Subnational public finance in the European Union

The subnational public sector in Europe is adapting to the environment marked by austerity plans by controlling its operating expenses although lower capital expenditure has been the price to pay

In brief

The decade that just ended will have been successively marked, for the subnational* public sector in Europe by:

- between 2000 and 2007, a steady growth rate of both revenue and expenditure that was slightly higher than that of GDP growth;
- in 2008 and 2009, during the worst of the crisis, a mostly counter-cyclical change in its finances, with, notably, support from the central governments and use of debt that allowed a high level of subnational public investment to be maintained;
- in 2010, a transitional period with timid economic growth of +1.8% during which subnational expenditure stabilised in volume terms amid the implementation of national austerity plans to restore public finances:
  - most current expenditure items increased slowly (+1.4% on average);
  - social spending continued to grow (+3.5%);
  - direct investment, however, fell sharply (-7.6%).

Subnational revenues were affected by successive rounds of crisis (-0.8%): an economic and social crisis which lingered into 2010 in several countries that especially depressed tax revenue; a public finance crisis that led several central governments to freeze or reduce their transfers to local authorities as part of budget savings.

As a result of these developments, the deficit and debt of the subnational public sector increased in 2010. However, they remain, on the whole, under control: the deficit and debt reached respectively 0.8% and 12.1% of GDP in 2010. These results mask, however, disparate realities from country to country and vary according to the economic situation and the nature of public policies that were put in place.

The subnational public sector reacted quickly to the context of the financial, economic and social crisis and more recently the public finance crisis. It used the various levers at its disposal, both in terms of revenue and expenditure, to participate in the collective effort to consolidate public finances while continuing to provide public services. It confirmed its leading economic role with expenditure accounting for 16.9% of GDP and one-third of public expenditure in 2010. More than €211bn in direct investments were made in 2010 by the subnational public sector, i.e. nearly two-thirds of European public investment.

Table of contents
- Methodology (p. 2)
- Macro-economic environment (p. 3)
- Public finances (p.4)
- Territorial organisation and reforms (p. 5)
- Revenue and taxation (p.7)
- Expenditure and investment (p. 10)
- Budget balance and debt (p. 14)

2010 provisional data

Macro-economic weight of the subnational public sector in the EU 27

<table>
<thead>
<tr>
<th></th>
<th>Amount (€bn)</th>
<th>As a % of GDP</th>
<th>As a % of total public sector</th>
<th>Average change by volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure</td>
<td>2,069</td>
<td>15.1</td>
<td>16.9</td>
<td>33.4</td>
</tr>
<tr>
<td>... Local level alone</td>
<td>1,671</td>
<td>11.5</td>
<td>13.6</td>
<td>25.5</td>
</tr>
<tr>
<td>Of which direct investment</td>
<td>211</td>
<td>1.6</td>
<td>1.7</td>
<td>69.9</td>
</tr>
<tr>
<td>... Local level alone</td>
<td>201</td>
<td>1.5</td>
<td>1.6</td>
<td>65.0</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,967</td>
<td>15.0</td>
<td>16.0</td>
<td>33.1</td>
</tr>
<tr>
<td>... Local level alone</td>
<td>1,591</td>
<td>11.5</td>
<td>13.0</td>
<td>25.3</td>
</tr>
<tr>
<td>Balance</td>
<td>-103</td>
<td>-0.1</td>
<td>-0.8</td>
<td>-</td>
</tr>
<tr>
<td>... Local level alone</td>
<td>-81</td>
<td>-0.0</td>
<td>-0.7</td>
<td>-</td>
</tr>
<tr>
<td>Debt</td>
<td>1,486</td>
<td>9.5</td>
<td>12.1</td>
<td>15.6</td>
</tr>
<tr>
<td>... Local level alone</td>
<td>826</td>
<td>5.6</td>
<td>6.7</td>
<td>9.6</td>
</tr>
</tbody>
</table>

*Subnational: federated level and local level (see “Methodology”)

July 2011
Methodology

Data

The primary source of data was Eurostat, the statistical office of the European Union, which uses data from national, public sources (national statistics institutes, central banks, ministries, etc.).

Data was extracted on 26 April 2011 covering all 27 Member States of the European Union. This data remains provisional and will be updated on 24 October 2011 by Eurostat.

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

Several reassignments were made for this analysis, including:

- **Spain**: re-integration of data on Spanish Autonomous Communities in the local public sector (Eurostat treats them as if they were federated entities);
- **Ireland**: reassignment of several items for 2000-2004, after Health Boards were shifted to the central government’s accounts on 1 January 2005;
- **United Kingdom**: reassignment of public investment expenditure for 2005 in order to neutralise an exceptional measure that affected the central administration;
- **France**: 2010 local public sector tax revenues and grants were restated in order to incorporate the initial effects of the abolition of the professional tax: the temporary compensation attributed by the State for 2010 was partially reassigned to tax revenues pending the allocation of new tax revenues to local authorities in 2011.

The data covers the period 2000-2010.

Analysis scope

**Public sector** ($S13$): classified as $S13$ under ESA95, it comprises four sub-sectors:

- $S1311$: Central administrations;
- $S1312$: Federated States and related public entities (only in Germany, Austria and Belgium);
- $S1313$: local authorities and related local public entities (see “local public sector” below);
- $S1314$: social security funds.

$S13$ data is consolidated (elimination of financial cross-flows between sub-sectors).

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

**Local public sector** ($S1313$): comprises local authorities with general competencies (local and regional governments) and bodies with more specialised competencies (variable scope from one country to the next).

Data from the local public sector is consolidated, except for Spain following the re-integration of the Autonomous Communities into $S1313$.

Principle indicators

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

**Direct investment expenditure**: gross fixed-capital formation (PS1) and acquisitions less non-financial assets (land and other non-financial non-produced assets).

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

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

**Non-tax revenues**: in opposition, all other revenues: tariffs and fees, assets revenue (property income), current and capital grants, social contributions.

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

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

Currencies

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

Changes

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

Changes between 2000 and 2010 are average annual changes in volume.

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Macro-economic environment

A slow economic recovery

While global growth reached 4.1% in 2010, the economic recovery in Europe remained sluggish, with GDP increasing 1.8% in volume. This “laborious” rebound was due to the depth of the recession, as European GDP fell 4.7% on average in 2009. However, the pace of the improvement varied from country to country in Europe. GDP growth was over 3% in eight countries including Sweden, Poland and especially Germany, which led the recovery in Europe again. On the other hand, GDP continued to slip in five countries including Spain, Ireland and Greece.

In 2011 and 2012, according to the European Commission’s forecasts from May 2011, the economic upswing should be maintained, gradually approaching a self-sustained recovery as domestic demand gains momentum. GDP growth should, on average, increase at an annual rate of 1.75% in the EU in 2011 before picking up slightly to 2% in 2012.

Rising inflation

In 2009, inflation (fluctuation in the consumer price index) was low (+1.0%); however, inflation increased to +2.1% in 2010 in the EU due to higher commodity and energy prices. This situation varies depending on the country with inflation rate ranging from -1.6% in Ireland to +6.1% in Romania.

According the European Commission economic forecasts, inflation is expected to accelerate in 2010, reaching nearly +3% in the EU but it could slow in 2012 to +2%.

Deterioration of the job market in 2010

In 2010, total employment fell 0.5% in 2010 compared with 2009 and the unemployment rate rose from 9.0% to 9.6% in 2010 on average in the EU. The worsening job situation affected nearly all countries, with the unemployment rate surpassing 15% in Spain and in the three Baltic countries. Germany, Austria and Luxembourg were the only countries to record a slight improvement. In 2011, the conditions on the job market should start to improve but in a gradual and uneven manner depending on the country, with average unemployment rate of 9.5% in 2011 and 9.1% in 2012.

Numerous risks and uncertainties

However, it is important to underscore that these forecasts are susceptible to the uncertain economic environment where risk is high including the political upheaval in the Middle East and North Africa, the economic repercussions of the earthquake and the tsunami in Japan, sovereign debt in European peripheral countries, the behaviour of the capital markets, a new fall in property markets, tension on the forex markets, oil prices, among other factors.
Public finances

Key public finance indicators in 2010

<table>
<thead>
<tr>
<th></th>
<th>Amount (€bn)</th>
<th>€ per capita</th>
<th>% of GDP</th>
<th>Annual average 2000-2010 (% volume)</th>
<th>Change 2009 - 2010 (% volume)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure</td>
<td>6,182</td>
<td>12,320</td>
<td>50.4</td>
<td>+2.4%</td>
<td>+0.9%</td>
</tr>
<tr>
<td>...of which direct investment</td>
<td>324</td>
<td>645</td>
<td>2.6</td>
<td>+7.2%</td>
<td>-7.9%</td>
</tr>
<tr>
<td>Revenue</td>
<td>5,400</td>
<td>10,760</td>
<td>44.0</td>
<td>+1.0%</td>
<td>+1.8%</td>
</tr>
<tr>
<td>...of which tax revenue</td>
<td>3,148</td>
<td>6,280</td>
<td>25.7</td>
<td>+0.7%</td>
<td>+2.5%</td>
</tr>
<tr>
<td>Balance</td>
<td>-782</td>
<td>-</td>
<td>-6.4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Debt</td>
<td>9,828</td>
<td>19,590</td>
<td>80.0</td>
<td>+3.9%</td>
<td>+9.7%</td>
</tr>
</tbody>
</table>

Drop in public deficits in the EU in 2010

On the back of the nascent economic recovery and the initial measures taken starting in spring 2010 to clean up budgets, which were part of fiscal discipline measures, European public finance (central administrations, Federated States, local public sectors, social security funds) began to improve in 2010.

After two years of strong rises, the growth of public spending stabilised in 2010 due to budget cutting measures taken by many Member States (+0.9% by volume). Direct investment fell nearly 8% while it had increased by around 5% in 2008 and 2009 as part of stimulus packages.

Revenues, which were depressed in 2009, increased (+1.8%) on the back of improved tax revenues, notably, that were up 2.5% (after plummeting 8.4% on average in the EU in 2009 as a result of the economic crisis), reflecting the impact of the improved economic situation but also tax measures built into the austerity schemes (e.g. the increase in tax rates, creation of new taxes, combating tax evasion, among others).

In all, the public deficit was reduced in 2010, standing at 6.4% of GDP, versus 6.8% in 2009. Twenty-one Member States recorded an improvement in their public budget balance while for six their bottom line worsened. Only five States were in compliance within the Maastricht deficit threshold of 3% of GDP.

Public debts worsen in 2010

However, public debt, “the most lasting heritage of the crisis” according to the European Commission, continued to climb significantly (+9.7% in 2010 after +14.2% in 2009), reaching nearly €10 trillion in 2010, i.e. 80.0% of GDP versus 74.4% in 2009. All countries, with the exception of Sweden and Estonia, saw their debt-to-GDP ratio increase, and for some, such as Portugal, the United Kingdom, Greece and Ireland, the increase was marked 10%. Fourteen countries had a debt-to-GDP ratio above the Maastricht limit (60% of GDP) while two countries (Italy and Greece) surpassed the 100% bar.

Continued improvement in public accounts in 2011

Driven by more robust economic growth, the end of temporary stimulus measures and the strengthening of budget reduction measures, the public deficit in the EU should, according to European Commission’s forecasts, continue to fall, eventually reaching 4.7% of GDP in 2011 then 3.8% in 2012. The change in public debt would continue to climb, reaching 82.3% of GDP in 2011 then 83.3% in 2012. It could surpass 100% of GDP in four countries (Italy, Ireland, Greece and Portugal).

Sovereign debt crisis

The risk of a heavily-indebted country on the euro area’s periphery becoming insolvent has led to tensions on the market for government bonds. Consequently, several of these countries (Greece, Ireland, Portugal) have experienced a funding crisis. In 2010 and 2011, the European Union and the International Monetary Fund (IMF), reacted by setting up aid programmes under the form of bilateral loans, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).

These two temporary programmes will be replaced in June 2013 by the European Stability Mechanism (ESM), a permanent framework for managing crises and anticipating and resolving future budget imbalances in the Member States of the euro area. The programme also seeks to provide temporary financial support in the event of a sovereign debt crisis. This mechanism’s goal will be to achieve a “qualitative leap” regarding the economic governance of the economic and monetary union by reinforcing budgetary and macro-economic monitoring, solidarity and stability.
Territorial organisation and reforms

Nearly 91,000 local and regional governments in the EU in 2010

The European Union is comprised of 27 Member States, including three with a federal structure (Germany, Austria, Belgium), two regionalised States (Spain and Italy) and 22 unitary States, some of which have a heterogeneous territorial organisation e.g. Portugal, United Kingdom and Finland (regions exist only on part of the national territory).

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

In all, there were 90,928 subnational governments in 2010 including 89,699 municipalities, 980 intermediary entities and 249 “regions” belonging to the 2nd or 3rd level (see table page 6). Among these regions, there are 31 federated entities: the 16 Länder in Germany, the nine Austrian provinces and the six regions and communities in Belgium.

A heterogeneous municipal level

In 2010, the average European municipality had 5,580 inhabitants over a surface area of 49 km². This average hides significant disparities: in six countries, including in France, the Czech Republic and Hungary, the average municipality has fewer than 4,000 inhabitants on average; in eight others the average municipality has greater than 30,000. The United Kingdom is an extreme case with 152,200 inhabitants per municipality. In the countries with “large municipalities”, there is often a structured sub-municipal level comprised of “localities” (i.e. parishes, freguesias, seniūnija, etc.), which sometimes are given a legal status.

For the last several years, reforms at the municipal level have encouraged inter-municipal cooperation and municipalities to merge. The economic crisis was the occasion to accelerate the movement toward reorganising territories, rationalise and pool resources in an effort to increase the efficiency of local public action.

Inter-municipal cooperation and “metropolisation”

Cooperation between municipalities continued to progress in many different European countries (Hungary, Finland, Austria, Estonia, Bulgaria, Portugal, etc.). In particular, a trend is underfoot to reinforce institutions within metropolises: in Finland (mandatory cooperation regarding land use, transport and housing in the seven largest urban regions in the country), in France (under the territorial reform of 2010, creation of metropolitan and municipal centres as well as the Grand Paris initiative), in Italy (creation by the new Act n°. 42 on fiscal federalism from March 2009 of a special status for “Roma Capitale” and nine metropolitan cities), in Luxembourg (implementation of urban communities), in the Netherlands (mandatory status of the “plusregios” for the eight largest urban centres) and in Poland (project to create a special status for 12 metropolitan areas). In the countries where inter-municipal cooperation is highly developed, there is now a willingness to shrink the inter-municipal map, as is the case in Italy and France, for example.

Ramping up municipality mergers

Following the trend set by Denmark in 2007 where the number of municipalities dropped from 270 to 98 and Latvia in 2009 where they went from 524 to 119, Greece has been the latest, and most aggressive to reform its municipalities. In July 2010, the Kallikratís programme went into effect and divided the number of municipalities by more than three (from 1,034 to 325).

Such municipal reforms are also underway in England (gradual replacement of the local councils by unitary authorities), in Northern Ireland (11 districts replacing the 26 current ones in 2011), in Finland (the PARAS Project to Restructure Local Government and Services), in the Netherlands, in Germany as well as in Luxembourg where the municipal restructuring project, which began in 2008, will cut the number of municipalities from 116 in 2009 to 71 in 2017. Lastly, in France, municipal mergers could become a reality due to the new status of “new municipality” created by the local government reform of 2010.

The intermediary levels called into question

Intermediate-level authorities exist in seven EU countries and occupy a peculiar place between regions and municipalities and are the subject of on-going debate in Europe. In recent years, this has been the case in Belgium (reform of provinces underway) and Italy where in 2010 the government proposed doing away with ten provinces deemed to be too small (less than 220,000 inhabitants). In England, the county councils are gradually being phased out and replaced with unitary authorities. In France, the creation of new territorial councillors who sit on both the general council (department) and the regional council (region), from 2014, could be a prelude to a redefinition of the role of the intermediary and regional levels, even leading to mergers between departments or between regions and departments.

Regional transformation

The regionalisation process has also occurred in numerous European countries and has taken various forms over the last twenty years, including: the reinforcement of competencies and resources of current regions, regionalisation experiments, overhaul of the regional level and the creation of a new level.

In 2010 and 2011, the regionalisation trend continues:
- In Spain, Italy and Germany, reinforcement of regional revenues following the implementation of recent laws on fiscal federalism.
• In Greece, replacement of 54 “prefectural departments” with 13 democratically-elected regions (the *Kallikratis* reform).

• In Sweden, confirmation by the government of its desire to transform, before 2015, the counties into six or nine regions by giving them healthcare and regional planning responsibilities. It was decided that the region status would be given to, definitively in 2015, the two counties of Skåne and Västra Götaland, which have experimented with this status since 1997-1998.

• In Finland, positive conclusions from the assessment of the pilot regionalisation project conducted in Kainuu since 2005 (only region in the country whose representatives are directly elected by universal suffrage). In March 2011, the government extended the experiment until 2016 and is going to propose spreading regionalisation to the entire country.

• In Slovenia, presentation in February 2011 by the government of a new regionalisation project based on the creation of six regions (instead of the 14 defined in the project abandoned in 2008).

Elsewhere in Europe, regional reform projects are still being debated in Poland (reinforcement of current *voivodeships*), Belgium (planned institutional reform which could give new competencies to the Federated States and revising the Special Financing Act), Ireland (consolidation of “regional authorities” spelled out in the local government reform), Portugal (creation of self-governing regions on the mainland), Bulgaria, Romania, etc.

However, in Latvia and Lithuania, the projects for creating autonomous regions were abandoned.

<table>
<thead>
<tr>
<th>Population, surface area and organisation of territories in the EU-27 Member States in 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Population (thousands)</strong></td>
</tr>
<tr>
<td>----------------------------</td>
</tr>
<tr>
<td><strong>Countries with one subnational government level</strong></td>
</tr>
<tr>
<td>Bulgaria ¹</td>
</tr>
<tr>
<td>Cyprus ²</td>
</tr>
<tr>
<td>Estonia</td>
</tr>
<tr>
<td>Finland</td>
</tr>
<tr>
<td>Ireland</td>
</tr>
<tr>
<td>Latvia</td>
</tr>
<tr>
<td>Lithuania ¹</td>
</tr>
<tr>
<td>Luxembourg</td>
</tr>
<tr>
<td>Malta ³</td>
</tr>
<tr>
<td>Portugal ⁴</td>
</tr>
<tr>
<td>Slovenia</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Countries with two subnational government levels</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
</tr>
<tr>
<td>Czech Republic</td>
</tr>
<tr>
<td>Denmark</td>
</tr>
<tr>
<td>Greece</td>
</tr>
<tr>
<td>Hungary</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Romania ¹</td>
</tr>
<tr>
<td>Slovakia</td>
</tr>
<tr>
<td>Sweden</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Countries with three subnational government levels</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
</tr>
<tr>
<td>France ⁵</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Italy</td>
</tr>
<tr>
<td>Poland</td>
</tr>
<tr>
<td>Spain</td>
</tr>
<tr>
<td>United Kingdom ¹</td>
</tr>
</tbody>
</table>

| **TOTAL EU 27** | 501,636 | 4,409,047 | 89,699 municipalities and local authorities | 1,125 regional and intermediary authorities | 104 regions |

¹ Existence of a sub-municipal structure level (communities, localities, parishes, etc.).
² Only in the Government controlled area.
³ Including four French overseas departments.
⁴ Including four overseas departments.
⁵ Including overseas departments.
In 2010, total subnational public sector revenue in Europe reached €1,967bn, i.e. 16.0% of GDP and 36.4% of public revenue. They dropped 0.8% in volume in 2010, marking a certain break compared with the period 2000-2010 (+2.0% per year on average), and even compared with 2008-2009 (+0.9%) where, despite the drop in tax revenue and property income, the support of central governments helped maintain revenues. In 2010, all revenue categories dropped except tariffs and fees.

M ore nuanced change per country

On a per country basis, the picture is more nuanced however. Europe can be separated into two large areas: thirteen countries in which revenue dropped while in the other area with fourteen countries revenue increased.

In broad outline, the first group includes countries in southern Europe, notably Greece, Spain, Italy and Portugal. The economic situation and the drop in State transfers were the main causes of this situation.

Whereas in northern countries including Germany, the Nordic countries and Central and Eastern European (CEE) countries, increasing revenue can reflect a pick up in the economy or result from measures implemented by the central and subnational governments to buoy or boost revenue levels, such as increasing grants, tax reforms, user fee policies or improving tax equalisation mechanisms.

A drop in subnational revenue in 2010

The non-tax revenue of subnational entities reached €1,176bn in the EU in 2010, i.e. 9.6% of GDP and nearly 60% of subnational revenue. The slight drop in 2010 (-0.4%) resulted, in reality, from various revenue sub-categories changing in different ways.

A drop in grants in 2010

As the leading source of revenue for the subnational public sector (see box page 8), grants and subsidies dropped 1.0% in 2010, a marked turnaround from 2009 (+6.4%) where governments had set up substantial aid measures for local authorities as part of stimulus plans (increase in operating and investment grants, activation of one-off, emergency grants and tax equalisation mechanisms, creation of new funds dedicated to equipment, acceleration of subsidy payments, etc.). In 2010, budget cutting measures taken by central governments, motivated by the public finance crisis, led many of them to reduce or freeze their transfers and subsidies to the subnational sector. This resulted in a volume drop in more than half of the countries including Greece, Italy, Spain, Portugal, Ireland and, to a lesser extent, France. This change affected investment grants in particular (-7.9%). Operating grants held steady at -0.01% by volume.

A differentiated change in non-tax revenue

Subnational revenue by country in 2010 (as a % by volume)
In a dozen countries however, grants continued to increase in 2010 with the support of European funds and especially the continued aid of central governments. In order to off-set the drop in tax revenue, several countries did indeed decide to maintain, or even temporarily increase, their transfers to the local public sector (Slovakia, Lithuania, Sweden, Poland, Germany, Finland, etc.).

The continuation of the drop in assets revenue
Particularly affected by the crisis due to their nature, property income (interest on deposits and investment, dividends, rent, etc.) continued to decrease in 2010 in approximately 20 countries. On average, however, the drop in Europe was less marked than in 2009 (-2.6% versus -14.0%) due to the strong increase in their revenue category in the United Kingdom and, to a lesser extent, in Germany.

Over the period, this change was relatively erratic, reflecting the fluctuation in the capital markets and transactions involving subnational assets.

The increase in tariffs and fees
Revenue from user fees and charges, which are generated when public authorities charge people for using a service, increased in 2010 by 2.3%, i.e. at a faster pace than in previous years (+1.6% per year on average between 2000 and 2010). While rising user fee revenue in 2009 (+0.8%) was partly slowed by the economic and social situation (lower user rate, reduced tariffs for struggling households), it would seem, in 2010, that local authorities wished to use this leverage to increase their resources amid a more difficult financial context (taxation, grants). This revenue grew in about fifteen countries, including in Greece, Italy, Germany and in several CEE countries due to increasing rates and the creation of new charges (garbage collection, elderly services, nursery rates and sport and cultural facilities, etc.).

A smaller fall in tax revenue
Own-source and shared tax revenue is the second largest source of revenue for the subnational public sector and in 2010 they dropped (-1.5%) to €791bn, i.e. 6.4% of GDP and 25.1% of public tax revenue.

The drop in 2010 was, however, less pronounced than in 2009 (-4.3%), a year in which the economic crisis and counter-cyclical tax measures (drop in rates, tax breaks and exemptions) made their full impact felt. Moreover, it covered fewer countries i.e. tax revenue was down in around ten countries in 2010 versus nearly double that in 2009. In 2010, a drop was recorded in several CEE countries as well as in Spain (-14.4%), Luxembourg (-2.7%), the United Kingdom (-1.3%) and Germany (-0.9%) while tax revenue jumped by more than 2% in twelve countries including Italy, Finland, France, Belgium and Denmark.

Changes vary depending on type of tax
Tax revenue based on economic inflows (household revenue, business turnover, value added, construction activity, price of real estate, consumption, etc.) continued to contract in the countries that remain mired in the crisis such as Spain.

Subnational revenue categories in 2010 (% of total revenue)
These same revenues began, however, to recover in countries that were back on the growth track and countries in which economic activity and the property market has rebounded. Better household and corporate revenue, the recovery in consumption, the increase in property transactions and growth in construction markets have resulted in higher revenue, whether they are from shared taxes (several CEE countries) or own-source tax sources. In Germany, for example, revenue from the professional tax, which accounted for around 45% of municipal revenue, increased 7.7% in value in 2010 while they had fallen sharply the year before. In France, transfer tax on real estate transactions, which had plummeted 26% in 2009, rebounded in 2010 (+35%) on the back of the robust property market.

However, the economic recovery did not always have an immediate effect on taxation. In several countries such as Luxembourg or Hungary, the return of growth will not have an effect on taxation before 2011 or 2012 due to the delay between the financial year of the enrolment and the year for which the revenues are collected.

Moreover, the effects were also attenuated by the decisions of the central governments that sought to speed up the recovery by cutting taxes or offering tax breaks on shared taxes (in Germany, for example, with the personal income tax) or own tax sources (e.g. a freeze of the Council Tax in the United Kingdom).

Tax revenue, which is less sensitive to economic fluctuations, held up better, in particular those that are based on property.

They also proved resilient in countries where local officials had the technical as well as political gumption to exercise their tax powers by increasing local tax rates or expanding the tax base.

**Numerous tax reforms were launched**

In order to attenuate the impacts of the crisis or to find new sources of revenue for local authorities, several countries temporarily or permanently reformed their local taxation systems by introducing new local taxes (e.g. creation of a property tax in Ireland and in Latvia), increasing the tax power of local authorities on certain taxes (e.g. the Czech Republic), reforming existing local taxes, hiking rates or widening shared tax bases and sometimes an increase in the percentage allocated to local authorities (Finland, Latvia, Spain, Slovakia, etc.), land registry reforms (Romania), updating of bases (Spain), combating tax evasion (Italy) and collecting on back taxes (Bulgaria), etc.

The return of a degree of tax revenue growth could continue if the economic situation keeps improving and if current reforms, aiming to solidify and stabilise subnational taxation systems, produce the desired results. With this in mind, there are also efforts in countries to reinforce tax equalisation mechanisms, notably those that involve taxation (France, Spain, Italy, CEE countries, etc.).

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**Focus on several recent or current reforms of subnational financing**

**Spain**: a reform of the financing regime of the Autonomous Communities (law 22/2009 of 18 December 2009) is gradually being implemented and therefore will not produce its full effects until 2011. It aims to guarantee a minimum level of public service throughout the territory (creation of a Guarantee Fund mechanism for basic public services and Fund for general sufficiency), improve tax equalisation mechanisms (implementation of two new convergence funds) and increase regional revenue through an increase in their tax revenues. The redistribution rate of national shared taxes jumped from 33% to 50% for income taxes and VAT and from 40% to 58% on special taxes (taxes on drinks, hydrocarbons, tobacco).

The reform of local government (competencies, financing, etc.), announced a few years ago (White paper from 2005), is still being prepared.

**Italy**: law 42/2009 on fiscal federalism, passed in March 2009 which amended Article 119 of the Constitution, is being implemented through eight decrees regarding its application that are scheduled to be adopted before 2016. The goal is to replace a portion of State grants with national shared taxes, to use the “standard costs” method for calculating State transfers to regions (replacing the system founded on the “historical spending” method, which has an inflationist effect) and finally to reinforce tax equalisation through a State-managed fund that also guarantees basic public services (healthcare, education and welfare) for low-income regions.

Three decrees were adopted in 2010 whereby the State gave municipalities a portion of its property. The other two concerned the status of “Rome Capital” and the definition of “standard costs”. In March and May of 2011, four decrees were adopted on municipal federalism, tax autonomy of regional and provinces, tax equalisation for the South and the sanctions system. A few years will be necessary before the impact of the fiscal federalism system is felt.

**France**: the business tax (taxe professionnelle) was abolished and replaced by the territorial economic contribution (CET), itself comprised of a business real estate tax (CFE) and a tax on businesses’ added value (CVAE). The former is capped at 3% of the taxpayers’ added value. In 2010, a transitional regime was set up and local authorities will no longer receive the business tax but will receive, for that year, compensation.

In 2011, the new resource sharing scheme will be operational, including the CET, new local taxes (IFER), a new scheme for sharing property taxes between local governments, a new definition of several State transfers and changes regarding local power on rates, notably for regions. It will be accompanied by a reform of the “horizontal” equalisation system.

**United Kingdom**: the government announced in October 2010 in the Spending Review that it would allocate extra funds to the local authorities that decide to freeze or reduce the Council Tax in 2011-12. It also launched a broader review of the way in which English local councils will be funded starting in 2013-14 under the Localism reform. The stated goal is to do away with the government formula grant and replace it with more own resources, anchored by the Council Tax and the business rates for which the local authorities currently have no leeway.
Expenditure and investment

Putting the brakes on subnational expenditure after 10 years of sustained growth

In 2010, growth in subnational sector expenditure in Europe was -0.04% by volume and -0.1% for the local level alone.

This stabilisation followed ten years of strong growth (+2.4% on average by volume), which resulted from the decentralisation process that has been underway in European countries as well as greater demand for local public services. Certain budget spending items increased significantly, such as social spending and healthcare.

This pause came on the back of two years (2008 and 2009) of strong expenditure increases, driven by the economic and social crisis and the implementation of the national stimulus plans.

In a tighter budgetary context in 2010 marked by restrictions laid down by national austerity measures, local authorities reduced or moderated several budget lines linked to current expenses and were forced to reduce their investments significantly.

The slowdown affected nearly every country in Europe (see table on page 11).

The weight of subnational expenditure in the European economy

At €2,069bn in 2010, European subnational public sector expenditure accounts for 16.9% of GDP on average and 33.5% of public expenditure (13.6% and 27%, respectively, for the local sector alone).

These two averages mask a wide variety of national situations, which can be explained by the size of each country, how territory is organised, the level of decentralisation as well as the nature of the responsibilities carried out by the local authorities.

Denmark stands apart with local expenditure that totals 38% of GDP and 65% of public expenditure. This is an atypical case which stems from the fact that the majority of social security flows are allocated to the local authority level.

A second group is comprised of Germany and Belgium, two federal countries in which the expenditure of the Federated States and the local public sector combine to reach high levels as well as Sweden and Finland, two Nordic countries that are highly decentralised.

On the opposite end of the spectrum is a group of countries that are not very decentralised, where local authorities have limited competencies, due to the small size of the country or the presence of a central government that has traditionally been strong.

Lastly, with ratios below the European average, France and the United Kingdom join approximately 10 countries of Central and Eastern Europe which, for a majority among them, are transitioning to a decentralised structure.
Moderation of current expenditure

Current expenditure of the subnational public sector grew at a more moderate pace in 2010 than in the recent past (+1.4% to reach €1,783bn i.e. 86% of budgets). Staff costs and spending on goods and services recorded the sharpest slowing while social expenditure remained buoyant.

Stabilisation of personnel expenditure

Personnel costs are the top spending item for the subnational public sector. They grew steadily between 2000 and 2010 (+1.9% per year on average) due to effects from decentralisation (transfers of personnel, for example in Spain and France) and from modernisation of the territorial public functions in Europe, in particular in the new Member States.

With the 2008-2009 crisis, policies supporting the job market led local authorities to maintain a high level of spending in this area (saving public jobs, development of subsidised job contracts for persons in difficulty).

It appears that the pace of personnel expenditure growth slowed in 2010, only increasing 0.7%. This downturn seems to reflect the first effects of policies aiming to reduce staff costs that have been implemented in many countries.

Personnel expenditure has even dropped in volume terms in half of the European countries with the largest falls occurring in countries that have overhauled their public sectors, lowered salaries and scrapped bonus or 13th month systems (Baltic countries, Romania, Greece, Hungary, Portugal, Ireland). In Spain, the fall has been less marked (-2.1%) but was the result of a 5% salary cut for public workers while in the United Kingdom (-1.3%), austerity has resulted in a freeze on public salaries and job losses in “non-essential” services (in England, 132,000 public jobs were lost in 2010 including 66,000 in local authorities).

In 2011, personnel expenditure is likely to decline further under the effects of tightening and the extension of policies to reduce staff and payrolls, which take on various forms depending on the country: retirees not being replaced, subsidised jobs and insecure contracts not being renewed, moratorium on recruitment, wage freeze or cuts, outsourcing the management of certain services, jobs cuts, etc.

Slowdown across nearly all of Europe

Despite average European spending growth of around zero, spending actually dropped in volume in more than half of the countries in the EU. For some countries, this drop was very marked, notably in Greece, Portugal, Ireland, Italy and Spain.

Only seven European countries increased spending significantly (at least +2%) including Germany, the three Nordic countries and several CEE countries. This increase mainly resulted from an expansion of social services and the weight of certain budget items (personnel expenditure) but also resulted from the transfer of competencies in 2010 (e.g. Lithuania) and a relatively healthy budget (Sweden).

Change in subnational expenditure by country in 2010 (% in volume)

Spending on goods and services slowed

Another budget item on which local authorities focused their efforts was intermediate consumption expenditure (i.e. supplies, maintenance costs, overheads, energy, telecommunications, IT, research and advisory services, insurance, etc.).

Particularly robust between 2000 and 2010 (+3.4% per year on average), they tended to slow in 2010 where they only increased +1.4%. On a per country basis, the downward trend is more marked as this budget item dropped in volume terms in around twelve countries, mainly those that were hit hard by the crisis and forced to make drastic budget cuts under the terms of austerity plans (Greece, Spain, Portugal, Ireland, United Kingdom, etc.). It also increased very slightly in four other countries, notably Belgium and France, reflecting efforts to rein in local authority spending via rationalisation and pooling expenses policies.

If long-term efforts continue, intermediate consumption expenditure could stabilise going forward, notwithstanding a sizeable increase in certain inputs (commodities, energy, etc.) which are liable to affect the operating costs of public services (transport, food service, urban lighting, heating, etc.).
Financial expenses continued to drop

Interest charges, which are characterised by their relative volatility, were particularly uneven over the period 2000-2010, peaking in 2007 on the eve of the crisis.

Over the entire period however, financial expenses were reduced an average of 1.7% per year, and even 3.0% for the local public sector alone. They dropped from 3.3% of subnational expenditure in 2000 to 2.2% in 2010 (and by 2.6% to 1.4% for the local public sector alone).

In 2010, financial charges continued to decrease in around 20 countries. However, since 2009 the trend has changed course: the drop was limited to -0.7% in 2010 versus -16.1% in 2009 which undoubtedly marked the lowest point. At that time, lower interest rates and the compression of banking margins in 2009, combined with deleveraging in 2007, sent interest charges markedly lower.

Social spending remained strong

The social fallout from the crisis, the effects of which lagged economic activity slightly, continued into 2010. Consequently, the number of aid seekers and the volume of services offered (unemployment payments, guaranteed minimum revenue, family support, housing subsidies, emergency aid, etc.) grew.

Against this backdrop, social spending, which had already grown 6.4% in 2009 remained robust in 2010 in approximately 20 countries (+3.5% on average in the EU). Growth was higher than 4.5% in a dozen different countries, including Germany, France, Sweden, Finland and the United Kingdom.

The continual increase in social spending has accelerated over the past ten years (on average +3.4% per year) as a result of several factors such as the ageing population, growing needs in terms of local public services and the trend towards the decentralisation of social services. This is why, even if social expenditure are likely to slow in 2011-2012 due to a brightening job market, this budget item should continue to expand over a long period.

Subnational public expenditure by economic function

Education is the number one budget item for the subnational public sector, accounting for 21% of subnational budgets on average in the EU. This rate is significantly higher in many CEE countries (over 36% in the three Baltic countries, Slovakia and Slovenia) but also in the United Kingdom and Belgium (32%) where local authorities are charged with building and operating infrastructure, with paying the salaries of teaching and technical learning staff salaries as well as school-related activities (transport, food services, scholarships, etc.).

The second-largest expense is social protection (social services and investments). The percentage easily exceeds the average (20% of budgets) in Germany, the United Kingdom and in the three Nordic countries, reaching 54% in Denmark.

After general public services (16%), healthcare accounts for 13% of subnational budgets, exceeding 20% in Austria, Lithuania, the three Nordic countries, Spain and in Italy where it reaches 44% of expenditure. The regions and/or municipalities in those countries are responsible for the bulk of the management of public hospitals, specialised medical services and primary care.

Within the European public sector, the subnational sector plays a major role in the areas of housing and community amenities (drinking water and lighting networks, etc.), environmental services (waste collection and treatment, sanitation, parks, etc.) as well as leisure and cultural activities (sports, libraries, museums, up-keep of heritage sites, theatres, etc.). In 2009, it ensured more than 70% of the public spending in those three respective areas.

Its weight compared with other public players is more balanced in the area of economic affairs and public order and safety while its role is less preponderant in the areas of healthcare and social protection.
Marked fall in capital expenditure

Capital expenditure (more than €285bn in 2010, i.e. 14% of expenditure) dropped substantially in 2010 (-8.3%), whether for direct investments (€211bn, -7.6%) or indirect investments (around €75bn in capital transfers, -10.2%).

Drop in direct investment

This particularly marked drop in direct investment in 2010 stands in stark contrast to the decade spanning 2000-2010 where direct investment rose quickly (on average +1.9% per year), and especially in Central and Eastern European countries (on average +8.1% per year).

Direct investment over the period has increased sharply due to decentralisation and the nature of the competencies transferred, the considerable needs in terms of the renovation and construction of public facilities and infrastructure (transports, water, waste, etc.) and bringing them in line with European standards. Strong growth was also the result of the loosening of the access to credit and the injection of European funds and the corresponding local co-financing.

However, especially compared with the last two years (2008 and 2009) the slowdown in 2010 appears particularly strong. During these two years marked by the crisis, subnational investment was robust (+4.2% and +4.7%, respectively) on the back, in particular, of counter-cyclical stimulus measures that were quickly adopted by governments to spur local investment by increasing subsidies and capital grants, alleviating public tendering procedures and loosening deficit and debt constraints, etc.

In 2010, the shutdown was widespread: direct investment dropped in volume in more than two-thirds of EU Member States. It dropped by more than 10% in eight countries including Greece, Portugal, Spain, Italy and Ireland as it once again played its traditional role as a budgetary adjustment variable and undoubtedly suffered from a backlash from efforts in 2009.

Direct investment maintained in ten EU countries

In 2010, only a few countries saw their subnational direct investments remain strong (Finland, Germany, Sweden), or get stronger, notably in several CEE countries (Slovenia, Romania, Poland, Slovakia, Hungary, Lithuania) where structural and cohesion funds continued to have a leverage effect.

The cycle of local elections most certainly contributed to this trend while local elections held at the end of 2010 (Hungary, Slovakia, Slovenia, Poland) or in 2011 (Lithuania) spurred elected officials to finish on-going projects.

The economic recovery in some of these countries that started in 2010, the need to finish stimulus projects (for example, Germany due to impact of 2009 law on future investments) as well as specific events (preparation for the Euro 2012 in Poland but also reconstruction work local authorities are obliged to carry out after the numerous natural catastrophes in 2010 in Europe) help explain why investment was maintained.

In 2011, the contraction in subnational investment could continue as major public works projects (set up under stimulus packages) are put to end by austerity measures, the cost of construction and public works rises and financing constraints increase.

Subnational investment could, however, begin to climb thereafter, thanks to an increase in local revenue and improved savings capacity. The end of 2007-2013 European programmes could also lift subnational investment.

From a more structural vantage point, investment needs remain high in Europe: beyond the necessity to renew, modernise and bring current facilities in line with environmental and security standards and norms, the subnational public sector will be confronted by the effects of such issues as the ageing population, climate change, communication, research and innovation, which will encourage strategies and investments that will testify to the economic vitality, the development of subnational government territories, the well-being of their inhabitants and, therefore, their future revenues.
Budget balance and debt

The subnational public deficit increased, albeit slightly, due to a drop in revenue even though expenditure stabilised, notching higher from 0.7% of GDP in 2009 to 0.8% in 2010 to reach €103bn, i.e. 13.1% of the public deficit.

This deterioration is, however, very relative. In fact, the subnational deficit/GDP ratio in 18 countries, including the United Kingdom, France and the Nordic countries, improved. Moreover, only one country had a positive ratio (Malta) in 2009 whereas today there are seven. Finally, three-quarters of European countries recorded a subnational deficit that was less than 0.5% of GDP or a surplus.

Among the countries with the worst deficits, three are federal countries, which bear both the local deficit and that of the Federated States, and especially Spain where the subnational deficit (42% of the European total) jumped from 2.6% to 4.0% of GDP (including 3.4% for the Autonomous Communities alone).

The improvement in budget balances at the European level should extend into future years riding the economic recovery, efforts to control subnational expenditure as well as the financial supervision and budget oversight mechanisms of local authorities that were reinforced as part of programmes to restore public finances (Spain, Italy, France, Austria, Germany, Belgium, CEE countries, etc.).

Subnational debt outstandings continued to increase

The drop in the subnational public sector’s self-financing as well as lower cash reserves and investment grants resulted in the use of debt in 2010.

However, subnational debt outstandings in Europe grew at a slower pace in 2010 than in 2009, although they remained robust: +6.0% in 2010 versus +9.9% in 2009. This use of debt was aided by the attractive level of interest rates as well as rules governing borrowing that remained favourable in 2010.

This debt growth occurred in nearly every country in European (21 countries). The strongest growth rates were found in several Central and Eastern European countries (Poland notably), the Netherlands, Germany, in Belgium and in Sweden (between +6% and +10%) and especially in Austria (+20.8%) and in Spain (+22.1%).
In Belgium and Germany, Federated States, which are not subject to the “golden rule”, are responsible for a large portion of this increase. Denmark and Italy were among the countries with debt outstandings that dropped in volume. Italy was one of the rare countries in Europe where, despite the crisis and stimulus measures, borrowing has been highly restricted over the last years due to internal stability pact rules.

Debt levels should however move towards a stabilisation in 2011 or perhaps in 2012, given slower investment, expected restoration of self-financing capacities and cash flow as well as new restrictions concerning borrowing. In fact, tighter conditions have been announced in many national stability and convergence programmes. This is reflected, for example, in the reinstatement of the pre-approval borrowing requirement, a return to the reinforced debt service/ceiling levels, greater observance of the golden rule (reserving borrowing to certain investment categories only) or limiting borrowing when budgets are particularly tight, as is the case in Spain for local authorities that have a particularly stressed budget or debt situation.

Over the period 2000-2010, local investment financing (excluding Federated States) was mostly ensured by self-financing and capital expenditure revenue. In 2007, just before the crisis, 54% of investment was covered by self-financing and 40% by capital transfers. Together, they covered 94% of investments, while borrowing was only necessary to cover the remaining 6%.

In previous years, this ratio had fluctuated between 8% and 20%. With the crisis and the deterioration of gross savings, the rate of investment coverage dropped. It is still significant however: in 2010, three-quarters of local investment was financed by savings (36%) and investment grants (38%). Borrowing was required for just one-quarter of investment needs.

At year-end 2010, subnational debt outstandings stood at €1,486bn, i.e. 12.1% of GDP and 15.1% of public debt. Around 42% of these outstandings are held by the German Länder.

Excluding the Federated States, local debt outstandings total €826bn, i.e. 6.7% of GDP and 8.4% of public debt. These more moderate ratios for the local sector are the result of the majority of local debt being allocated to financing investment (i.e. the “Golden Rule”) and the fact that it is governed by strict prudential rules.

France holds 19% of this local debt followed by Spain (18%), Germany and Italy (16% each) and the United Kingdom (10%). Despite the strong increase of local debt in the new Member States over the past 10 years (+15.6% on average per year), their debt outstandings did not exceed 4% of local European debt (2% for Poland).

In the last 10 years, subnational debt growth (+3.6% per year on average in the EU) accompanied local investment growth. However, it has not been linear. In 2007, local public sector debt sagged as a result of savings, which were boosted by growth, and local borrowing limitations under the Maastricht protocol (Germany, Austria, Italy, Spain, etc.).