Local & Regional Europe

Local Finances and the Green Transition

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

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8. Conclusions and recommendations

The objectives of this CEMR report were to evaluate (i) local finances over the past decade, framed as they were by two major crises, and (ii) how local and regional government investments can contribute to this century's main challenge: climate change.

After the economic downturn of 2008-2009, general government finances and various public sector mechanisms operated under unusual pressure. They had to be overhauled in a restrictive fiscal climate, despite the fact that such systemic changes can only be implemented at a slow gradual pace.

A comprehensive evaluation of local activities and the role played by subnational governments during the 2010-2020 period is difficult for two reasons:

- *CEMR countries are quite heterogeneous*, with very different levels of economic development and varying degrees in their scope of decentralisation.
- Another constraint is that local government systems could only be assessed using the limited comparable fiscal data available at the national macro level. The very essence of decentralised actions could not be adequately studied owing to a lack of territorial data and information focused on the work of local and regional governments.

Despite these impediments, some lessons can be extrapolated on the key areas of local finances and their connection to climate change. These conclusions from our data analysis and the recommendations are intended for both policymakers within the national governments and the many stakeholders shaping subnational, European or international programmes.

Responding to the two crises: from cooperation and partnership to coordinated actions

At the beginning of the past decade, major financial and institutional reforms were hindered by the slow economic recovery and stagnation that followed the 2008-2009 global crisis. Pressure to respond to the issue of climate change also increased, both at national and local government levels. The resulting actions for climate change adaptation and mitigation were gradually incorporated into national programmes and local government actions.

One key lesson from the first economic downturn is that effective responses to the crisis require new forms of cooperation among various government actors and also between the public sector and private entities.

By the end of the 2010s, more favourable economic conditions supported balanced development. Local government reforms, the modernisation of public decision making through greater transparency and improved local accountability and fiscal decentralisation efforts all started to produce results in service efficiency.

These positive trends in development and democratisation were abruptly put on hold by the pandemic in 2020. This new crisis not only led to human losses and drastic economic changes but transformed the demand for public services and increased the role of local and national governments as well. These economic and fiscal policy responses were different from the reactions to the previous economic crisis a decade earlier. This time, more coordination was needed with intensified national government actions (OECD, 2020). At this stage, it is still too early to fully take stock of the long-term consequences of these interventions and looser fiscal policies.

Local and regional governments were faced with a dual challenge throughout the period under study. They had to cope with the long aftermath of the 2008-2009 economic and financial crisis, followed by the sudden shock of the pandemic with its scissors effect (demand for increased expenditure amidst a decrease in revenue from taxes and transfers). All the while, local governments continued to gradually develop their climate change adaptation capacities and mitigation measures.

The two tasks of crisis management and environmental risk mitigation are interconnected. They both strongly need new forms of coordination between government tiers, improved service management methods, additional and restructured investments, adjustment of local revenue to changing requirements, better administration capacities, modified planning and improved budgeting practices.

Local impact of economic regulations

After the 2008-2009 economic downturn, subnational governments were subjected to their national austerity policies. These governmental actions targeted the entire public sector, primarily the budget sphere. Overall, the CEMR countries provide a wide range of welfare and administrative services: general government expenditure averages 42-45% of GDP. Setting aside this average, the share in total government expenditure can vary significantly, from 35 to 50% depending on a country's level of development and its public sector traditions. Local governments are responsible for a substantial part of their country's government functions (25% on average in the CEMR countries).

As evidenced by the macroeconomic data analysis, public spending was limited by strict budget constraints in the first few years after the economic crisis. This resulted in serious limitations on local spending and municipal borrowing. Any changes to economic and fiscal policies affect the local scope of manoeuvre.

Austerity measures should be proportional to the fiscal weight of subnational governments, legislated for all government entities in general and introduced in a straightforward and transparent way.

Towards the middle of the decade, budget conditions gradually normalised, although there were striking differences between CEMR member countries. A high level of diversification in government functioning overall can have a bearing on decentralisation prospects. Countries with a larger than average public sector are better placed to devolve more services to subnational governments and expand decentralisation programmes. This objective condition should be taken into account in decentralisation policy design.

In 2020, the first year of the pandemic, all economies contracted. In contrast to the earlier economic crisis, several active fiscal instruments (wage subsidies, special spending programmes, tax reductions) created a more favourable financial environment for the government sector.

Active fiscal policies financed through increased borrowing and higher general government debt affect the future of subnational government budgets and the local capacity to invest in the green and digital transition. These overall fiscal conditions should not augment the risk of fiscal re-centralisation.

Managing administrative-territorial reforms

There is a wide array of subnational government configurations in the CEMR countries. They can differ in the following: (i) constitutional form (whether they are federal or unitary countries); (ii) number of elected government tiers (two or three) and (iii) population size of subnational government units (fragmented or amalgamated models).

During the past decade, several CEMR countries have implemented administrative-territorial reforms and decreased their number of first tier governments. The stated aim was to improve municipal service efficiency by establishing larger territorial units. Citing economies-of-scale, this rationale was used to promote municipal mergers and comprehensive local territorial changes. It will only be possible to evaluate their actual impact on service efficiency and local finances after some time has passed.

Larger administrative units mean more influential local governments with improved service efficiencies. Mergers of first tier local governments were also sought out in response to an increase in regional differences

over the past decade. Measuring the differentiation using a ratio of the highest and lowest GDP per capita of the basic regions (NUTS2) showed an increase from 2.37 (2010) to 2.46 (2020) on average in the 36 countries studied.

These administrative-territorial reforms have been implemented over a longer period than the one under study. Similarly to all other decentralisation efforts, they are highly political actions (Boex *et al.*, 2022). The decade-long preparatory processes were precipitated by the crisis and economic fallout.

Highly political territorial-administrative changes are generally initiated under favourable economic conditions, but implementation of structural reforms usually only follow once any financial shocks subside.

Balanced central-local relations support more collaboration in a multi-tier government system (Smoke-Cook, 2022). Large and autonomous local governments tend to be more experimental with their climate change actions, which can then be transposed into national (or even European) policies. A proper intergovernmental system provides options for assessing governmental climate actions. Implementation of climate-related policies can be made more effective by ensuring that all the critical local-regional conditions (regulatory powers, planning practices, capacities, collaboration mechanisms) are taken into account.

Administrative-territorial reforms also increase the effectiveness of climate change mitigation actions.

Diverse expenditure assignment influences economic recovery

There are strong arguments for establishing local governments with extended public functions and the corresponding administrative fiscal powers (Martinez-Vazquez, 2021). First, decentralisation improves the public service performance of responsive and accountable service providers. Larger local governments with broader powers benefit from economies-of-scale in service management and are able to incorporate externalities to deal with free riders. However, traditional national government tasks, such as economic stabilisation and fiscal policies for debt management, may be hampered by wide-ranging decentralisation.

Over the past decade, subnational governments have slightly increased their financial weight in general government expenditure (from 25% in 2010 to 26% by the end of the decade). However, the CEMR countries have generally used very different roadmaps in following a path towards or even away from decentralisation. One group of countries supported subnational governments, which led to their higher share in overall government spending, while others followed radical centralisation policies. The more decentralised countries experienced an increase (or lower cuts) in subnational spending in contrast to the more centralised ones, where subnational governments lost some of their spending powers. The devolution of public services and administrative-territorial structures influences in turn any decentralisation policy objectives and methods.

Countries with more devolved government structures continued to decentralise further, while others with lower subnational spending often remained anchored to centralisation policies. Any transfer of decentralisation methods and exchange of best practices in service management should therefore also bear in mind this possible path dependency in countries with different local functions and municipality sizes.

The more decentralised CEMR countries bear greater responsibilities in providing human and social services such as education and health care. Local governments with extended functions are capable of more successfully exercising their planning and coordination functions, regulatory powers and human capacities. They can also manage spillovers more effectively through cooperation (e.g. in water services). Even though these often strictly local public services cannot supplant national government environmental protection actions for the restructuring of energy production and decarbonisation, they can effectively work as useful adjuncts.

Under more centralised structures, local governments only manage the core administrative functions as well as the key public utilities and municipal services. In these cases, the basic public services where local governments can have an impact on climate change are the following: municipal transport services, solid waste management, housing, public lighting, etc. Accordingly, their impact on climate change will inevitably be more limited.

The scope and form of decentralisation, as basic determinants, have shaped the responses to the two crises and will be influential in managing climate change successfully.

Local capital investments matter

On average, a significant part (40%) of total capital expenditure is managed locally, even though this capital expenditure represents only a minor share in subnational budgets (15-18%) in the CEMR countries. The ratio of local and regional government capital expenditures in general government expenditure increases according to the scope of decentralisation. However, there are also cases of less decentralised CEMR countries that were able to enhance the local share in total government capital expenditure during the past decade, whereas in other similar countries, the subnational governments lost capital investments.

Subnational governments have the powers to manage capital expenditure in several areas that are typically devolved functions and which also fall under the climate and environmental objectives of the EU Taxonomy regulation. As a result, local government green capital investments are especially prevalent in three COFOG service areas: housing and community amenities (88%), environmental protection (74%) and economic affairs (50%).

The specific cases presented in this study demonstrate the diversity of local government planning and regulatory responsibilities. Local governments well suited to developing local environmental risk management strategies as well.

Subnational government capital expenditure is mainly driven by national investment programmes and grant schemes. Nonetheless, there is a great deal more that local governments can do to better the environment beyond investments in municipal services.

Local revenue autonomy for crisis management and pollution control

Subnational governments control a significant share of taxes in the more decentralised Scandinavian and federal countries. Interestingly, countries with higher local tax revenues increased the weight of local taxes further. In comparison, other countries with lower local tax shares seemed disinclined to extend their own-source revenue raising powers.

Two typical local tax models characterise the CEMR countries. They are either dominated by income (personal, profit) taxes or by taxes on property (land, buildings). The more decentralised countries rely on personal income-based taxes. This revenue is primarily shared, allocated using various methods (origin-based, surcharges or formulas) between the national and the local (or regional) government budgets.

Over the past decade, the grant dependency ratio has changed but no general pattern has been discernible. Increases or declines in the share of national budget transfers can be explained by various country-specific factors: overall budget restrictions, radical centralisation or changes in national tax policies. These national grants and budget programmes often target local environmental investments and the improvement of service management.

In the CEMR countries, responses to the fiscal challenges of the economic crisis tend to follow the pattern of revenue decentralisation in place in a given country.

During the post-2009 crisis period, local tax systems unsurprisingly did not undergo any significant transformations. The most decentralised CEMR countries relied predominantly on income-based local taxation. In the countries where the local tax burden on businesses and production decreased, local taxes shifted towards property taxation. Countries that moved away somewhat from property taxation experimented either with income-based taxes or taxes on products.

A broad revenue base and convergence of local tax systems make local budgets more stable and financially resilient to withstand economic fluctuations.

Subnational tax autonomy is determined by a local government's power to levy and collect taxes. Tax autonomy can be increased by allocating powers over setting tax rates and reliefs to local and regional governments. In countries with tax sharing schemes, the method of resource split needs to be stable and predictable to increase revenue autonomy.

Local revenue-raising autonomy is essential to regulating polluting activities. Local taxes, charges, levies and other revenue-raising options all have an indirect impact on the climate. They affect water management, forms of transport, land use and urban planning to minimise disaster risks and reduce pollution.

Borrowing is generally a minor source of local budget revenue in the CEMR countries. Subnational debt issue is determined by the borrowing capacity and creditworthiness of the general government. Due to regulated borrowing procedures at the EU and national levels, accumulated local debt in the CEMR countries is kept below 4% of GDP. In the federal countries, regional governments have a higher own-source revenue base and could thus borrow more actively (their debt ratio reached over 15% of GDP). During the past decade, local governments have often used loans to co-fund EU grants and finance capital investments in environmental services. They also experimented with green bond investments targeting environmental and climate change actions.

Subnational government loans are essential to finance capital investments. Local debt issue should be regulated by a general control mechanism that reflects the dynamic status of local creditworthiness and leaves limited discretion to the higher government tier.

Public Financial Management

To supplement the present data analysis, select PFM issues on the overall quality of fiscal rules, budget openness and accountability have also been addressed. The level of decentralisation or economic development has been shown to be connected to various aspects of budget openness (*Open Budget Index, Statistical Performance Indicator)* and corruption control (*Corruption Perception Index*), but is not correlated with the country ranking measured by the *Fiscal Rules Index*.

The Recovery and Resilience Facility: an opportunity for local governments

Under the RRF allocation criteria, the per capita grant is higher in the newer less economically developed EU member countries. The four countries with strong regional structures appropriated more than 40% of their RRF budgets to climate-related interventions and policy areas.

The share of green transition among the main RRF spending areas is higher in the decentralised countries. Stronger local and regional governments can support more recovery and resilience programmes and actions.

Subnational governments in these countries may benefit from the RRF grants in cases where their local functions and competences align with the core RRF pillars. Actions involving typical local functions, such as solid waste management, sustainable water services and other environmental pollution prevention measures represent only 2-4% of total expenditure under Pillar 1 on green transition. The bulk of spending under the social and territorial cohesion pillar is taken up by territorial infrastructure and services, which further bolsters support for increased decentralisation.

Local and regional governments will be directly affected by the planned reforms and they are also often the beneficiaries of RRF-funded investments. Yet, a joint CEMR/CoR survey of local government associations revealed that the majority of respondents had only been informed about the overall planning process but not consulted. This limited of course their impact on planning outcomes and investment selection. To increase local and regional governments' monitoring capacity over RRF implementation, the core data and not only the aggregate ratios also need to be made publicly accessible.

According to the member associations, the national RRF plans must respond to key local and regional challenges more effectively. Local and regional governments also need to have a say in the monitoring of RRF implementation.

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