 3 billion euros). Since 2000, 80% of all PPP projects have been launched at the municipal level, mostly in the field of education.
- **Greece:** a legislative framework and a task force were established in September 2005. Funding is granted to municipalities wishing to set up a PPP project via *Thiseas*, a programme from the Home Office, which was endowed with a 4 billion euros budget over a 5-year period.
- **Belgium:** the Flemish region actively develops PPP projects for transportation and education (legislative decree in 2003 and *PPS Expertise Centre*), but PPP represent only a very small share of national public investment (less than 2%).
- **The Netherlands:** PPP developed at a national level after an Expertise Centre (*Kenniscentrum*) was created in 1999, and many projects were initiated nationally. However PPP remain marginal at the local level.

Elsewhere in Europe

PPP programmes are quite scarce although some countries have expressed a growing interest, notably the **Czech Republic, Poland** (a law on PPP was passed in 2005), **Hungary** (for road infrastructure), **Latvia** (PPP law passed in October 2006) and **Luxembourg**.

FISCAL REVENUES

TAX REVENUES						
In 2005	Bn €	€/inhab.	% of GDP	% of total revenues	% of public tax revenues	Evolution 2004/2005
Sub-national sector	708.2	1,532	6.5	42.1	24.6	+1.8%
Local and regional sector	509.9	1,103	4.7	37.8	17.7	+3.1%

LOCAL AND REGIONAL FISCAL REVENUES

Sustained growth in Europe between 2000 and 2005

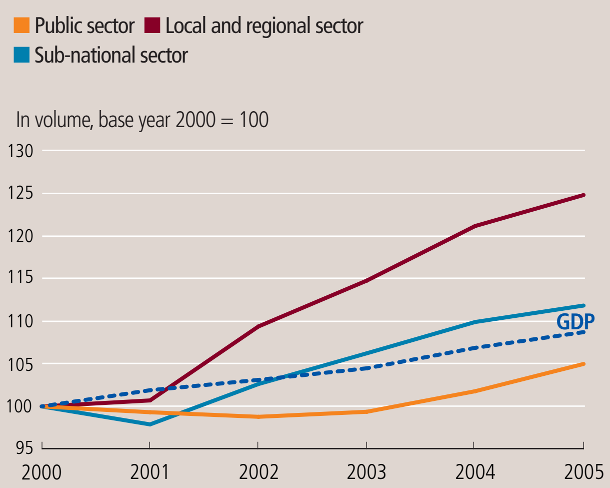
In 2005, local and regional taxes yielded 510 billion euros throughout Europe, i.e. 1,100 euros per capita. Between 2000 and 2005, territorial fiscal income grew steadily: +4.5% per year on average, while GDP progressed by +1.7%, total territorial income by +3.2% and public fiscal income by +0.9%. Territorial fiscal revenue, which stood at 4.1% of GDP in 2000, went up to 4.7% in 2005, while its weight within total public fiscal income grew from 14.8% to 17.7%. In 2005, taxes represented 37.8% of all territorial financial income (35.3% in 2000), the remainder corresponding to State grants, fees and capital revenues. Increasing taxation revenues are a consequence of the extension of territorial responsibilities. In 2005, though it slowed down in comparison with previous years, fiscal growth remained strong (+3.1%), on a par with public fiscal income. It stood higher than GDP growth (+1.7%) and than territorial public income (+2.7%).

National variations in fiscal revenues

The territorial tax income/GDP ratio goes from 0.3% in Greece to 16.5% in Denmark (Malta stands out as an exception because it has no local taxes). Its weight within total fiscal income also varies greatly from one country to another, from 1.3% in Greece to 45% in Spain. The three Nordic countries, Spain, Italy, the Czech Republic and Latvia form a group of countries with high territorial fiscal income as their territorial governments receive a fraction (or even 100%) of national personal income tax revenues.

Considerable variations in the territorial tax income/total territorial revenues ratio also highlight the variety of national models of territorial finance throughout Europe.

TAX REVENUES FROM 2000 TO 2005 (EU25)



National trends between 2000 and 2005

The strong increase (+4.5%) in territorial fiscal income on a European level between 2000 and 2005 is largely due to significant fiscal transfers in favour of the Spanish autonomous communities, which were compensated for the financial costs of their new responsibilities in healthcare and education. The Spanish territorial fiscal revenues thus grew by 15.8% a year on average, boosting the European average.

Other countries have experienced similar growth rates on a lower scale, but they do not affect the larger European picture. Territorial fiscal income grew vigorously (+9.3% per year on average) in the new Member States, as witnessed in Poland, the Czech Republic and Latvia but mostly Slovakia (+24.7%). Not only did they receive additional State grants to finance their new responsibilities, most territorial governments in the EU10 also benefited from full or shared State tax transfers as well as from the creation of new own-source taxes.

In some countries fiscal income growth proved more dynamic than global income growth. Within the EU15, the United Kingdom, Ireland and Belgium have experienced an average annual progression of around +5% over the period. This dynamic growth rate in countries operating traditionally on limited territorial taxation is largely due to the progression of the "Council Tax" for the United Kingdom and of "commercial rates" for Ireland. "Commercial rates" now provide Irish cities and counties with 25% of their income. In Belgium, fiscal growth was fostered by the rise of the local property tax rate (*centimes additionnels*) and of the local rate of personal income tax.

Only a few countries experienced a contraction of their fiscal income over the period, mainly Lithuania (-7.7% in tax revenues but compensated by an increase in grants, the total income of territorial authorities going up by +5.3%), Luxembourg (-2.4%) and Austria (-0.2% for municipalities).

Trends in 2005

In 2005, the fiscal landscape in the 25 Member States is quite contrasted, depending upon the fiscal reforms implemented at a national or territorial level, and upon the overall economic trend, which may have a positive or negative impact upon tax bases and fiscal yields.

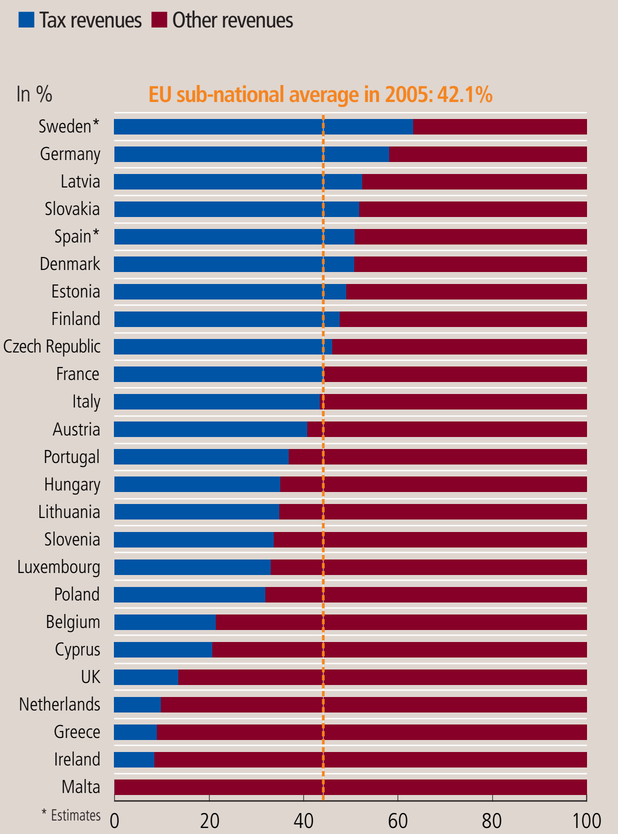
Some countries experienced a significant or even spectacular rise in fiscal revenues. The strong growth of fiscal revenue in Slovakia (+138%) results from buoyant economic growth and the full overhaul of the financing system for municipalities and regions ("fiscal decentralisation"), implemented in 2005. Sustained economic growth also explains rising territorial fiscal revenues in the Czech Republic, the Baltic States and Poland. Further fiscal reforms, allowing territorial governments added shares of national taxes or revising allocation mechanisms in their favour, also had a positive impact upon some EU10 territorial governments' financial situation.

On the other hand, territorial fiscal revenues in the EU15 either stagnated or only grew marginally, both because of the sluggish state of the economy and because of policies aiming at diminishing fiscal pressure on companies and households. A few countries (Germany, France and Greece), however, saw their territorial fiscal income grow by more than +5%. In France (+7.6%), this trend is related to the dynamic evolution of fiscal bases and to increasing tax rates, but mostly to tax transfers (domestic tax on oil products, special tax on insurance policies) made to cover the new responsibilities entrusted to regions and departments.

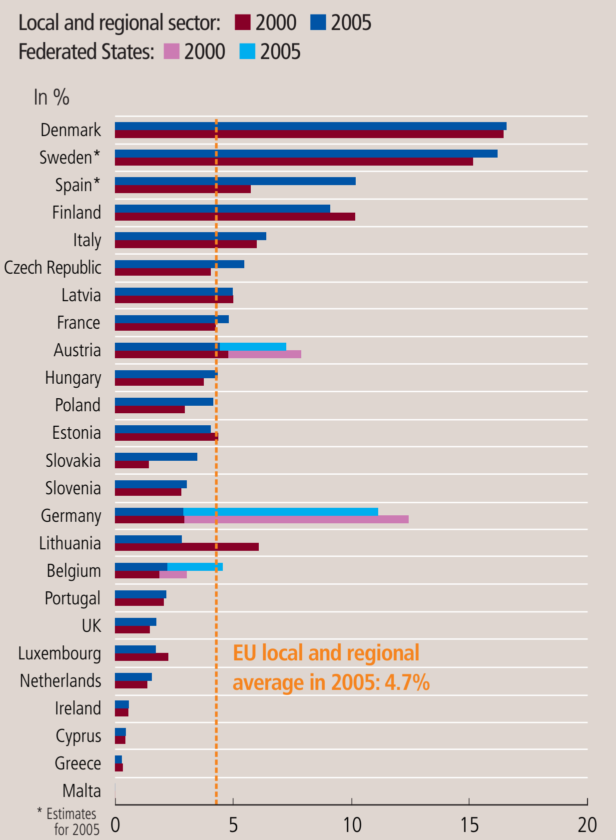
FISCAL REVENUES IN THE FEDERATED STATES

Fiscal revenues in the Federated States totalled more than 198 billion euros in 2005. Over the 2000-2005 period, the German and Austrian *Länder* experienced negative fiscal growth (respectively -2.2% et -0.4% per year on average), a receding trend continued in 2005 (-0.6% et -0.3%). In both countries, the contraction in fiscal income is linked to the dull state of the economy, impacting fiscal yields. For the Austrian *Länder*, one must also take into account the sharp reduction in personal income tax rates and in company income tax rates, decided in 2004-2005. In Belgium, fiscal growth was dynamic for regions (+16.7%), especially in 2002 (+75%), due to the implementation of the July 2001 Special Law on refinancing communities and extending fiscal responsibilities for regions.

TAX REVENUES AS PERCENTAGE OF SUB-NATIONAL RESOURCES IN 2005



SUB-NATIONAL TAX REVENUES/GDP IN 2000 AND 2005



MAJOR TAX REFORMS IN 2005, 2006 AND 2007

Current trends in shared taxation

In **Germany**, VAT rates will increase from 16% to 19% after the first of January 2007. The tax revenue of municipalities and *Länder* is thus expected to increase, as they share the VAT revenue with the *Bund* (they receive respectively 2.1% and 46.5%). But the reform also entails an increasing burden for sub-national governments as consumers. This cost has been estimated at 500 million euros for municipalities.

In **Austria**, municipalities (especially those counting less than 10,000 inhabitants) stand to benefit from the latest revision of the allocation system for the 14 shared taxes over the period 2005-2008. But local tax income has decreased as a result of a policy of easing tax pressure, implemented through a diminution of the personal income tax (PIT) for low salaries (2004, extended in 2005) and the reform of the company income tax (CIT) in 2005.

In **Finland**, the 2005 tax reform lowered the CIT rates from 29% to 26%. Its impact should be compensated by the rise of the percentage allocated to municipalities from 19.75% to 22%.

In **Spain**, the reform of the autonomous status of Catalonia in June 2006 defines new rules for sharing tax income: the community will receive 50% of PIT (previously 33%), 50% of the VAT raised on its territory (previously 35%) and 58% of special taxes on fuel, alcohol and tobacco (previously 40%). Other autonomous communities may follow this example.

In **Portugal**, the Local Finance Law of January 2006 modifies the reversion procedure of the share of national tax revenue paid to municipalities. A grant (FEF) equal to 25% of the mean revenue generated by VAT and income taxes (both for persons and legal entities) will be the major source of territorial revenue. Another earmarked grant (FSM) will cover the extra expenditure due to the transfer of responsibilities from the State to municipalities.

Since 2005, departments in **France** receive a share of the rate of the "special tax on insurance policies", to be added to their part of the "domestic tax on oil products" (TIPP). Regions will also receive a fraction of the TIPP rate, and will be granted some leeway on this fraction from 2007 onwards.

In the **United Kingdom**, part of CIT was transferred to local authorities in April 2006 as a "Business Growth Incentive".

In **Lithuania**, municipalities may suffer from the evolution of personal income tax rates, which decreased from 33% to 27% in 2006 and may fall to 24% in 2008. PIT represents 90% of their fiscal revenue.

In **Latvia**, the share of PIT allocated to local governments rose from 71.6% to 73% in 2005, and to 75% in 2006.

In **Estonia**, the share of PIT allocated to municipalities gradually rose from 11.4% in 2004 to 11.8% in 2006. This measure is to compensate local governments for their loss of revenue due to the lowering of the national rate from 26% in 2004 to 20% by 2009.

Current trends in own-source taxation

Tax abolition

In the **Netherlands**, 2006 saw the withdrawal of the property tax for tenants and the capping of both the property tax for landlords and the tax on commercial building, three measures inducing a significant reduction of municipal tax revenue.

In the Walloon region in **Belgium**, several provincial and municipal taxes have gradually started to be suppressed in 2005 and 2006 (surface tax, industrial compensatory tax and tax on power units).

In **Hungary**, the withdrawal of the business tax, which had been voted in 2005 and was to come into effect on the first of January 2008, was annulled by the Parliament in June 2006.

Creating new sources of local fiscal revenue

Since 2005 the local authorities in **Greece** are entitled to levy a special tax on driving licenses and vehicle sales.

Rewriting existing taxation law

In **Belgium**, the Walloon region decided to redefine for the second time in 2005 the local real estate withholding tax, which represents around 40% of municipal tax revenue: new industrial equipment is exempted from the tax since January 2005. The indexation of cadastral revenue has also been frozen.

In February 2005, the Brussels-Capital region followed the Flemish region's example and lowered the gift tax rates for movable assets. The Walloon region followed in December 2005.

In **France**, the business tax was revised in 2006, capping companies' contribution at 3.5% of their added value from the first of January 2007 onwards. The portion of contribution above 3.5% is taken in charge by the State and local governments. The latter's fiscal leverage is reduced as a consequence.

In **Cyprus**, municipal property tax rates were raised from 0.8% to 1.5% in 2005.

In **Latvia**, real estate constructed after January 2007 will be exempt from the local property tax. The property tax on commercial real estate will also be modified by a re-evaluation of property value and the introduction of a new tax rate.

Since 2006, the property tax base in **Lithuania** includes commercial leaseholds. Municipalities are allowed to fix their rates within a range of 0.5% to 1.5%.

Global reforms of local finance

In **Denmark**, territorial reorganisation led to a reform of local finances, to come into effect on the first of January 2007.

Tax will only be levied by two (instead of three) government tiers, since the new regions are to be entirely funded through grants and will not exercise fiscal power. Most of the tax revenue of the abolished counties will be given to municipalities, whose fiscal revenue will thus be compounded of four taxes: a share of PIT (rate ranges having been extended), a share of CIT, a property tax on land value and one on corporate real estate.

In **Slovakia**, a new system of local finance, adopted on the first of January 2005, raises both shared and own-source taxes. 70.3% of PIT is now allocated to municipalities, who before received a fixed amount. 23.5% is paid to the regions, previously without fiscal income. Moreover, several State grants were replaced by own-source taxation for municipalities and by the tax on company vehicles, allocated to regions.

In 2005, the rise in local fiscal income was such that it is now question of reducing the share given to municipalities. In August 2006, the criteria for tax equalisation were altered in favour of mountain municipalities.

Reforms under study

In the **United Kingdom**, the "Lyons Inquiry into Local Government", an independent inquiry commissioned by the Prime Minister in 2004, should present its results by the end of 2006. This White Paper is likely to state the need for further local autonomy in taxation.

In **Ireland**, the independent survey on "Local Government Financing", published by the Government in March 2006, advises a raise in local fiscal revenue to cover the increasing amount of responsibilities falling to local governments.

PUBLIC BALANCE AND DEBT

LOCAL AND REGIONAL BALANCE

Near budget balance equilibrium at the European level

In 2005, EU25 territorial governments deficit added up to almost 25 billion euros, representing 0.23% of GDP and 9.8% of total public deficit. In 2000, the global balance had indicated a slight surplus, equivalent to 0.05% of GDP. Some erosion occurred between 2000 and 2002, due to the combination of a contraction in fiscal revenues and an increase in social expenditure in a context of economic slowdown. Since then, the average deficit held steady. Between 2004 and 2005, it rose nevertheless by +21% in volume, from 0.19% to 0.23% of GDP.

BUDGET BALANCE AND DEBT

In 2005	Bn €	% of GDP	% of public	Evolution 2004/2005
Budget balance				
Sub-national	44.0	0.41	17.4	-6.0%
Local and regional	24.8	0.23	9.8	+21.0%
Debt				
Sub-national	1,135.6	10.5	16.5	+3.7%
Local and regional	633.0	5.8	9.2	+4.9%

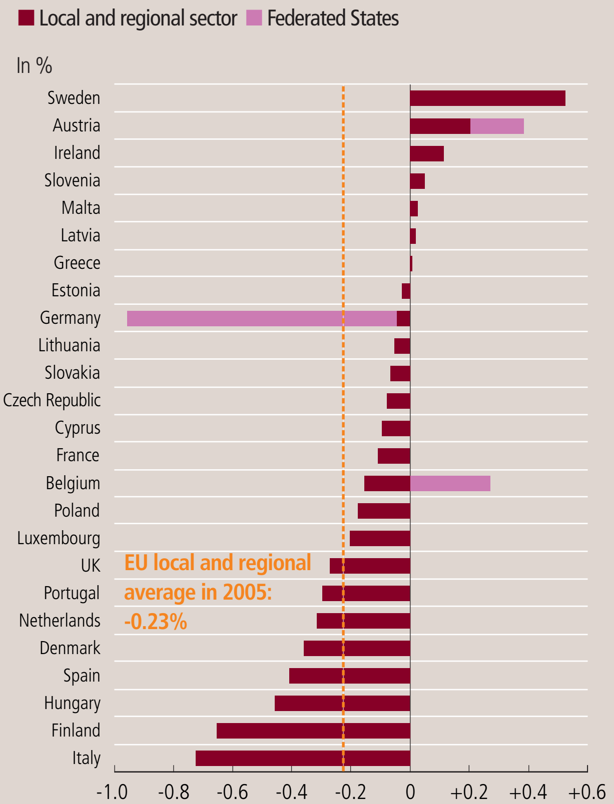
Mild deficit in a majority of countries

Territorial budget balances range from – 0.73% of GDP (Italy) to +0.53% of GDP (Sweden). The territorial governments of seven countries reported a budget surplus in 2005. In most of EU countries, the local and regional sector does thus present a budgetary deficit, which however in most cases remains modest and under control. Between 2000 and 2005, budget balances followed an erratic pattern. In some countries, surplus turned into deficit (Germany, Denmark, Finland, France, the Netherlands) or existing deficits deepened (by a 6-fold increase in Italy and a 4.5 fold one in the United Kingdom). Others cut their deficit down, sometimes slightly, sometimes entirely (Latvia, Ireland). In Austria and Sweden, significant budget surplus either were maintained or even accrued between 2000 and 2005.

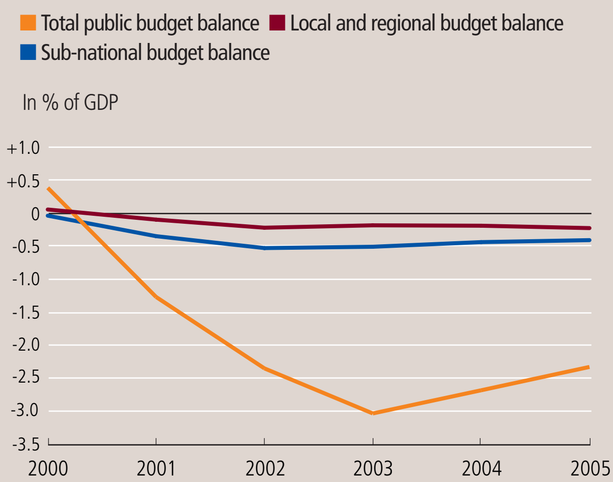
In 2005, ten countries reported a rising weight of their deficits within the GDP, since additional territorial expenditure was not compensated by an adequate increase in revenues. Everywhere else, deficit levels either held steady or decreased.

Balance variations may be explained by the impact of the overall state of the economy on the territorial public sector. In Finland, the deficit degradation echoed a lack of dynamism of fiscal revenues (the company income tax was revised and local personal income tax revenue progressed only slightly) and soaring social and healthcare expenditure, a consequence of demographic change. One should also take into account the fact that transfers of responsibilities and constraints imposed by the State were not always adequately compensated financially: this happened in France when departments took charge for the *Revenu Minimum d'Insertion* (minimum income) and when they had to set up additional welfare benefits for the elderly and the dependent.

SUB-NATIONAL PUBLIC DEFICIT AND SURPLUS/GDP IN 2005



BUDGET BALANCE FROM 2000 TO 2005 (EU25)



In a growing number of countries, territorial budget balances in 2005 were impacted upon by a tightening of prudential rules or internal stability pacts. Other factors, such as needs to finance investment, also played a major role.

FEDERATED STATES BALANCE

In 2005, deficit for the Federated States amounted to 19.2 billion euros. This was entirely provoked by the German *Länder* deficit, since the Austrian *Länder* as well as the Belgian regions and communities reported surpluses. The German *Länder* deficit escalated between 2001 and 2003, when it peaked at 1.5% of GDP. Between 2004 and 2005, it subsided by 23.6% in volume, arriving at 20.4 billion euros and 0.9% of GDP in 2005.

LOCAL AND REGIONAL DEBT

Territorial debt slightly rising

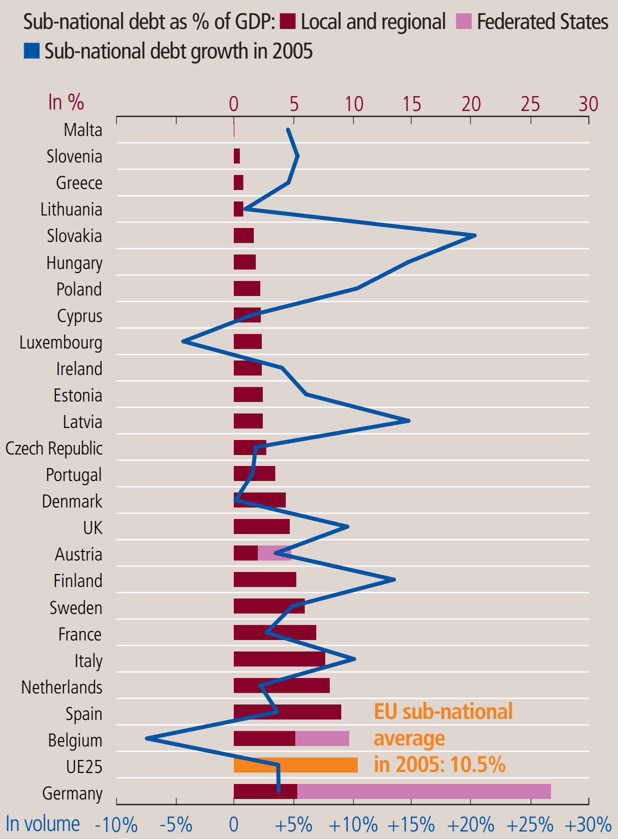
In 2005, territorial debt amounted to 633 billion euros in the EU25, i.e. 1,370 euros per capita. Between 2000 and 2005, it increased mildly, its weight within GDP going from 5.6% to 5.8%, and its share of total public debt from 9.1% to 9.2%. On average, it grew by +2.4% per year over the five-year period. It picked up speed in 2005 (+4.9%).

Contrasting trends between the EU10 and the EU15

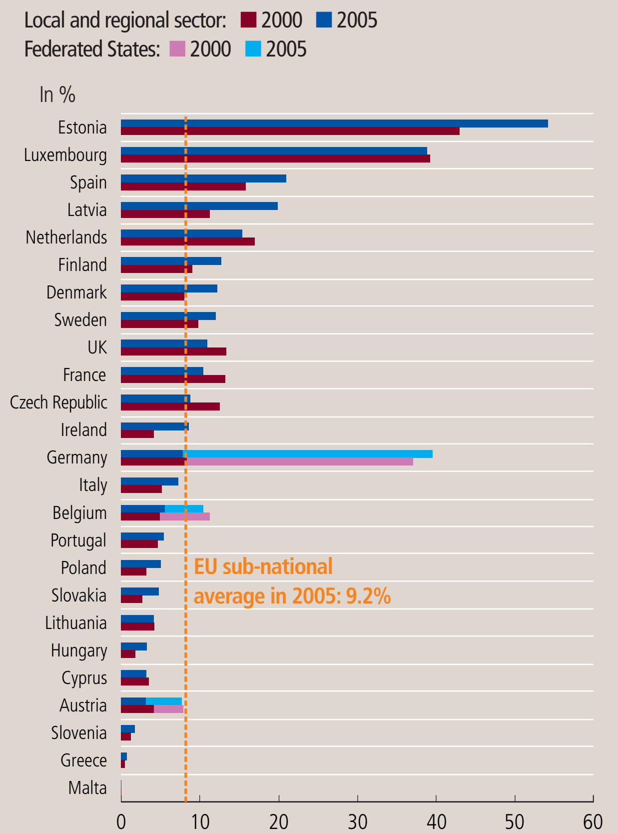
There are considerable national variations in the ratio of local and regional debt to GDP: Malta reports virtually no debt, while territorial debt weighs more than 9.1% of GDP in Spain. The territorial debt/total public debt ratio mostly remains below 20%, Estonia and Luxembourg standing out as an exception since they report very little total public debt.

Territorial governments in the new Member States have significantly less debt than those of the EU15: respectively 2.1% and 6% of GDP in 2005. However, their debt increased strongly in volume between 2000 and 2005 (+13.6% per year on average) especially in Hungary, Poland and Latvia. Even if debt levels remain low, such growth showcases dynamic borrowing policies, designed to catch up on norm requirements and to build new utilities in the context of an increasingly liberalised borrowing market (Czech Republic, Poland, Latvia, etc.). EU10 territorial debt remained dynamic in 2005 (+10.1%), allowing the new Member States' territorial governments to make the necessary contribution to EU cofinancing programmes.

SUB-NATIONAL DEBT IN 2005: EVOLUTION AND WEIGHT IN GDP



SUB-NATIONAL DEBT AS PERCENTAGE OF TOTAL PUBLIC DEBT IN 2000 AND 2005



Territorial governments of the EU15 often report heavier debt loads. This is the case in Spain, the Netherlands, Italy, France and Sweden. This development is sometimes due to extended investment responsibilities for territorial authorities. It can also be a consequence of more flexible borrowing protocols. The weight of the debt may sometimes fall on only a handful of territorial authorities. For example, 60% of the debt of the Spanish autonomous communities is held by only three of them (Catalonia, Valencia, Madrid).

Elsewhere, low levels of borrowing may be explained by a sufficient capacity for self-financing (Luxembourg) or by strict borrowing rules. Those borrowing rules are a tradition in more centralised countries and/or can be imposed in order to avoid excess indebtness (Greece, United Kingdom, Ireland, Denmark, Portugal). Such rules have moreover lately been tightened under budgetary constraints.

Although EU territorial debt only grew by +2.4% per year on average between 2000 and 2005, it proved more buoyant in countries where territorial governments usually report low debt levels such as Greece, Ireland or Portugal. On the contrary Austria, the Netherlands and the United Kingdom have been cutting their debt down over the period.

In 2005 in the EU15, territorial debt soared in three countries: United Kingdom (loosening of borrowing protocols in 2004), Italy and Finland (restricted leeway on fiscal income).

FEDERATED STATES DEBT

The debt of the Federated States totalled 502 billion euros in 2005. The debt of the German *Länder* alone amounts to 482 billion euros, 46% of which were distributed among only three *Länder*. Between 2000 and 2005, *Länder* debt grew on average by +5.5% in Germany and by +4.8% in Austria. In Belgium, rising fiscal revenues have contributed to the implementation of debt relief policies (-6.4%). ■

"RULES OF GOOD PRACTICE" THROUGHOUT EUROPE IN 2005 AND 2006

Member States have implemented increasingly integrated budgetary policies to comply with their obligations under the European Stability and Growth Pact, designed to achieve Economic and Monetary Union. Some "internal stability pacts" were negotiated at a sub-national level and new disciplinary protocols were added to existing prudential rules for public budgets.

Budget surveillance

A few rules are already common practice in Europe: balanced budget requirements, application of the "Golden Rule" (i.e. deficit < investment), prevention of operational deficit reaching or exceeding given thresholds. Today, some Member States go further and officially set objectives of budgetary surplus. For example, in **Austria**, within the framework of the 2005-2008 domestic Stability Pact (aiming to balance public budgets by 2008) a new law was passed in February 2006: it defines surplus objectives for the *Länder* and a zero deficit imperative for municipalities. In **Belgium**, the October 2005 Agreement which defines budgetary objectives over the period 2006-2008, forecasts a budget surplus of 0.2% of GDP for Communities and Regions, and of 0.1% for local governments (except in 2006, an election year). In **Spain**, the Budget Stability Law for 2006-2008 defines a ceiling for public deficit, which must not exceed 1% of GDP if economic growth remains below 2% of GDP (autonomous communities are capped at 0.75%, the State at 0.20%, municipalities at 0.05% of GDP). Should economic growth prove stronger, public entities are bound to attain zero deficit.

Capping expenditures

Public expenditure capping is common practice in Europe, although implicit guidelines are more frequent than official protocols. **Germany** decided in February 2006 to curb the growth of public expenditure (in value) below 1% on a yearly average over the period 2007-2009. Moreover, since the reform of the federal system launched in September 2006, the weight of potential EU-imposed financial sanctions is to be shared between the State (65%) and the *Länder* (35%). In **Italy**, the Finance laws of 2005 and 2006 have reinstated capping expenditure policies and even extended them to all operating and capital expenditure, with the exception of personnel and healthcare expenses. Expenditure growth rate must not exceed 2%, and specific thresholds have been established for each category of territorial government.

Borrowing regulations

In addition to usual rules (borrowing is only allowed to finance investment, prior authorisation by supervisory bodies is required), a number of countries such as Estonia, Portugal, the Czech Republic, etc., have decided to strengthen prudential ratios on debt service or debt levels. In **Italy**, the 2005 Finance law lowered the ceiling on debt annuities for municipalities and provinces from 25% to 12% of total operating revenues. In **Slovakia**, since 2005, local governments are only allowed new loans if their debt and their debt service do not exceed respectively 60% and 25% of the preceding year's total operating revenues. In **Portugal**, the new law on local public finance will tighten already existing debt capping protocols: debt must not exceed 125% of the municipality's total revenues and State guarantees will be restricted. However, borrowing protocols have been made more flexible in some countries. In **Slovenia**, an amendment was added to the Law on Municipal Finances in November 2005. It raises the ceiling for borrowing in a given year from 10% to 20% of the preceding year's total revenue. In **Latvia**, the budgetary law capped at 41.7 million euros the global amount of new loans local governments may contract for the year 2005.

Recognised for its expertise and know-how in public infrastructure financing, structured project finance and financial services to the public sector, Dexia has become the leading world operator on this market. With its headquarters located in France and Belgium, Dexia is active mainly in Europe, but also on the American continent and in the Asia/Pacific region.

The Research Department at Dexia Crédit Local has developed an in-depth knowledge of how the sub-national public sector operates and is financed, both in Europe and the rest of the world. Within this department, the Research Team dedicated to the "Local Public Sector in Europe" closely monitors the institutional and economic evolution of the local and regional public sector, both in terms of organisation and financing, in all the Member States of the European Union. Over the last few years, the Dexia Research Department has published a number of European-wide benchmarking studies on local and regional finance, hospitals, sub-national public sector employment as well as local public companies.

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