*Council of Europe and Local Government and Public Service Reform Initiative of the Open Society Institute (LGI)*

**The impact of the economic downturn on local government: what is happening and what can be done about it?**

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# Local government contribution to economic recovery and sustainable development

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This brief summary of the CoE/LGI survey of 27 countries is an attempt to identify the options invented by local governments for stimulating development. Despite the ongoing theoretical debate whether local governments have a decisive role in economic policy formulation and in promoting development or not, municipalities are actively involved in managing the consequences of the recession. Two years after the beginning of the financial crisis the local governments - as many other public actors and the businesses - are looking for new solutions for the problems caused by the economic downturn. Cities are targeted by national programs, design their own local strategies for coping with the decline and actively search for the actions supporting the economic recovery.

Obviously local governments' primary task is to continue investing in infrastructure, by guaranteeing the resources of *capital investments* in this period of fiscal austerity and shortage of cash. So this paper will give an overview of the financing options, such as extensive use of EU grants, national funds and other potential external sources, like borrowing and resource generated through private sector participation.

Beyond the traditional local government investments means of *local economic development* are gradually re-invented. This is a slower process and the potential results will be visible with some delay.

## 1. Investing in local governments

Due to the spillovers local jurisdictions themselves cannot effectively influence economic development. The potential benefits of local investments in the economy, the returns on tax breaks, the multiplier effects of economic actions financed by municipal borrowing are partially realized outside the boundaries of the specific local government. There are also huge differences between local governments, so their capacities will significantly vary in promoting local economy.

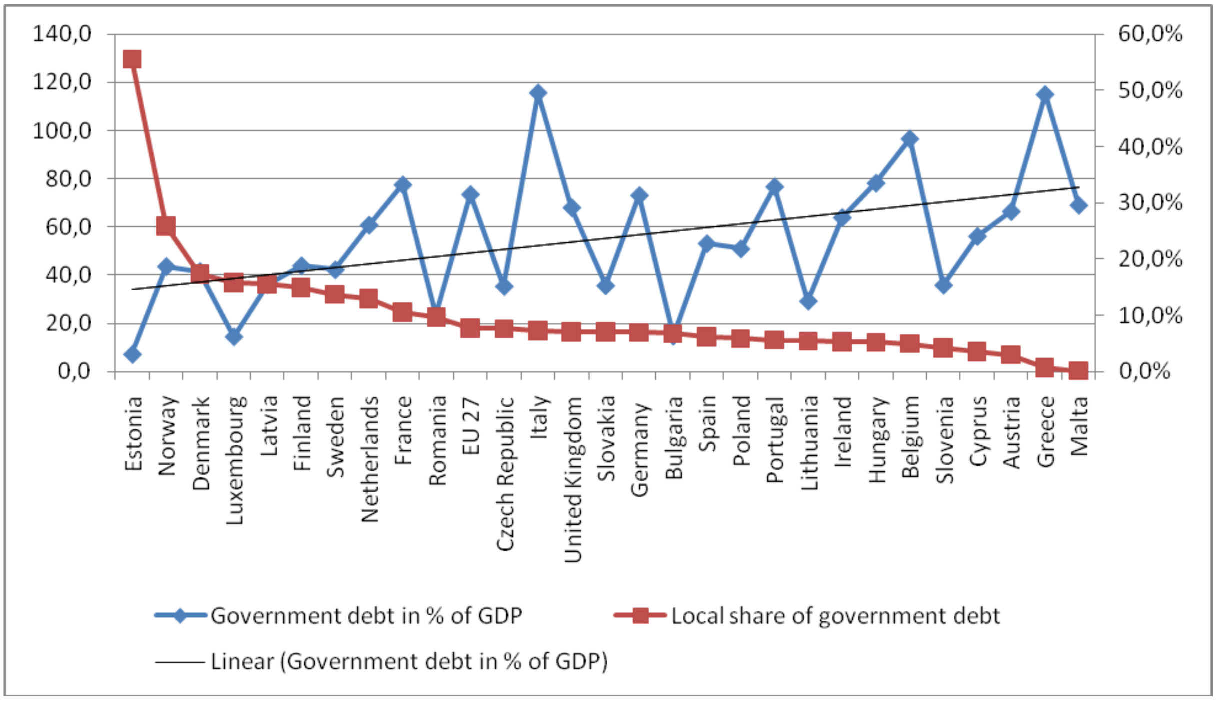
However, in the globalised economy when infrastructure and other soft factors, like conditions of life influence economic development, local governments learned that they have a role in sustainable development. There is a competition between cities internationally and also domestically, as well. Local economic development determines the employment opportunities, influences municipal tax base, the options for development and consequently the quality of life. So partnering with the national governments municipalities can influence the speed and focus of economic recovery, which would bring benefits at both levels. The European Union new cohesion policy design also targets the "place-based development strategies", which rely on local knowledge and linkages[1].

During the past two years anti-crisis policies and economic stimulus programs were primarily launched in the more developed countries of Europe. The less developed ones and the transition countries with opened, export oriented economies had limited capacities for launching major national programs. In this period of economic decline the main source of development is the government borrowing, which has reached a high level by now: public debt in the average of European Union 27 countries is 74% of GDP. So it is a serious constrain in both groups of countries, as they all have to introduce fiscal restrictions and they should invent new forms of economic development.

[1] Barca, F., 2009: An agenda for a reformed cohesion policy. A place based approach to meeting EU challenges and expectations.

The countries with high public debt (above EU 27 countries' average of 74% in 2009) are Italy, Greece, Belgium, Hungary, France, Portugal (left scale in Chart 1.). Interestingly in this group of countries local governments' share in the overall public debt is relatively low (below the 7.7% of total government debt, right scale in Chart 1.). The access to loans at local level is very much influenced by the country's overall creditworthiness, so it will not be easy for local governments to benefit from this under-utilized borrowing opportunity. The other end of the spectrum is the group of decentralized countries of Scandinavia and the Netherlands. In these countries local government borrowing is more significant, which might have helped to limit the public debt more effectively. So, at least in this respect, local governments might have a role in economic recovery.

**Chart 1. Government debt and the local share of government debt, 2009**



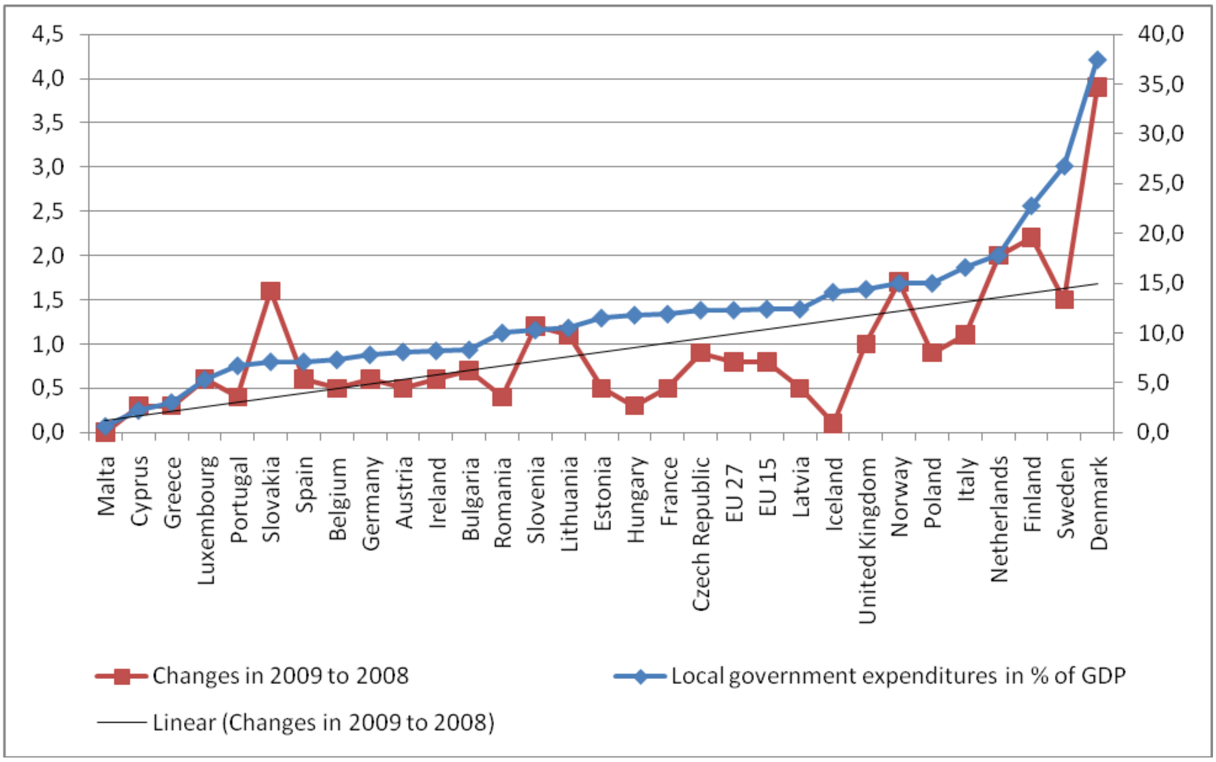

Source: http://epp.eurostat.ec.europa.eu/

*Changes in local spending*

The general indicator of fiscal decentralisation, the share of local expenditures in percentage of GDP last year was increased in all countries of the European Union. In both the EU15 and the EU27 countries the average ratio was +0.8% higher compared to the previous year (see Chart 2., left scale; on the next page). It might be the result of lower economic output, but at least shows the increasing relative importance of the local budgets.

Expansion of local government spending was higher in the more decentralised countries, with a few exceptions of the new EU member states (Slovakia, Slovenia, Lithuania). The other end of the spectrum with lower increase is a mixed group of countries. Obviously the less decentralised countries are in this group (Malta, Greece, Cyprus), but also here are those countries where there is a limited room for further decentralisation, such as Iceland, Hungary, Estonia, France, Latvia.

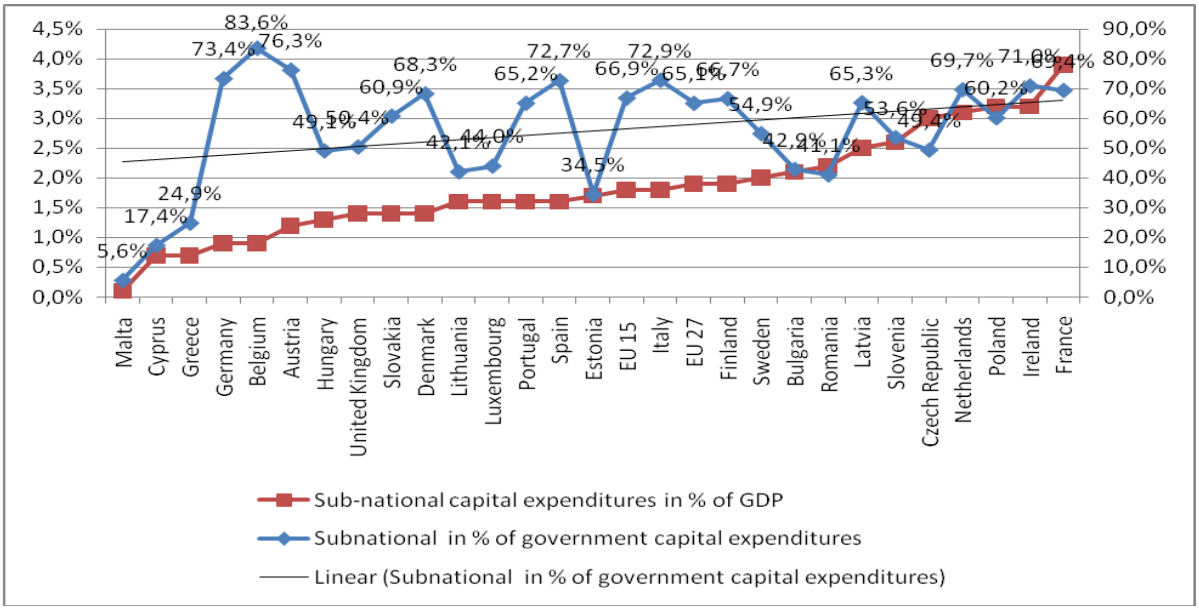
**Chart 2. Changes of local government expenditures in % of GDP**




Source: http://epp.eurostat.ec.europa.eu/

Sub-national governments manage the majority of the total government capital investments: in the EU15 countries they are responsible for 67%, while in the EU27 average for 65% of total government capital investments in 2009. This ratio of the EU countries' average was not changed since the last year (albeit it slightly decreased in the EU15 countries). Local governments were able to keep their relative positions within the general government sector. Local capital investment spending is equal to 1.8%-1.9% of GDP.

**Chart 3.Sub-national capital expenditures, 2009**




Source: http://epp.eurostat.ec.europa.eu/

According to the changes in the weight of local capital investments between 2008 and 2009 there are two different groups of countries. The ones where the sub-national government capital expenditures in percentage of general government capital investments were shrinking are on one hand the rich, big economies (Italy, Germany, UK, France, Belgium, Finland), where the stimulus programs probably targeted the central government. On the other hand this group also consists of the smaller, poorer economies with limited resources for public sector investments (Estonia, Romania, Cyprus, Portugal).

The other – larger – group of countries with increasing local capital investments comprises the new European Union member states, which are the present major beneficiaries of EU grants (Bulgaria, Latvia, Slovakia, Hungary, Slovenia, Lithuania, Poland, Czech Republic) or the decentralising countries (Ireland, Austria, Spain, Netherlands, Greece).

## *2. Better access to EU funds*

Increase in the ratio of local capital investments within the total government investments between 2008 and 2009 was typical in the group of new EU member states. By this time the European Union Structural and Cohesion funds started to actually flow to the local government budgets. After the long planning and preparatory process these funds are almost the only major resources of local government invests. In the EU member countries – according to the responses on our survey - national governments supported the utilization of these funds by various *administrative measures*:

a) local governments received higher advance payments for implementing the projects accepted by the various national operational programs in Bulgaria, Hungary, Poland. By raising the usual 25% of advances to 35%-40% local governments (and businesses) were compensated for the potential losses in shrinking bank loans.
b) the administrative procedure of project preparation and approval was simplified (e.g. Czech Republic, Estonia), so even with the unchanged structural fund procurement rules, the local governments could have easier access to these grants.
c) as local projects are often better prepared and smaller in size, the funding sources could be brought forward from later years (Finland, Ireland).
d) in this period of relatively limited number of public contracts, the local governments expect lower tender prices (see the report from Ireland), which also justifies the accelerated spending on local investment programs within the present EU budget period.
e) beyond these tangible measures some countries provided better information on funding opportunities through briefings and active lobbying (UK).

The *non-member countries* – being in different stages of EU accession - started to establish regional development funding schemes. These coordinating bodies are aimed to harmonize the various sectoral investments programs and they are also the entry points for the future European Union programs and funds. So for example in Albania the Regional Development Fund was set up and the Ministry of Integration has this coordinating function. The institutional changes are often combined with capacity development at local level: there is a compulsory training of local government staff on EU funding matters in Croatia.

The *sectoral focus is rather diverse* of these external funding schemes. The classical local infrastructure projects (roads, environmental services, housing) and local human services (education, social services) are supplemented with support to ICT (e.g. in Spain). Beyond local government services funding is available for the implementation of the administrative reform (Greece), improving the local employment opportunities (Iceland) or creating competitive economy (Ireland).

## 3. National funds for investments

Local government capital investments are also supported by national programs and funding mechanisms. Typically in the non-EU member countries, where the local capital budget financing schemes are rather centralized, these coordinated national investment programs and the government agencies managing them are the key players. The Public Investment Program (BiH/RS), the National Investment Program (Serbia) or the Municipal Development Fund (Georgia) are the institutional forms of coordinated national government support.

There are capital investments programs which indirectly influence local government services and capital investments. The programs for modernisation of heating systems and use of renewable energy target the customers or beneficiaries, but local government service organization also benefit from them. In other cases intermediaries, like housing companies (Finland) are targeted by these national funding schemes.

National policies for promoting municipal capital investment project preparation vary. Government agencies are set up for managing investments in centralized systems, like Ukraine or the counter-cyclical effect of local capital spending is questioned by the researches commissioned by the local government association in Norway. For limiting local capital expenditures capped costs standards on road construction, buildings and infrastructure are introduced in Romania.

*Energy efficiency*

The reported sectoral focus of these national programs are local infrastructure (water, gas in BiH/RS, Georgia), housing, road building or village rehabilitation (e.g. in Georgia). However, the single largest issue is the energy rationalization through improved efficiency and shifting to renewable energy sources. Beyond the environmental benefits these programs give some security in energy supply, result financial savings, might create local jobs and help social development of the community[2].

All these positive impact are started to influence local government strategies, so they develop energy efficiency improvement programs and action plans under various domestic and international programs, networks and associations promoting sustainable cities, green cities, use of renewable energy.

The country surveys also reported various local actions: energy efficiency improvements at public institutions (Bulgaria, Germany, Greece, Hungary), modernization of public street lighting system or urban transportation (Bulgaria, Greece). Local governments invest in using renewable, alternative energy, as well (e.g. Czech Republic). When the final user are targeted by national programs (heating system reconstruction, insulation programs in Austria, Georgia) then indirectly the local governments also benefit from these actions through lower heating subsidies.

[2] See NALAS, 2010: Energy efficiency measures in SEE municipalities and the role of national associations and NALAS. NALAS Secretariat, Skopje

Funding of these energy efficiency programs is sometimes automatic and the financing mechanism is regulated. Funds from sale of $CO_2$ quota are used for urban transportation modernization projects (Estonia) and in Norway national governments purchase local climate quotas. In other cases the environmental fines are shared local government revenues.

## 4. Municipal borrowing

In the period of economic restrictions local government borrowing was regarded as a new external source of funding municipal investments in several countries. National government strategies, often supported by international development assistance programs, targeted municipal bond issue and other forms of local borrowing. It is considered not only as an additional resource to limited public funds, but market based funding schemes are expected to improve local financial practices and financial management discipline.

Following the budgetary and local government finance legislation the *secondary rules* and regulations on *municipal bonds*, local debt management are being developed in several countries (e.g. Albania, Serbia). Countries with more stable and tested legislation widely used these alternative forms of bank loans, primarily to co-finance the large projects funded by EU grants. This is the case in Hungary and Poland, where new municipal bond issue was the typical source of funding.

New measures also supported local government borrowing. In Spain the limits on local government debt were increased (from 110% to 125% of current revenues). In Iceland, where local governments were hit by the crisis a Municipalities Loan Fund was set up for restructuring local debt.

However, the high level of overall public debt forced national governments also to constrain municipal borrowing. So there are countries where new regulations were introduced on local government borrowing and debt (e.g. in Greece) or new loans are limited temporarily (Albania). Croatia has restricted the total amount of all local government loans (the debt stock should not be higher than 2.3% of total operational revenue), even if individually municipalities could borrow because they are below the limits (20% of operational revenue). In the new EU countries where local government borrowing was stopped (Estonia) or the limits were decreased (Romania) the loans for co-financing EU projects are exempted.

## 5. Private Sector Participation

Public-private partnership schemes the most visible victims of the economic downturn. Joint construction projects are stopped, project implementation is delayed and no new bankable programs are prepared. So these infrastructure projects, housing construction, public transportation projects all suffered from the crisis.

Some countries have prepared specific legislation on PPP (BiH/RS, Croatia), but it did not really help, as the number of PPP projects decreased after the new law was introduced. Other surveys reported that due to the declining land prices and the lack of bank funding the urban regeneration programs could not bring the estimated public benefits. Indirect benefits of these urban development programs in increased local property tax revenues or higher private contribution to municipal infrastructure development was not materialized.

## *6. Local Economic Development*

Local governments often take responsibilities beyond their narrow mandatory public service provision functions, assigned to them by the law on local governments and the sectoral legislation. They should deal with the problems of unemployment, expand municipal tax base by promoting the development of the local economy and create linkages between business interest and local infrastructure development.

Local economic development is a particularly important municipal task in the transition countries. Here municipalities traditionally manage active development policies and have more “interventionist” attitudes, inherited from the former state ownership based planned economy. However, local governments gradually learn the new indirect methods of economic development. They try to create favorable local economic climate for investors, design public services for attracting businesses and develop joint schemes for infrastructure development.

All these techniques of local economic development are adjusted to the local circumstances in a *long learning* and *adaptation process*. The present economic downturn did not fundamentally change local policies, but it has forced municipal officials to deal with some aspects of local economic development more actively. As the OECD LEED Programme guidelines emphasized local development strategies have to be revisited. In the short term the available factors of production have to be retained, openness to the global economy should be kept and the communication with other tiers of government has to be maintained[3].

These actions will not bring immediate benefits and they could help economic recovery only in the long run. Various local government actions are supported by the national governments and international organizations. For example within the European Union the limits of state aid to businesses was increased from EUR 200,000 to EUR 500,000. Local governments might also benefit from these funds if their projects target economy (e.g. business park development). Simplification of administrative procedures, provision of tax reliefs, local public procurement targeting towards local businesses and support to new, flexible local employment opportunities all assist economic recovery in the short or medium term[4].

Our survey respondents formulated similar programs trying to intervene more directly in order to promote local economic development. Special loan schemes for paying local contractors were set up (Romania) or subsidized loans are provided to SMEs (Croatia), enterprise stabilization fund was set up (Ireland). Beyond these direct interventions tax reliefs, tax deductions and SME innovation programs are introduced, as well (Germany).

In those countries where *public property* was not fully transferred to local governments, these potential new assets became more important in this period of economic downturn. So countries like Albania has speeded up the property transfer process, Armenia has developed computerized cadastre system for local governments. In Hungary, where the property transfer process was completed in the mid-1990s it is an important regulatory tool, so for example greater proportion of nationally collected land development fee is decentralized to municipalities. In general, property is not as important source of economic development as it was during the economic boom, but it is still relevant for local governments. They started to invent asset management techniques and develop new forms of cooperation with the private sector.

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[3] Clark, G., 2009: Recession, recovery and reinvestment: the role of local government leadership in a global crisis. OECD LEED

[4] URBACT, 2009: Cities and the economic crisis. Survey on the impact of the economic crisis and the responses of URBACT II. cities. European Union, Barcelona.