The Impact of the Economic Downturn on Local Government in Europe

What Is Happening and What Can Be Done?

Collected texts from the Council of Europe with edited commentary by Kenneth Davey

The Impact of the Economic Downturn on Local Government in Europe

What Is Happening and What Can Be Done?

Collected texts from the Council of Europe
with edited commentary by Kenneth Davey

Council of Europe

F–67075 Strasbourg, France

Telephone
+33 (0) 88 41 20 00

Fax:
+33 (0)3 88 41 27 84

E-mail
isabelle.etter@coe.int

Web Site
www.coe.int/local

Local Government and Public Service Reform Initiative
Open Society Foundations–Budapest

Október 6 utca 12
H–1051 Budapest, Hungary

Mailing address
P.O. Box 519
H–1357 Budapest, Hungary

Telephone
(+36 1) 882 3104

Fax
(+36 1) 882 3105

E-mail
lgprog@osi.hu

Web Site
http://lgi.osi.hu/

First published in 2010
by Local Government and Public Service Reform Initiative, Open Society Foundations–Budapest

ISBN: 978 963 9719 21 7

The publication of these country reports has been funded by the
Local Government and Public Service Reform Initiative of the Open Society Foundations–Budapest.

Copies of the book can be ordered by e-mail or post from LGI.
Managing Editor: Tom Bass
Cover photo: © Stefan Boness | Panos | 2010
Printed in Strasbourg, France, 2010 | Budapest, Hungary, 2010
Design & Layout: Judit Kovács | Createch Ltd.

Table of Contents

The Impact of the Economic Downturn on Local Government in Europe

What Is Happening and What Can Be Done?

Collected texts from the Council of Europe
with edited commentary by Kenneth Davey

This collection of texts contains updates of the documents presented and/or adopted at the 16th Session of the Council of Europe Conference of Ministers responsible for Local and Regional Government, held in Utrecht, 16–17 November 2009. It is based on final data for 2009 in Council of Europe member countries.

The report was prepared in the framework of a joint project of the Council of Europe and the Local Government and Public Service Reform Initiative of the Open Society Foundations.

Foreword

This document contains the texts[1] on the impact of the economic downturn on local government across Europe presented or adopted at the 16th session of the Council of Europe Conference of Ministers responsible for Local and Regional Government, held in Utrecht (The Netherlands) on 16–17 November 2009, under the general theme of "Good local and regional governance in turbulent times: the challenge of change."

Ministers agreed that governments must take responsibility to mitigate, counter, and overcome the impact of the economic crisis, all the more so because it has potentially wide destructive effects on social cohesion and risks exacerbating societal tensions. Any and all action in response to the crisis must remain fully compatible with member states' obligations under the European Charter of Local Self-Government. There is a widespread recognition of the need for improvements in governance and in the management of public expenditure, for increasing efficiency across the whole public sector, and for greater collaboration between all stakeholders, central government, and local and regional authorities as well as their associations.

The Utrecht Declaration adopted by ministers contains two main parts on this topic, reproduced in this collection as I i) and I ii) respectively.

i) Declaration on the Impact of Financial/Economic Crisis on Local and Regional Government

ii) Guidelines for Policy Responses by Central Government to the Impact of the Economic Crisis on Local Government

1 Texts have been updated to reflect the final financial data for 2009.

This collection further contains the updated report adopted by the European Committee on Local and Regional Democracy (CDLR) as the official document for the Ministerial Conference on this topic (MCL-16(2009)6a), and the updated report presented by the LGI/OSI to the Council of Europe (MCL-16(2009)Inf 1), of which the first chapter is the report mentioned above.

Further to the Utrecht Declaration, work on this topic is continuing as part of the Utrecht Agenda. The review conference will take place on 11–12 October 2010 in Strasbourg.

Jean-Louis Laurens
Director General of Democracy and Political Affairs

Rober Ebel
LGI Steering Committee Chair

September 2010

Executive Summary

How have local budgets fared in the recession? And, more importantly, how are local governments across Europe coping with the prevailing fiscal crisis? What, if anything, can be done to minimise harm to the public services they perform?

These questions are addressed in this updated version of a report presented to ministers responsible for local and regional government at their 16th Council of Europe conference in Utrecht in November 2009. They called for continued monitoring and a review during 2010.

This analysis has been prepared by a team convened by the Local Government and Public Service Reform Initiative of the Open Society Foundations (LGI) and the Council of Europe's Committee on Local and Regional Democracy (CDLR), as part of their established collaboration.[2] It is based on final data for 2009 and a survey of policy responses conducted by observers in member countries.

The crisis started in late 2007 with the collapse of overheated housing markets. This undermined banks whose failures and government bailouts dominated 2008. By 2009 these phenomena plunged most European economies into recession. Although 2010 has brought about a weak recovery, the costs of fiscal stimulus programmes, bailouts, and falling revenues have taken a huge toll of national budgets, whose deficits rose from 2.3% of GDP in 2008 to 6.85% in 2009.

Inevitably this has subjected local governments to a budget squeeze between falling revenues, threats to state budget support and the rising costs of debt service and social assistance to affected households.

[2] The team was greatly assisted by observers in 32 countries who have supplied data on the financial performance of local governments in 2009 and commented on the relevance to their countries of the policy options discussed below.

The severity of the squeeze has varied widely, however. It has depended on several variables including:

- The scale and timing of the national economic downturn.
- National policy responses; many governments have compensated local governments for revenue shortfalls, at least temporarily, to minimise damage to employment, construction, and general demand; others have been forced to reduce transfers to local government as part of their own austerity packages.
- The vulnerability of the local revenue base to economic misfortune in the majority of countries surveyed; property taxes have generally proved the most stable, while shares of corporate profits or value added taxes have predictably been the most volatile. Shares of personal income tax, the most important source for local government again in the majority of states, have inevitably reflected cuts in jobs, wages, or hours.
- Delays in the payment of taxes or in their transfer to local budgets.
- The degree of responsibility by local budgets for increased social assistance costs.

Allowing for inflation our data on 2009 shows absolute declines in local government revenue (compared to 2008) in 16 countries. Elsewhere revenues are simply growing far more slowly than before.

How far this situation will improve and how quickly is far from certain. Threats of a double-dip recession are receding and the sovereign debt crisis so far has not spread beyond Greece. But experience has shown that the worst impact of previous recessions has been felt by local budgets two to three years after general economic recovery as national governments try to restore their own fiscal fortunes and cut back on intergovernmental transfers. Local government is faced with the possibility of this happening again in 2011 or 2012. There is also the likelihood of long-term increases in expenditure arising from the ageing of European populations and measures to combat climate change.

There have so far been few, if any, major changes in the structure of local revenue and expenditure, merely temporary *ad hoc* adjustments. (An exception is Romania where the transfer of competences to local government has been accelerated). For the longer term, recent experience must call into question the major reliance of some South Eastern European local government systems on shares of a highly volatile tax like VAT. In a few cases, national restraint has been imposed on local tax rises, but the general trend has been to ease restrictions on local financial autonomy.

More attention has focussed on cutting costs, though in a fairly random and short-term manner. Pay freezes have been widespread, and even pay cuts. Vacancies have been widely frozen, Serbia has mandated staffing cuts, and Hungary has substantially reduced the number of elected councillors as terms of office expire.

More systematic scrutiny of efficiency has not been widespread, although the Council of Europe's European Label of Governance Excellence aims to promote this. However, Internet publication of items of local budget expenditure is spreading in a number of countries as an agent of transparency and accountability.

The crisis has added impetus to municipal amalgamations already in progress in five countries. More widespread has been enhanced co-operation between local authorities in service provision and the sharing of administrative resources and processes. This has generally arisen from local initiative.

Cutbacks in services have not been widely reported, but there has been a cull of underutilised institutions, notably small primary schools. In some countries economies have been frustrated by unrealistic service standards rigidly enforced by sectoral ministries.

Capital expenditure is normally the first casualty of a fiscal squeeze. This has been averted in the new member states of the European Union, since their enhanced entitlement to structural funds has come on stream over the past two years. Local governments in the old member states have generally benefited from "fiscal stimulus" programmes, funding "shovel ready" projects to sustain employment and the construction industry; these are very limited in scope and duration. Governments have widely relaxed restrictions on borrowing for both cash flow and investment purposes.

The rising costs of social assistance, arising both from economic distress and demographic change, call for improved targeting of welfare benefits to the most needy. This has been recognised in some cities or states, but not yet widely. It is bound to command increasing attention as dependency ratios worsen.

The suddenness and severity of the fiscal crisis has been a shock because it has interrupted a prolonged period of steady growth in local budget resources. It challenges previous assumptions about the capacity of the state, both national and local, to deliver an indefinite improvement in the scope and standard of public services. To maintain the previous momentum will surely demand higher taxation or greater co-operation with civil society, particularly in the social sector.

I.
Excerpts from the Utrecht Declaration Adopted by the Ministerial Conference

i) Declaration on the Impact of Financial/Economic Crisis on Local and Regional Government

We, the European Ministers responsible for Local and Regional Government, meeting in Utrecht on 16 and 17 November 2009 for the 16th Session of our Conference,

Concerned about the shockwaves the current global economic crisis is sending through all our member States affecting them at all levels and in all sectors;

Having examined the impact of the economic crisis on local government in our member States on the basis of our individual experiences and the document prepared by the European Committee on Local and Regional Democracy in co-operation with the Local Government and Public Service Reform Initiative of the Open Society Foundations;

Considering that

1. the economic crisis is already having a measurable impact on local government in our member States, with both a reduction of revenue and an increase of expenditure causing a budget squeeze;
2. so far, the impact differs significantly within and between countries both in terms of scale and in terms of timing;
3. these differences result from a variety of causes, notably the severity of the downturn, the parallel fortunes and responses of national government, the nature of the local government revenue and its vulnerability to economic change as well as time-lags in taxation systems;
4. unfortunately and notwithstanding signs of recovery in some sectors, the budget squeeze for local government in many cases is likely to get worse before it gets better because cushioning effects will wear off and the full extent of the cost to communities and people to be borne by local authorities will only become apparent in the months and years to come; moreover, the increase in social expenditures arising from recession will be exacerbated in the long term by the ageing of European populations;

Agree that

5. we, the European ministers responsible for local and regional government must take responsibility in our areas of competence to mitigate, counter and overcome the impact of the economic crisis, and all the more so because it has potentially wide destructive effects on social cohesion and risks exacerbating societal tensions degenerating into extremism;

Affirm that

6. the pressure on available resources at all levels further underlines the importance of our common objective of delivering good local and regional governance;
7. to that end local and central government each have their part to play in facing up to, sharing the burden of and overcoming the economic crisis;
8. central governments have a clear responsibility in the resourcing of local authorities, whilst underlining that all levels of government have an obligation to maximise efficiency;
9. because of their knowledge of communities, people and businesses at local and regional level, local and regional government can be extremely powerful actors in addressing the needs of citizens and facilitating business in overcoming the economic crisis;
10. whilst the means to be deployed will differ over time and vary from place to place, there will be a constant need for efficient and effective collaboration between all stakeholders—central government, local and regional authorities and their associations—in order to transform the economic crisis from a threat into an opportunity for improvement;
11. exchanging and sharing information and experience at local, regional, national and international level, as well as the identification of good practices this enables, will be key to achieving success at the earliest possible time;
12. any and all action must remain fully compatible with the obligations of member States under the European Charter of Local Self-Government;

Commit ourselves

As concerns our respective domestic situations:

13. to ensure efficient and effective collaboration between all stakeholders—central government, local and regional authorities as well as their associations—and;

14. to make use of the guidelines for policy responses to the impact of the economic crisis on local government appended to this declaration in order to counter, mitigate and overcome the impact of the crisis;

As concerns our co-operation:

15. to develop and make the best possible use of our membership of the Council of Europe to exchange and share information and experience as well as to identify good practices;
16. to contribute to continued collection of financial and policy data and ensure appropriate participation in a review conference to be held in the second half of 2010;
17. to make use of and help develop further the Council of Europe's capability to organise peer reviews, provide legislative and policy assistance as well as capacity building programmes;
18. to work together on the implementation of the Utrecht Agenda as it appears below;
19. to review the overall situation as regards the impact of and responses to the economic crisis on local government at our 17th session;

Invite

20. the Congress and the Parliamentary Assembly to participate in the work to be carried out as set out above.

In view of the wide-ranging impact the economic crisis is having on the social and societal fabric of our member States and thus on human rights, democracy and the rule of law,

We further recommend

21. to the Council of Europe as a whole and the Committee of Ministers in particular to reinforce its focus on the quality of governance (good democratic governance) and to establish it as a transversal dimension to guide all intergovernmental activities.

ii) Guidelines for Policy Responses by Central Government to the Impact of the Economic Crisis on Local Government

I. General

1. Any policy response by central government to the impact of economic downturn on local government must be fully compatible with its obligations under the European Charter of Local Self-Government (CETS 122), which recognises that questions as to the financial resources for local authorities are to be determined within a Party's national economic policy.
2. The two recommendations of the Committee of Ministers in the field of local finance: Rec(2004)1 on financial and budgetary management at local and regional levels and Rec(2005)1 on the financial resources of local and regional authorities, offer a powerful and coherent set of guidelines aimed at ensuring a sound local finance system, many of which are ever the more useful in the context of the economic downturn.
3. The economic crisis has generated a widespread recognition of the need for radical improvements in governance and in the management of public expenditure. Whilst the means to be deployed will differ over time and vary from place to place, there will be a constant need for increasing efficiency across the whole of the public sector, and hence for greater collaboration between all the stakeholders, central government, local and regional authorities as well as their associations. The aim should be to remove duplication and to drive down costs arising from a lack of co-ordination, integration and of flexibility in the delivery of public services, not only to meet the demands of the current fiscal situation, but also to be better placed to address longer-term social and economic change.
4. Exchanging and sharing information and experience at local, regional, national and international level, as well as the identification of good practices this enables, will be key to achieving success at the earliest possible time.

II. Possible Policy Responses Identified So Far

The survey of member states carried out in preparation of the 16th Session of the Council of Europe Conference of Ministers responsible for local and regional government has identified five main possible policy responses, which are reviewed below. It is to be stressed that the feasibility and desirability of these options vary from country to country and thus are to be seen a range of policy options and not a prescriptive set of measures.

The five main options identified so far are:

1. Reform of intergovernmental financial relations
2. Improving accountability and efficiency
3. Improved targeting of social benefits
4. Innovative redesign of public services
5. Enhancing local flexibility and discretion

Reform of Intergovernmental Financial Relations

Major changes in the distribution of responsibilities and resources between levels of government are unlikely since in most of the countries surveyed the national budgets have suffered more severely than those of local government. Moreover local governments need to retain and develop their competences innovatively to respond to economic and social challenge.

Local Revenue Bases

Governments and local authority associations might wish to consider changes in those local revenue bases which depend substantially on shares of highly volatile taxes such as those on corporate profits and value added, since these fit precariously with a high percentage of fixed, recurrent commitments like public employee wages and service maintenance.

Personal income is the only tax base which is both technically susceptible to variation by local decision and capable of funding a large proportion of the costs of major services, such as education and social and health care. In reforming local revenue bases, governments may wish to continue expanding the local sharing or surcharging of personal income taxation, a recent trend across Europe. That expansion should continue if major progress in fiscal autonomy is to be made, but accompanied by an adequate system of equalising differences in the tax base and avoiding unduly high rates to minimise adverse effects on labour market supply in an increasingly globalised world.

Discretion to Set Local Tax Rates and Charges

Whatever the short-term desirability of restraint, the longer-term period of recovery will probably demand increases in local taxes and charges and the Charter's requirement of local autonomy in this respect should be respected. Local government discretion to set the rates of local taxes and charges should be enhanced in those countries where it is still highly restricted. This applies particularly to the taxation of property. Experience across Europe has shown that cautious but regular increases in tax rates in line with, or just ahead of the general rate of inflation, are a necessary condition for maintaining the tax's significance.

Control over Taxation Pressure

Experience of previous recessions suggests that pressure will mount to increase taxes and charges once economic recovery is well in progress. Two considerations, however, argue for some restraint. For some kinds of taxation—notably personal income tax (PIT) —high tax rates may have long-term effects on labour supply. The second is that a number of national laws and policies impose restrictions to ensure that local taxation does not discriminate unfairly between domestic and business payers.

Benchmarks to Assess Local Finance Policies

Attention can usefully be given to the set of benchmarks developed by the Council of Europe—Centre of Expertise for Local Government Reform—and LGI/OSI to assess both the intergovernmental financial relations and the quality of the financial management performed by local authorities. Considerable use has been made of the benchmark on financial management, and both these benchmarks, along with other benchmarks states may develop, could be very useful for governments seeking to understand their strengths and weaknesses and aiming at reforming intergovernmental financial relations in response to the crisis and beyond.

Improving Accountability and Efficiency

Cost Control

Most effort so far this year has gone into cuts in administrative overheads. These may well be justified, but this is only one area for achieving efficiency savings. Furthermore, some of these tend to be short-term freezes that do not affect long-term efficiency. Governments and local authorities should strive for more fundamental examination of the practical ways in which services are run, and work to redesign service delivery, making use, as appropriate, of both public and private sector partners. This may be assisted by several value-for-money and benchmarking techniques that have been developed in individual countries, and also by the Council of Europe and the Open Society Institute. Budgetary information should be readily understandable by the public and open to public scrutiny.

A drive to increase efficiency can be associated with implementation of the Council's current ambitious Strategy for Innovation and Good Governance at the Local Level. Municipalities should be encouraged to seek award of its European Label of Governance Excellence (ELOGE) for reaching a certain level of quality in their overall governance.[3]

Performance Audit

Both national and local governments should endeavour to train and employ sufficient personnel to apply performance audit, both externally and internally, to all local authorities and their service institutions, and to stimulate public interest in their findings.

Removing Incentives to Expensive Service Provision

National and local governments should reform those administrative and financial arrangements that encourage services like health and social care to be provided in an unnecessarily expensive way. Funding norms, for example, should be based on numbers of elderly people, rather than those in residential care.

---

3 Based in particular on a benchmark/measuring tool specifically tailored to the needs of local authorities, the label will be launched following a road test to start in late 2009.

Reviewing Unsustainable Norms

Responsibilities delegated to local governments should not be regulated by national governments (and sectoral ministries in particular) in ways that debar local initiatives to make services more efficient. Such regulations often apply to the most expensive services like education and health care, prescribing types and levels of input rather than outcome. Signatories of the European Charter should ensure that national ministries do not micro-manage services entrusted to local government whether technically delegated or not.

Delegating Institutional Management

Similarly, local governments should so far as possible delegate budgets and their management to their service institutions, so that their directors are encouraged to maximise efficiency in the use of their resources. In doing so, they should take full account of exogenous variations in cost such as population density and social background in allocating resources between institutions. Audit and other forms of accountability should also match degrees of financial delegation. Political steering capacities and political accountability of local government bodies should be maintained.

Territorial Reorganisation and Cooperation

National and local governments could consider territorial reorganisations which can reduce expenditure on administrative overheads, increase economies of scale, particularly in highly fragmented systems of local government and which may open the way to achieving a redesign of service delivery, both driving down costs and improving service quality. Such reorganisations may well include the types of amalgamation recently undertaken in Denmark, Latvia and Turkey and ongoing in Finland, or the kind of reorganisations implemented this year in certain areas of the United Kingdom. Savings along with quality improvements may be achieved, as in the case of Austria, France and Hungary by encouraging, including through appropriate incentives, greater co-operation between local authorities, both in operating services and undertaking administrative tasks.

Improved Targeting of Social Benefits

Governments could apply means testing to the allocation of social benefits to ensure that funds are adequate to increase or sustain assistance to those who are in real poverty. Both national and local governments should also review their benefit procedures to ensure that the poor are not hindered from access by legal and bureaucratic obstacles.

Innovative Redesign of Public Services

Given both the immediate effects of the fiscal crisis and the longer-term ageing of European populations, governments could consider redesigning local public services to increase partnership across the public and private (commercial and not-for-profit) sectors, including with nongovernmental organisations and offer more practical support to care for the aged and infirm provided by families and neighbours. Such innovative redesign might be part of a territorial reorganisation or an intermunicipal co-operation programme.

Enhancing Local Flexibility and Discretion

The downturn has demonstrated the dependence of local fiscal fortunes on differences in national policy. But this should not be exacerbated by a deliberate or instinctive re-centralisation of authority. The kind of efficiency gains and redesign of services outlined above are more likely to be achieved through more local flexibility and discretion, not less. It will be important for governments to create the circumstances where such flexibility and discretion can flourish, including removing administrative and legal barriers and ensuring that the tasks legally required of local authorities remain commensurate with the available resources.

II.
Reports Presented on the Impact of the Economic Crisis

i) The Impact of the Economic Crisis on Local Government in Europe: What Policy Responses by Governments[4]

1. Overview

1.1. Introduction

Amid crashing banks and soaring government debts, local budgets have avoided the headlines. But how have they fared in the recession? And, more importantly, how are local governments across Europe coping with the prevailing fiscal crisis? What, if anything, can be done to minimise harm to the public services they perform?

These questions were posed by ministers responsible for local and regional government at their 16th Council of Europe conference in Utrecht in November 2009. They were debating an earlier version of this analysis prepared by a team convened by the Local Government and Public Service Reform Initiative of the Open Society Foundations (LGI) and the Council of Europe's Committee on Local and Regional Democracy (CDLR), as part of their established collaboration.[5]

The Utrecht Declaration named the impact of the financial crisis as their first priority for the Council of Europe's attention. It called for continued monitoring, and in answer to a subsequent questionnaire CDLR members put particular emphasis on comparing the practical responses of individual states and local authorities.

---

4 Chapter II.i. "overview" was adopted by the European Committee on Local and Regional Democracy (CDLR) for presentation at the Council of Europe Conference of Ministers Responsible for Local and Regional Government. It was reproduced in full as a first chapter in document MCL16(2009)Inf 1. Subsequent chapters of MCL16(2009)Inf 1 appear at p.39. The entire report was updated in August 2010 with figures and new analysis for the situation up to the end of 2009.

5 The team was greatly assisted by observers in 32 countries who supplied data on the financial performance of local governments in 2009 and commented on the relevance to their countries of the policy options discussed below.

This analysis has been prepared by the LGI/CDLR team on the basis of final data for 2009 and a survey of policy responses conducted by observers in member countries.

1.2. Impacts

1.2.1. The Crisis

OECD reports that GDP in the Eurozone fell by 4.1% in 2009 and unemployment reached 10%.

It all started with the collapse of overheated housing markets, initially in the United States late in 2007, but repeated in the United Kingdom and other EU member states. This undermined banks which had provided mortgages too generously, again initially in the United States but soon infecting European banks that had also bought into the sub-prime mortgage market. Bank failures and bailouts by national governments dominated 2008. Those banks that did not fail were imbued with a new and heightened caution which led them to scale back or deny previous support to business through working capital, letters of credit, and investment loans.

The banking crisis affected local governments directly:

- Loss of dividends from banks partly owned by local governments such as Dexia and the Austrian Kommunalkredit. (€52.7 million in the case of Flemish communes).
- Loss of reserves and devaluation of pension funds (14 Dutch municipalities lost €85 million and British local authorities over €1 billion in failing Icelandic banks).
- Difficulty in obtaining or rolling over credit for investment (particularly from previously active foreign lenders such as the Scandinavian banks in the Baltic states or Austrian banks in Central and Eastern Europe).
- Increased cost of servicing debt denominated in euros with depreciating national currency.

The collapse of housing markets devastated construction industries across Europe (and the employment of much migrant labour sending remittances home). The contraction of bank commercial credit has widened the impact to business activity overall leading to the following:

- Rising unemployment (20% in Latvia at the beginning of 2010, 19% in Spain);
- Declines in industrial production (down 19.4% in the European Union in the year to April 2009; Slovak car production fell by 50% in the same period);

- Falls in external trade (Bosnian exports fell by 19% in the year to March 2009, imports by 25%);
- Dramatic falls in remittance income to the labour exporting states which is estimated to provide 30% of GDP in Moldova, 15 in Bosnia and Herzegovina.

Having devoured housing markets and banks, the crisis has now moved on to its latest victim, government budgets. Deficits of EU member governments rose from 2.3% of GDP in 2008 to 6.85% in 2009, due to losses of tax revenue, expenditure on "fiscal stimulus" programmes, and bank bailouts. Deficits exceeded 10% of GDP in four countries, Ireland, Greece, the UK, and Spain. Ironically the same rating agencies that had been discredited by their failures to identify the weakness of banks have threatened the ability of governments to refinance sovereign debt; starting with Greece this has precipitated governments in 2010 to fiscal austerity policies, which Keynesians regard as premature.

Inevitably this has subjected local governments to a budget squeeze between falling revenues, threats to state budget support and the rising costs of debt service and social assistance to affected households. The timing and magnitude of that impact, however, depends on tax bases, tax procedures, and national policies. These forces will be discussed in the following paragraphs.

1.2.2. Current Revenues: Taxation and Fees

The impact of the crisis on local government current revenues has varied widely depending on several conditions:

- The severity of the downturn.
- The parallel fortunes and responses of national government.
- The nature of the local revenue base and its vulnerability to economic change.
- Time-lags due to the taxation system. In Hungary, for example, receipts of shares in personal income tax (PIT) in 2010 are based on collections in 2008 (a similar delay occurring in Belgium) while business tax payments are assessed on turnover in 2009, leading to a one-year delay, at least in the downturn being fully experienced by local budgets. In Denmark and Sweden PIT is collected by the centre which forwards to the local authorities the amounts they have voted in their budgets, reconciling these with actual collections two years later.

OECD analysis of its member states finds that previous economic downturns have had the least adverse effect on revenue from property taxes, moderate impacts on personal income taxes, and the most severe effects on the taxation of business turnover and corporate profits. These statistics confirm common sense expectations and are borne out so far by the experience of the current recession.

The dramatic fall in housing values might have been expected to affect revenues from ***local taxes on property***, the most common local tax source in Europe. Radical declines have occurred in those American cities (20% in Washington, D.C.) where assessments are automatically indexed to changes in market values. This is not the case, however, in most European countries since property taxation is generally based on formula valuations which are updated very infrequently, if ever. This robs the tax of buoyancy when times are good, but provides welcome stability during an economic downturn.

In the United Kingdom, revenue from the residential property Council Tax has continued to rise by £1 billion in each of the last four years. Most countries report a rise in property and land tax yields, some sharp (e.g., 25% in Ukraine in 2009, 28% in Russia, 23% in Czech Republic). It is likely that local authorities faced with a decline in revenue from more lucrative taxes or from transfers have simply put more effort into improving the assessment and collection of property tax. Sofia, for example, obtained court orders freezing the bank accounts of defaulters; it collected arrears worth €20 million in 2009.

Property tax receipts are, however, vulnerable in times of recession to growing default and to pressure, particularly from business owners, for exemptions and reductions. In France, the *Taxe Professionelle*, which was assessed on the rental value of business assets, has been replaced in response to business pressure. Default reduced Greek yields by 19.5% in 2009. Rural municipalities in Poland granted 32% more individual rate concessions in 2009. In both France and United Kingdom, incapacity to pay the tax is effectively compensated by government, a hidden but rising subsidy in times or places of economic distress.

By contrast, ***local taxes on property sales*** have fallen instantly and dramatically. Previously worth over €8 billion annually in France, their decline has been a particular blow to French *departements* (which are also faced with the major costs of social assistance). In Bulgaria, revenue from this source fell by over 30% in 2009. In Spain 2008 receipts were 40% lower than in 2007.

Access by local government to ***personal income taxation*** varies across Europe, as does its method—whether by sharing with national government or local surcharge, whether assigned by origin (place of residence or employment) or by formula. But regardless of method, where such access exists the revenue is highly significant to local budgets (70% of total local revenue in Ukraine, 50% in Estonia) and buoyant (growing by 47% in Slovakia over the four years preceding the crisis). PIT is also a major resource for large local governments throughout Nordic countries, Central Europe, and Switzerland.

Rising unemployment obviously hits PIT revenues, and those still with a job may earn less through cuts in hours, bonuses, or even wage rates (15% for public employees in Latvia, excluding teachers and the lowest earners). Some countries have also reduced income tax rates in attempts to boost consumption; maximum rates in Poland had already fallen from 40% to 32%, and taxable income thresholds have been raised in Hungary. Most dramatically in Ukraine, where PIT accrues entirely to *oblast*, city, and *rayon* budgets, revenues have fallen over the last year by over 20% in real terms largely due to wage arrears.

Local taxes on ***business profits or turnover*** are isolated and idiosyncratic, often victims to accusations of distorting competition in a global marketplace. They are also highly vulnerable to economic recession. German local governments are reporting major declines in the *gewerbesteuer (*a local tax based on company profits), losses reflected in major increases in municipal overdrafts with local savings banks. Similarly the Hungarian Business Tax, levied retrospectively on turnover, will show the effects of downturn mainly in 2010. But Czech municipalities have experienced a 27% fall in corporate profits tax shares in 2009, and Finnish municipalities expect revenues from their 22.3% share of this tax to have been 24% lower in 2009. Polish regions received 14.3% less from their share in 2009. Portugal reports reduction in Municipal Contributions (a surcharge on corporate profits tax). Russian regions suffered the biggest drop in CPT revenues in 2009, amounting to 70%.

Value added taxation is widely shared with local governments in South Eastern Europe, as compensation for the abolition of the local sales taxes, prevalent in the former Yugoslavia. Its yields are directly related to volumes and values of production and commerce and therefore highly vulnerable to their decline. These shares represent half the municipal revenue in Bosnia and yields declined by 17.5% in 2009 in Republica Srpska.

Impacts on revenue from ***fees and charges*** are less clear since they are divided between the budgets of local authorities and their utility companies. Reductions of income from building permits and other development charges have been widely reported, particularly in the United Kingdom. Falls in water supply, sewerage, heating, and refuse collection charges have been reported in Latvia, while in Ukraine only 60% of households are actually meeting utility charges.

1.2.3. Revenues: Intergovernmental Transfers

OECD analysis of previous recessions indicates that intergovernmental transfers are historically the most volatile source of local budget revenue. This experience is being repeated.

National government responses to falling municipal revenues have varied radically. In 2009, Albanian, British, Danish, Finnish, Norwegian, Polish, Slovak, and Swedish governments all compensated local governments for falling revenues and rising expenditures, partly through deliberate countercyclical policy and partly as an automatic result of equalisation formulae. Danish fiscal rules require general grants to be countercyclical. Norwegian grants rose by 1.2 billion krone. The Ukrainian government has added 10%

of corporate profits taxation to the equalisation pool. The Russian Federal Budget for 2009 included a 36% increase in transfers to regional governments.

In contrast, Bulgaria reduced its grant for mandatory services (education, social welfare, health service, etc.) by 10% in 2009. Also in 2009, Serbia reduced grants by 15bn dinars (equal to 8.5% of total revenue), Estonia cut its Equalisation Fund by 20% while grants for preschool education and road maintenance were eliminated in Latvia. The Irish government cut its general purpose grants by 9.6%. Despite increases in federal funding, a number of Russian regions have reduced equalisation grants to their municipalities because of falls in their own CPT revenues. In a number of cases such as Serbia, these cuts have been mandated by standby agreements with the International Monetary Fund (IMF).

1.2.4. Current Expenditure

Mention has already been made of the increasing cost of servicing debt, due partly to banking failures, partly to rises in bank lending rates and partly to the devaluation of national currency against the euro in which many municipal loans have been denominated. The cost of municipal debt service in Serbia, for example, rose by 26% in 2009. The burden is particularly severe for those local governments that were already heavily indebted before the crisis.

The impact of increased social expenditures on municipal budgets varies greatly, partly because of differences between countries and regions in the severity of the crisis, but also because of great variations in the extent of municipal responsibility for social assistance. A further variable is the duration of unemployment insurance benefits after dismissal, delaying eligibility for social assistance.

Responsibility for basic entitlements like unemployment benefits, old-age pensions, and incapacity allowances normally lies with national government or its insurance agencies. Depending on country systems, however, local government may bear some of the extra costs of the following:

- Housing and utility allowances (because of falling household incomes or slower reimbursement by central government).
- Safety net payments to the long-term unemployed and others eligible for minimum income guarantees.
- Emergency aid to families in advance of awards of state benefits.

Local governments may also administer state benefits, subject to reimbursement.

Costs to Danish municipalities of social assistance and employment initiatives have risen by 8%. Croatia and Russia also report rising social assistance costs, while both

British and Italian local governments are coping with higher demand for housing allowances and homelessness. Since there is generally a time-lag between recession and the growth of unemployment (and between economic recovery and recovering employment), this burden may be expected to grow in 2010; Hungarian municipalities are experiencing a 22% rise in social assistance expenditure so far in 2010, on top of a 14% rise in 2009. The full impact is also delayed by the short-term coverage of unemployment insurance.

1.2.5. Capital Budgets

Local government capital expenditure has generally ranked high as a proportion of general public investment, 55.6% in the EU in 2008. Its regular funding sources have, however, been badly depleted by the crisis:

- The current budget squeeze has reduced or eliminated operating surplus.
- The ability or willingness of banks to supply credit or buy bonds has been severely reduced (although Central European banks are proving able to provide short-term pre-financing of EU structural funding).
- Shortage of credit has also reduced the appetite of private enterprise for public-private partnerships (these petered out in Slovakia in 2008; there have been no projects in Poland although the legal framework was enacted in 2005).
- The potential value of, and market for, asset sales have also shrunk.

Nevertheless there has been a vigorous and widespread governmental response to this aspect of the downturn. Accelerated capital investment features prominently in countercyclical policy, protecting employment particularly in the damaged construction industry and stimulating consumption generally.

As a result governments have made additional funds widely available to local governments for capital projects:

- Austria has a €3 billion Municipal Infrastructure Package financed by loans but with federal and state governments meeting 75% of debt service costs.
- France is advancing the reimbursements of VAT on local government construction.
- The German federal budget has allocated €10 billion for state and municipal investments (25% cofunded by recipients).
- Greece has established a €2.3 billion local investment fund jointly funded by government, the European Union, and local authorities.
- Norway spent 4 billion krone on small local investments in 2009.

Similar funds have been established in Portugal, Spain (€8 billion), Sweden, and Ukraine (371 projects repairing schools, hospitals, sports stadia, etc., at a cost of UAH 20 billion).

These funds have two frequent features. They are expected to finance projects that are "shovel ready," i.e., capable of immediate execution. Second, they often have a strong environmental bias, e.g., energy saving modification of public buildings (and occasionally social housing), replacement of street lighting bulbs (Netherlands), or home insulation (UK). In Spain, the condition to access the 2010 State Fund for Local Investment is that projects have a research, development, and innovation content related to sustainable development.

Coupled with this effort by national governments is an acceleration in the disbursement of European Union structural funds in new member states. Fortunately, the major increase in allocations to them under the 2007–13 budget, came on stream as the crisis developed. This has also involved some relaxation of the EU's own accounting and procurement rules. It has also been facilitated by national efforts in countries such as Bulgaria, Estonia, and Hungary to provide bridging finance for municipalities faced with heavy costs of prefinancing and noneligible expenditure. In Hungary over 80% of structural fund allocations available under the 2007 to 2013 EU budget are already covered by construction contracts.

In some respects the abrupt decline of supply-led pressure by banks to lend is a benefit. The flow of bank credit to local governments is in most countries now well regulated by appropriate debt or debt service ratios and legal procedures governing municipal default. Much of the accelerated flow of EU investment funding is now supported by short-term bank funding of matching contributions, prefinancing, and nonreimbursable costs.

1.2.6. The Overall Impact

The impacts of the crisis on local budgets have been very specific to individual countries and authorities within countries. Falling revenues and rules prescribing balanced budgets make contraction almost universal, but its scale and timing are not.

Allowing for inflation our data on 2009 shows absolute declines in local government revenue (compared to 2008) in 16 countries. These falls were sharpest (over 10% in real terms) in Republika Srpska, Latvia, Serbia, Russia, Ukraine, and Iceland. Lesser falls, again in real terms, were experienced in Armenia, Bulgaria, Croatia, Czech Republic, Estonia, Germany, Hungary, Lithuania, Portugal, and Romania. Elsewhere revenues are simply growing far more slowly than before.

This may seem less catastrophic than might have been supposed, and in all except three countries, less severe than the plight of national budgets. But in several countries such as Hungary the impact has been delayed until 2010 by tax time-lags. It has also been cushioned where own revenues have fallen sharply but national government has been both anxious and able to sustain levels of local expenditure through grants or to facilitate increased borrowing as part of a countercyclical policy, a typical situation in Western Europe.

In the Baltic states, the recession grew rapidly from early 2008 and the impact on local budgets was already severe. Elsewhere the crisis has been equally sudden but more recent, with several countries recording declining revenues in the first quarter or half of 2009, despite growth through 2008.

1.3. Responses

1.3.1. The Need for Policy Responses

Every local government system in Europe has experienced some financial downturn, in some cases merely a slowdown in growth rates, but in others a real contraction. It has come as a shock, following a period of sustained growth.

The downturn's severity varies greatly and its duration is unknown. First half data for 2010 suggests a slow recovery of GDP; OECD predicts 1.2% growth this year in the Eurozone (contrasting with a more robust 4.6% worldwide) with unemployment at 8.5%. The EU/IMF bailout of Greek government debt and widespread adoption of fiscal austerity measures have so far stemmed the collapse of bond markets for Italian, Portuguese, and Spanish sovereign debt predicted during the Greek debt crisis. The European economic situation is better than seemed likely at the end of 2009, but still sufficiently volatile that chances of a double-dip recession, aggravated by government belt-tightening cannot be dismissed.

As we have seen, some local revenues will only feel the impact of current circumstances in one or two years' time. Inflation fell to zero in May 2009 and construction costs have generally fallen, but inflation is currently back to 1.5% and the recent volatility of oil prices underlines the risk of resumption along with its effect on local expenditure. How soon local governments' fiscal fortunes will benefit from recovery and how far remain very open questions.

Moreover, the OECD's memory of a squeeze on local government following, rather than during, previous recessions is sobering. It is when economic recovery is in progress that governments seek to reduce their newly inflated debt, cutting transfers and encouraging tax increases in the process. The 2010 G20 summit failed to agree, despite the urging of the United States, to sustain fiscal stimulus policies, but how long markets will allow governments to run spending deficits that grew in the G20 states from 1.1% of GDP in 2007 to 8.1% in 2009, remains to be seen. The IMF reckons that all European governments except Norway will eventually have to tighten budgets in order to pay interest on accumulated debt. Local governments cannot expect to escape the consequences.

To add to this pressure on local budgets, most European countries face the long-term consequences of demographic change involving local government in the care of an increasingly elderly (though not necessarily infirm) population. The developed world's population over 60 is set to increase from 22.5% now to 35% by 2050. The IMF reckons that the effect of increased pension, health, and social care costs on public budgets will be about nine times the cost of servicing the extra debt incurred during the current fiscal crisis. Serious measures to slow down the rate of global warming are likely to add to the strain.

Economic and social distress may also lead to wider threats to public order with their own consequences for public budgets at all levels of government. Conversely, recovery will demand local investment in the infrastructure, skills, and environmental improvement critical to the revival of local employment and economic activity.

Governments, national and local, should not therefore treat the current strain on local government as a purely temporary blip, with a return to previous growth just round the corner. Longer-term measures to cope with fiscal pressure and make the most of lower resources have to be considered. This section outlines some of the options. Their feasibility and desirability vary from country to country, an *a la carte menu*, not *table d'hôte.*

1.3.2. Reforms of Intergovernmental Financial Relations

Conceptually, one way to relieve pressure on local budgets is to change the framework of intergovernmental finance to:

- reduce local government responsibilities, or
- increase its revenues.

Is such reform feasible or desirable?

As mentioned already, some European governments have compensated local governments for falls in revenue and/or increased costs, but this has not involved any fundamental reform, just the application of existing equalisation systems. The only substantive reform has been in Ukraine where 10% of corporate profits tax (not a pot of gold in current circumstances) has been added to the equalisation pool and its scope extended to the lowest tier of local government and the cost of housing and communal services; this is likely to represent more a redistribution of local budget resources than an increase. Minor adjustments to the assignment of PIT shares have been made in Croatia along with a proclaimed intention to increase property tax rates.

However bad the impact of the downturn on local budgets, the impact on national finances is generally worse. Country reports show national budgets contracting to a greater degree than local budgets in all except three countries (Germany, Hungary, and Estonia, where only a doubling of EU funding and property sales have partly compensated for the fall in national taxes). National governments are more dependent on the more vulnerable revenues from corporate profits, customs duties, VAT, etc., and have to pay unemployment benefits and fund fiscal stimulus packages. They are generally ill-placed to relieve local governments of cost burdens or transfer revenues to them. Most are struggling to raise debt finance and will be struggling to repay it.

Only one reduction in responsibilities has been reported by observers; the Romanian government has assumed the full cost of minimum income guarantees (previously cofunded by municipalities). This is rational since gross disparities in local revenue bases were spilling over into basic social provision, a clearly undesirable result. In any case, it has been offset by the transfer of hospitals and public transport systems to local government. Generally, however, a diminution in local government responsibilities is not an answer to the fiscal crisis, which gives added importance to the potential virtues of local initiative and responsiveness.

Major changes in intergovernmental finance are, therefore, unlikely. But two issues remain. The first concerns the assignment of shares in volatile taxes like VAT and corporate profits taxation to local government in the relatively few countries where this is practised. It seems logical that levels of government with a high percentage of fixed, recurrent commitments like public employee wages and service maintenance should not depend significantly on volatile revenues. One can argue, *au contraire*, that local public services should enjoy their fair share of rising public revenues and equally share the consequences of their decline. The question is open, the answer depending both on the severity of the crisis and on which services are performed by local government; more political priority usually attaches to the protection of education and health care than to the maintenance of physical infrastructure.

The most lucrative local tax source across Europe is sharing or surcharging of personal income tax. It is the only tax base that is both technically susceptible to variation by local decision and capable of funding a large proportion of the costs of the major educational and social care services. Local freedom to determine its incidence has expanded in recent years from its Scandinavian and Swiss heartlands to Spanish regions, Italian regions and municipalities, and Croatian counties and municipalities. That expansion should continue if major progress in fiscal autonomy is to be made, but accompanied by an adequate system of equalising differences in the tax base and some limits on rates to avoid adverse effects on labour market supply in an increasingly globalised world.

Property is the most common base of *autonomous* local taxation, (i.e., subject to local rate setting), but a relatively low percentage of local revenue overall. It is unlikely that radical changes in valuation methods will be undertaken, but the political resistance to increased incidence could be countered by greater attention to the link between tax bills and household income. In Eastern Europe, experience has shown that municipal freedom to apply cautious but regular increases in tax rates in line with, or just ahead of the general rate of inflation, is a necessary condition for maintaining the tax's significance.

One interesting conclusion of our data analysis is that the most vulnerable revenue bases have been those relying heavily on a single source, whether own revenue or intergovernmental transfer. The most resilient bases have been those like the Polish combining a mix of revenue sources with rational distributive formulae.

The second question relates to the freedom to set the rates of local taxes and charges, enjoined by the European Charter of Local Self-Government but still very restricted in several Eastern and South Eastern European countries.

Increasing taxes and charges may ease budget strain and improve the efficiency of utility services, but (as opposed to countercyclical grants) it may restrain consumption and exacerbate recession. This is a dilemma, with which local authorities are already grappling. Different Polish municipalities are taking contrary approaches, variously increasing or reducing rates of property tax. Danish municipalities wishing to increase PIT surcharges are in conflict with national government. The Irish government has persuaded local authorities to restrict annual property tax rate increases to 1.15% overall. The incoming British government has frozen Council Tax rates for two years. On the other hand French *departements* and *communes* increased taxes in 2009 by an average 5–6% without national restraint.

Whatever the short-term desirability of restraint, the longer-term period of recovery will probably demand increases in local taxes and charges and the Charter's requirement of local autonomy in this respect should be respected universally. Two considerations, however, argue for some restraint. For some kinds of taxation—notably PIT—high tax rates may have long-term effects on labour supply. The second is that a number of national laws and policies impose restrictions to ensure that local taxation does not discriminate unfairly between domestic and business payers. These are justifiable, not only because commercial recovery should not be impaired, but also because the underlying reason for fiscal autonomy is to encourage accountability to electors, and households should therefore share the consequences of local fiscal policy. Increases in utility charges also need to be accompanied by an adequate system of housing subsidies for the lowest income households.

Based on the Council of Europe *acquis*, the Centre of Expertise of the Council of Europe and the Local Government and Public Service Reform Initiative of the Open Society Foundations developed a set of benchmarks to assess both the intergovernmental financial relations and the quality of the financial management performed by local authorities. While the benchmarks concerning local financial management proper met with demand and have already been successfully implemented, the ones aimed at helping central governments to assess their policies concerning local finance are yet to raise interest among central governments. These benchmarks could, however, be very useful for governments seeking to understand their strengths and weaknesses and aiming at reforming intergovernmental financial relations in response to the crisis and beyond.

1.3.3. Improving Accountability and Efficiency

Making the most of more limited resources is likely to be an ongoing challenge. Improving the efficiency and effectiveness of local government expenditure has many manifestations, discussed more fully in Chapter III. They aim chiefly to make both elected and appointed officials more accountable for the use of public funds.

Cost Control

Country observers' reports detail many efforts by individual local governments to reduce costs. These mainly apply to administrative overheads and include cuts in overtime, bonuses, official entertainment, and telephone usage, while purchases of vehicles and furniture and filling vacancies have been frozen. In the case of Romania, some of these have been mandated by efficiency measures agreed with the European Union as conditions for national budget support. In Latvia, municipal employees have shared a national 15% cut in public service pay while Hungarian municipal staff have lost their 13th month bonus; public service pay will be frozen for two years in the UK. In Serbia, GPS systems have been fitted in municipal vehicles so that both drivers and town halls know where they are.

Justified as they may be, these are temporary or one-off savings that do not greatly affect longer-term efficiency. This requires more fundamental examination of the practical ways in which services are run, the subject of "value for money" approaches and performance audit systems developed over the last three decades under the umbrella of New Public Management. Chapter III outlines three such efforts that deserve wider application:

- "Value for money" assessments of individual authorities and services are undertaken on a voluntary basis by the Danish Local Government Association, based like their British equivalents on disseminating the practice of those municipalities that perform well in a comparison of unit costs.
- Benchmarking individual service and administrative service costs carried out in Bulgaria by the Open Society Foundations in collaboration with the Resource Centre for Decentralization and Municipal Development and Club Economika 2000.
- Performance standards measured by the Benchmarking Club of Hungarian water company managers, with the consultant help of the Regional Centre for

Energy Policy Research at the Corvinus University of Budapest and based on comparing a range of technical and management issues.

Benchmarking is one of the tools designed to help the public scrutinise the care with which its money is being used. Another is the Citizens Charter, usually a promise to citizens to deliver services at certain standards and a set of procedures by which they can check its fulfilment.

The Council of Europe has been helping to develop performance management capacity in a number of countries such as Bulgaria, Russia, and Serbia. It also supports French efforts in this field. The financial downturn emphasises the need.

A less formal approach to curbing excessive costs has been adopted by a variety of local governments from Greece to the UK who publish details of all items of expenditure over a fixed limit (Windsor's €600 is typical) on the Internet for scrutiny by zealous media.

Performance Audit

In 2006, the Local Government and Public Service Reform Initiative surveyed the audit of local governments in 12 Eastern and South Eastern European states. It found that most states had an adequate legislative framework, much of it newly enacted with EU assistance, but so far implementation has been weak:

- Qualified auditors were in short supply in the public sector and as a result actual external audits infrequent. Inevitably the situation was worse in countries with large numbers of small authorities. (Only 84 out of 7,455 Romanian local government final accounts had been audited.)
- Audit was still largely concerned with legality and conformity with required procedure; performance and efficiency, though within its terms of reference, were rarely examined. Audit training in these aspects was often inadequate.
- Public interest in audit findings was generally low, not aided by the customary opacity and circumspection of published reports.

The Council of Europe has been helping to develop performance audit capacity in a number of countries such as Bulgaria, Russia, and Serbia. The financial downturn reinforces the need.

The current ambitious Strategy for Innovation and Good Governance at Local Level, launched by the Council of Europe, includes among its implementation measures the development of a European Label of Governance Excellence (ELOGE) that would be attributed in a decentralised manner to municipalities reaching a certain level of quality in their overall governance. Based in particular on a benchmark/measuring tool specifically tailored to the needs of local authorities, the label, if successful (it is currently being road tested), could be very effective in supporting the improvement of local governance.

Removing Incentives to Expensive Service Provision

The crisis has encouraged a cull of underutilised service institutions. Bulgaria, Hungary, Moldova, Romania, and the UK all report such measures, with small rural schools the most common target. But local government is often encouraged by administrative and financial arrangements to provide services in an unnecessarily expensive way.

For example, in a number of countries such as Hungary and Ukraine, responsibilities for residential care for the elderly and infirm and hospital care lie with the upper tiers of local government, while the municipalities provide domiciliary and primary health care. Funding of the upper tier service may well be based on formulas involving numbers housed or treated. These arrangements may provide strong incentives to place social service clients in residential homes or patients in hospitals when it may be neither the most appropriate nor sympathetic response to their need. In most cases it is the more expensive solution.

Medical care costs can also be inflated by a system of paying providers per admission or individual treatment. These perverse incentives are widely recognised and systems like DRG (diagnosis-related group) funding have been designed to reduce them. But such reforms have not been universal and the crisis underlines their importance. The recent introduction in Hungary of a small charge for seeing general practitioners was also effective in reducing unnecessary demands on their time, until countermanded by a referendum.

Other examples of excessive social sector costs abound. Schools with declining pupil populations, for example, frequently retain previous numbers of teaching staff while mandated contact hours with pupils are generously low.

Reviewing Unsustainable Norms

Local governments that would like to cut costs are frequently debarred by national regulation. This applies particularly in countries that distinguish between the "autonomous" and "delegated" tasks of local government and place the more expensive services like education, social service, and health care in the latter category.

Delegated services are often regulated by detailed standards of provision, and local government management is subject to close supervision by sectoral ministries. These norms typically govern inputs, rather than outcomes. Ukrainian local governments cannot close grossly underutilised schools or social and cultural institutions without the permission of national ministries, frequently withheld. Such institutions may well have lost their custom through changes in population or public preference.

The problem is typically exacerbated by the fact that the sectoral ministries concerned are not faced with the consequences of running uneconomic services, since the financing of delegated services is usually governed solely by the Ministry of Finance. Several national rapporteurs comment that failure to meet unsustainable service standards is widespread but tolerated. Others identify national insistence on observing the norms as a serious problem. Signatories of the European Charter should be ensuring that national ministries do not micromanage services entrusted to local government whether technically delegated or not.

Delegating Institutional Management

The same principle applies to the relations between local governments and their own subsidiary agencies and institutions.

When budgets have to be cut, it is usually their managers who know best where waste is occurring. It is only the school head who will bother that lights are switched off at the end of the day and only then if the school budget keeps the savings.

Delegating budgets and their managements to service institutions is another aspect of New Public Management that is now widespread; per-pupil funding of schools is now widely adopted, for example.

These solutions, though timely in a period of recession, need careful introduction, however. Budget allocations need to take full account of exogenous variations in cost. Population density and social background have major impacts on school expenditure, for example. Audit and other forms of accountability must match degrees of financial delegation.

Territorial Reorganisation

The average size of local governments varies enormously between countries; average municipal populations range from 1,640 in the Czech Republic and 1,720 in France to 56,570 in Lithuania and 139,480 in the United Kingdom. Amalgamation, widely practised in the 1960s and 1970s, but also widely reversed in former socialist countries after 1989, is back on national agendas.

Denmark has merged 271 municipalities into 98. Georgia replaced 985 municipalities, mostly villages, with 64 large district authorities based on the former *rayons*, a policy already adopted in Lithuania. The number of Finnish municipalities has been reduced from 447 to 348, and new rules are imposing the minimum population required for the provision and administration of services such as health care and vocational education. Greece, Iceland, and Latvia have also greatly reduced the number of municipal authorities.

Larger municipalities should spend a smaller proportion of their resources on administrative overheads and achieve greater economies of scale. But, while amalgamation may enable local authorities to provide a larger range or quality of services, there is no evidence that it saves money overall. Quite apart from the one-off costs of reorganisation, there is a tendency for merged authorities to adopt the most expensive habits of their individual forerunners. The failure of empirical studies to show savings from amalgamations may be explained by the fact that the more obvious economies of scale had already been realised by intermunicipal co-operation.

It may be easier to achieve economy by increasing co-operation between municipalities. In Hungary, the number of municipal landfills has shrunk by 90% through the formation of joint utility companies able to maximise the use of modern technology and EU structural funding, while subregional associations share the professional resources and equipment needed for administrative operations like tax collection and development control. In France, both legal and financial incentives have led to a large increase in the number of *communautés urbaines* providing integrated planning and service delivery within conurbations.

Even in the UK where local authorities have on average exceptionally large populations, the crisis has promoted much joint management of services. The city of Westminster has joined its neighbouring borough, Kensington and Chelsea, in running a single education service. Northern Irish authorities have formed "coalitions" to manage procurement, IT, and development control.

Improved Targeting of Social Benefits

Social benefits are frequently distributed without regard to financial circumstances. All British pensioners (including the writer) automatically receive a winter fuel allowance of £200, without application. In Lithuania, 64% of social assistance costs are on universal benefits, notably child allowances. In the countries of the former Soviet Union, numerous allowances or free services are provided to various categories of "veteran" (of war, labour, natural catastrophe, etc.).

Mothers of young children and pensioners tend to be the main beneficiaries. What probably unites pensioners is not poverty (those with inflation-proof pensions, discharged mortgages, and grown-up children may well have ample disposable income), but the time to vote and complain.

Means testing the allocation of social benefits is resisted by governments because it is divisive, open to corruption—and plain difficult. But if money is tight, its introduction may be the price of providing assistance to those who are in real poverty. The World Bank estimates the proportion of the poorest households receiving cash benefits to vary from 25% in Poland to 95% in Hungary. Research funded by the Local Government and Public Service Reform Initiative in Armenia, "the former Yugoslav Republic of Macedonia," and Moldova found that many very poor households were excluded from entitlements by bureaucratic hurdles such as the difficulty of people moving into towns getting certificates of residence, or of obtaining evidence of previous employment when both the enterprise and its owner, the former Yugoslavian state, have been disbanded. The Russian report cites the need to queue for a mountain of documents as a deterrent to the claim of housing allowances.

Again the crisis is beginning to promote attempts to target benefits more precisely. Some Romanian cities, including Bucharest, have abolished subsidies to heating companies, replacing them with means-tested subsidies to individual consumers. Chisinau has started to means test public transport subsidies.

The Boundaries of the State

The severity of the crisis in some countries and its abruptness everywhere have stimulated a welcome concern to reinforce accountability and improve the productivity of local budgets.

These responses do not, however, challenge the underlying nature or scope of what local government is trying to do—simply its ways of doing and funding it.

Yet such challenges will arise if the crisis is even more severe or long lasting than currently forecast. Predictions tend to be based on the experience of past recovery from recession, not on hard current evidence. Given the accumulating levels of public debt, long-term demographic trends, and the responses needed to global warming, a return to previous levels of public service cannot be taken for granted.

Much of what government, national and local, now provides its citizens was the responsibility of communities and families before the Second World War. Turning the clock back is hard to imagine; abandoning mass literacy and letting old people shiver to death in winter are not conceivable options.

But burdens could be shared to a greater extent. Means testing has already been mentioned. Another option is the greater involvement of civil society in the provision of welfare. Partnership between local government and nongovernmental organisations is common in Europe, aided by the growing numbers of retired people who are still physically fit and potentially active. But there are still countries where NGOS are seen as threats rather than allies, and also where "volunteering" is associated with memories of totalitarian coercion.

These attitudes of mind are neither healthy nor affordable. It is true that they are often associated with societies where family solidarity remains a stronger support for the aged, infirm, and unemployed than in Western Europe. But in an ageing and urbanising society family support can no longer be taken for granted. Voluntary care can be subsidised and supported, such as by "respite breaks" for family carers or petrol allowances for volunteer drivers. Public funding of public services is not all or nothing.

The downturn challenges both the public expectation that the state should provide for everything and the politicians' pretence that they can. Modern technology offers more and more interactive processes. Perhaps it is the model for postcrisis local government.

Finally, we return to the boundaries *within* the state. The downturn has demonstrated the dependence of local fiscal fortunes on differences in national policy. But this should not be exacerbated by a deliberate or instinctive recentralisation of authority. The responses outlined above call for more local flexibility and discretion, not less. The case for the principles and provisions of the European Charter of Local Self-Government remains intact.

ii) The Impact of the Economic Downturn on Local Government in Europe: What Is Happening and What Can Be Done?[6]

1. Overview

(See the introduction to Chapter II.)

2. Comparative Analysis of European Local Budgets in Crisis

At the end of 2009, it is still rather early to gauge the full impact of the global economic crisis on the local budgets in all European countries. First, the events are still unfolding, with a lot of correction changes scheduled by governments for 2010, while data on local budget execution are notoriously hard to produce in real time. The figures presented in this chapter are based on Eurostat, plus information collected first-hand through a network of local operators and Council of Europe partners, in order to be able to illustrate local government budgets broken down by their main components. Second, subnational financial arrangements differ tremendously from country to country, and so do the official reporting templates for the local/regional budgets execution, the degree of data centralization, or the time-lag with which they are made available tothe public, even among EU member states. Therefore, the results referring to recent periods should be regarded as preliminary: the task to integrate everything into a comparative format is time consuming and successive revisions have been necessary as the team continues to receive information from the local operators.

Nevertheless, a number of patterns seem to emerge that enable us to formulate tentative conclusions, most of which are summarized and discussed in the other chapters of this report. At the beginning of 2009, it seemed that the financial crisis hit

6 The original Report by the Local Government and Public Service Reform Initiative and the Council of Europe was presented at the Ministerial Conference as document MCL16(2009)Inf 1.

disproportionately the public budgets of the western and central parts of the continent, and less the eastern-most ones. While the continental local governments were better off in 2008 compared with 2007—with the notable exception of Iceland, where inflation eroded all budgets—only in Central and Eastern Europe did local revenues continue to increase in nominal terms in the first quarter of 2009.

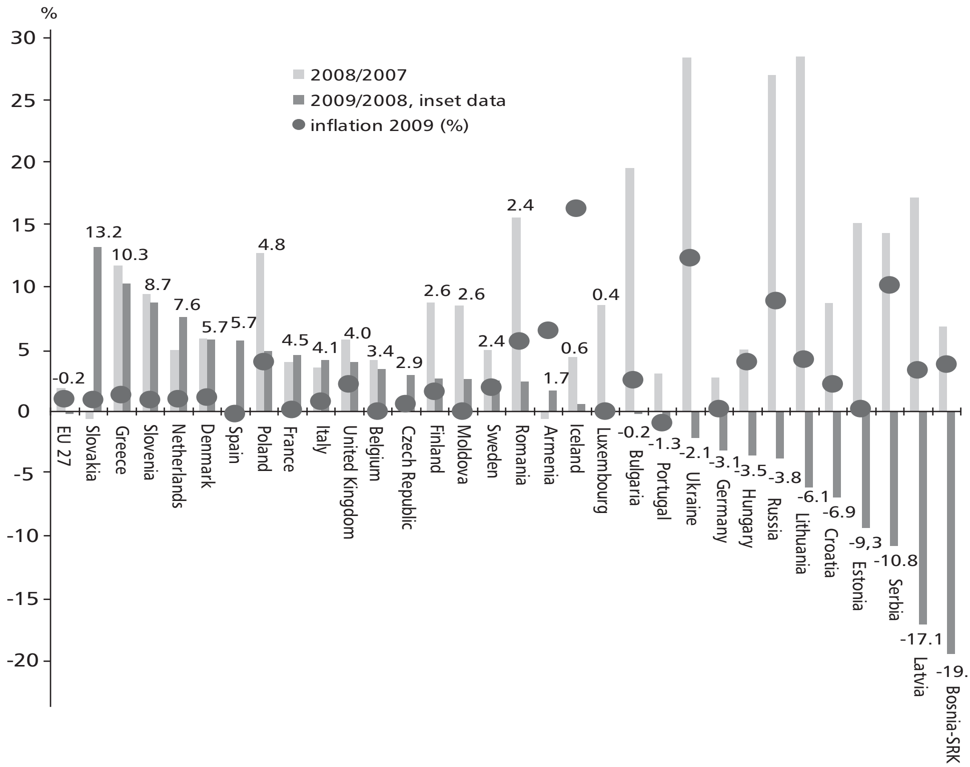
However, this trend did not last long and the full 2009 execution altered the picture completely: some new member states (the Baltic states, Hungary, Bulgaria) or nonmembers (Russia, Ukraine, the Balkans) have witnessed a dramatic combination of surging inflation and nominal shrinking of local finance (Figure 1). The same happened in old member states such as Germany and Portugal, where for various reasons the central governments probably did not transfer funds to compensate the local governments for their revenues losses, unlike in other hard-hit countries (Spain, Greece).

Overall, the landscape is very uneven across countries when looking at the European local budgets: from financial collapse in the Baltic states, CIS, and Western Balkans, to managed cuts in some new members states and Germany, to buoyancy or at least resilience in the rest of the continent.

There are two competing explanations for this: the happy scenario is that local finance will survive the crisis better than expected, due to the relative stability of the local revenue sources and the timely compensation transfers introduced by central governments. The alternative, unhappy scenario is that there may be only a time-lag between the moment the crisis hits the local economy and the moment when this is felt in the local tax collection:

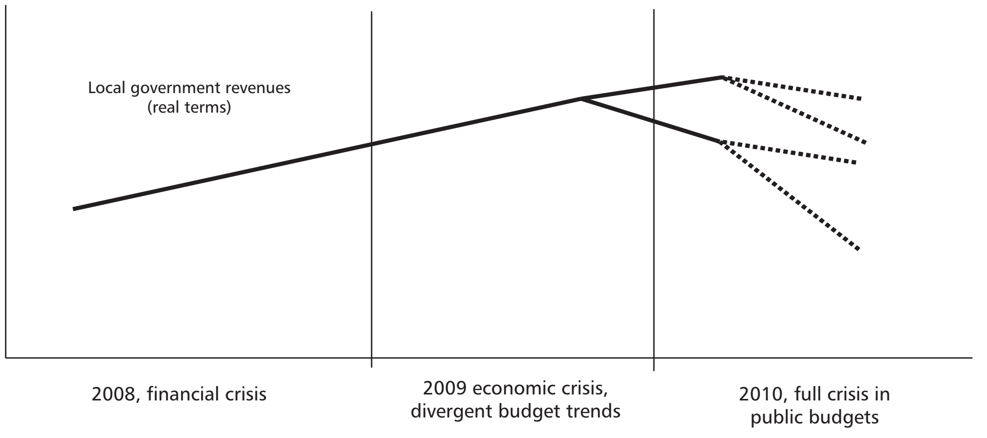
- Many own or shared taxes are tied with indicators reflecting last years' performance, and therefore the yield will decline in subsequent quarters (e.g., property, personal income tax, or local business tax in countries).
- Real estate transaction fees, a source that presumably reacted quickly to the crisis, in sync with the respective market, did not represent a very high fraction of the local revenues in the countries surveyed.
- Our data collection itself involves a time-lag, and therefore the picture might worsen as we receive information from the 2010 execution.

Figure 1.
Trends in Local Revenues (All Tiers Combined) and Inflation



Which scenario prevails will probably depend on the length of the crisis and the margin of manoeuvre each national government has in applying stimulus packages and compensating local governments for lost revenues. From this perspective, it is better to be cautious for the moment: the end of the crisis it is not yet in sight, in spite of the recent positive signs of recovery in industry; the few data we have at this point from the beginning of 2010 seem to support the unhappy scenario (local revenues getting worse); and most countries, especially in Central and Eastern Europe, already run substantial structural budget deficits, which do not allow their governments to be very generous with handouts and transfers. It is therefore possible that the European local budgets display a positive dynamic in the first stages of the financial crisis, only to collapse later, squeezed from below by slowly increasing social expenditure and declining own revenues, and from above by the reduced possibilities of the central government assistance. If so, 2010 may represent the peak of the crisis for the local communities (Figure 2).

Figure 2.
Stages of the Crisis and Local Budget Revenues



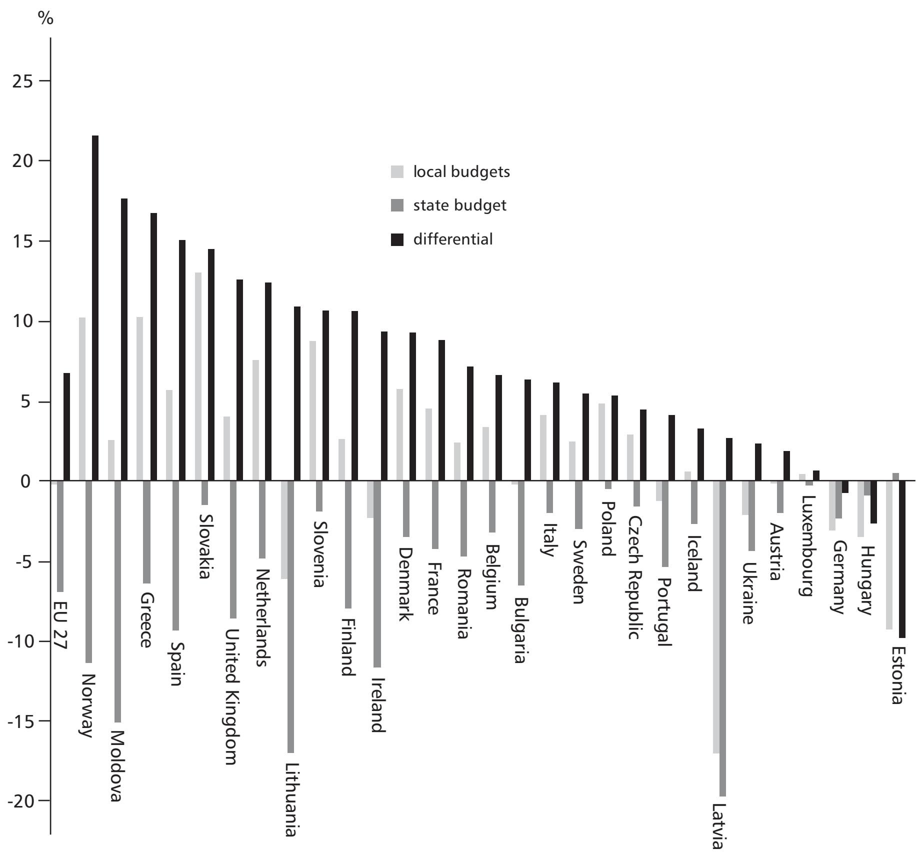
Going back to Figure 1 and analyzing it in more detail, a number of observations can be made. Apart from what happened in old member states, the crisis hit with extreme severity in early 2009 the local budgets in the Baltic states (Estonia) and some Western Balkan states, with nominal decline in revenues of more than 10%. To a less extent, this is true for Moldova and for the upper tier of the Russian subnational authorities (the "federal subjects"). However, these are nominal figures.

If we also take into consideration the inflation rate in 2008–2009, the general situation looks much worse: the net loss in Russia, Ukraine, Serbia, or Iceland is dramatic. In fact, the countries where local revenues increased in real terms in the first quarter of 2009 are very few, and, for some of the rest, governments intervened with central grants or fiscal policy changes over the course of the year. The overall picture is that, across the region, local governments struggle to maintain the previous levels of expenditure, which is eroded by inflation and the economic slowdown.

The crisis has generated a major shock not only in the budgets as such, but also in the expectations of local decision-makers and budget planners. Successive years of growth—or impressive growth, in CEE and SEE—in revenues, notably those deriving from taxes on individual or commercial property, personal income, or corporate revenues, have left local government people unprepared for the downturn. While in 2008 the local revenues were higher than in the previous year in almost all the countries covered by the analysis (Figure 1), only a few months later the picture changed and the local budgets turned into the red. Having to shift from planning spending increases to negotiating budget cuts requires a traumatic change of mindset.

On the one hand, this change may help focus the attention on efficiency and performance management, objectives often honoured more often in words than in deeds. With less resources available, decision-makers have now to face the tough choices they might have avoided in the years of plenty. In this sense, the crisis may also represent an opportunity to speed up reforms, in those places where they are needed. On the other hand, there is no guarantee that reductions in staff or other reallocations of resources, implemented in haste in a year of crisis, will be optimal for the service provision.

Figure 3.
Trends in National and Local Revenues in 2009 and 2008, in Percent



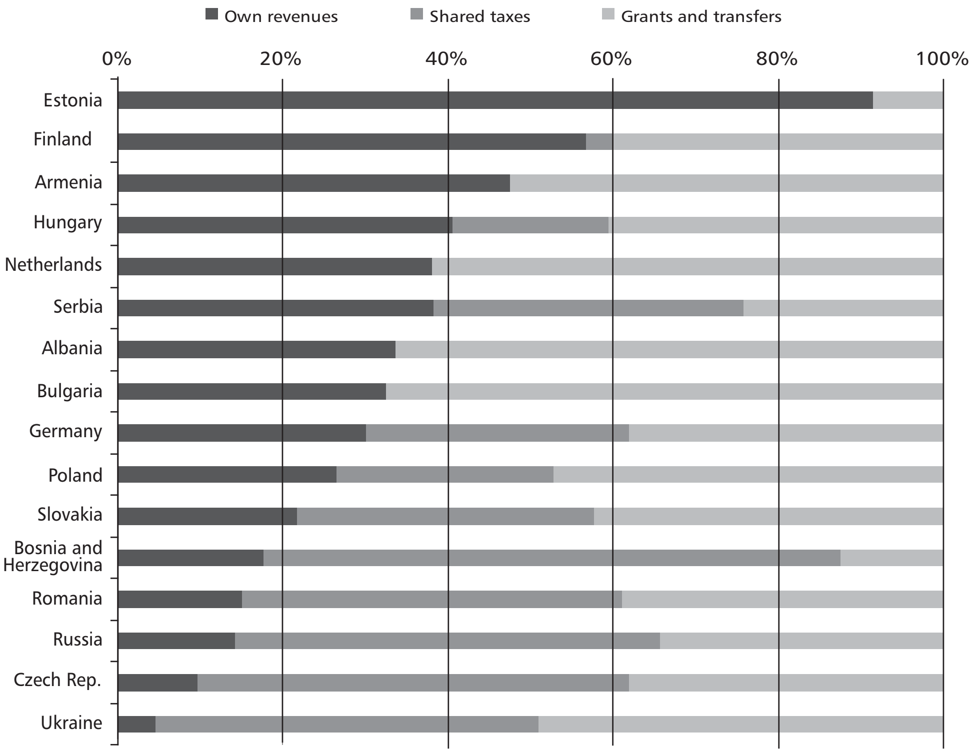
There are reasons for optimism in local communities due to the fact that in most of the countries surveyed, the budget crunch of 2009 did not affect them disproportionately. With the exception of Estonia, Hungary, and Germany, the central government was hit hardest and local budgets comparatively less, as Figure 3 shows: the latter grew more, or declined less than the former, and so the differential in dynamics plays in their favour. There are even situations when in the first quarter of the year the revenues to the central budget declined, while those to the local budgets continued to increase (Hungary, Romania, Croatia, Armenia; or France and the UK in the previous year). This trend appears to support a "generous government's hypothesis", i.e., that national treasuries reacted quickly to compensate through emergency transfers the losses at the local level, save for the three exceptions mentioned. Or it may be just that revenues at the local level are by comparison more volatile.

Both explanations may be true. There is evidence that in most places the central transfers were indeed bolstered; but also that central budgets were more exposed to the first stages of the crisis, relying to a larger extent on corporate and indirect taxes, or other contributions tied more directly to the level of economic activity. Nevertheless, a note of caution is necessary, as this situation may not last for much longer:

- The local revenues may decline later on (the time-lag effect mentioned).
- Even when central governments manage to overcompensate losses at the local level (transfers larger than the drop in revenues), these extra funds are usually earmarked. As a result, the local budget may be larger, but the autonomy in deciding how to spend it is more limited. It would be most unfortunate if the local autonomy ends up as a collateral victim of the drive to protect the local service provision against the vagaries of the crisis.

A downturn is obvious in large countries like Germany, Ukraine, and Russia (Figures 1 and 3), both at the central and local levels in the first case, and especially at the federal level in the second. Otherwise, by and large the local budgets followed the trend from the beginning of the year, just growing at a slower pace (Poland, Romania, Russia). This happened both in countries where the GDP held steady (Poland) and in those where a severe contraction was registered (Romania, with –7.2%). In Russia, if the upper tier of subnational governments is taken out of the picture (the "federal subjects"), local governments proper have witnessed small increases in revenues over the first half of 2009 and stagnation later.

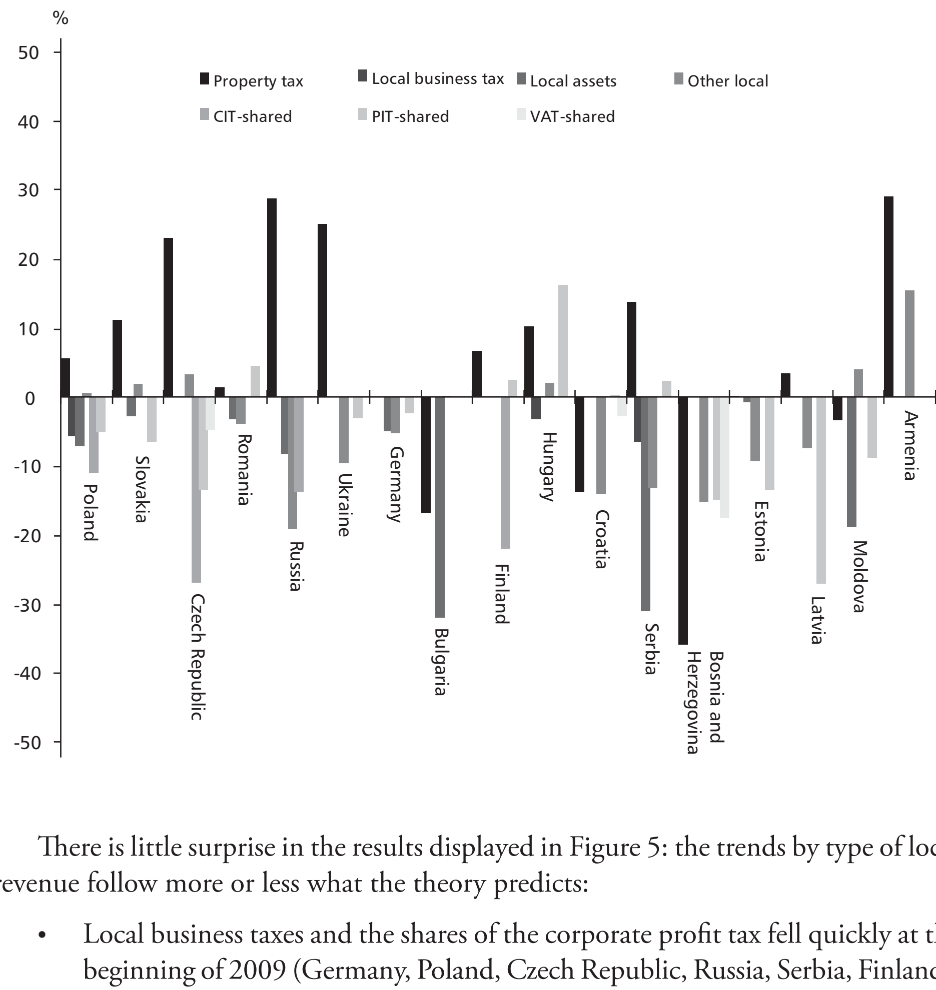
Figure 4.
Local Financial Autonomy before the Crisis: Own Revenues in Total (2008)



In other countries, such as Slovakia, substantive policy changes that occurred after the start of 2009 make the situation hard to compare with the previous period (reassignment of revenue sources downwards, or a boost in capital spending). Nevertheless, difficult as it is to generalize based on such a small number of cases, the trend after the first quarter seem to be downwards, at least in the larger countries.

The vulnerability of local budgets does not depend on their degree of financial autonomy prior to the crisis, as Figure 4 indicates. We find countries hit hard by the crisis at both ends of the scale. In Estonia, Serbia, or Finland, local budgets rely more on own revenues and were badly hurt by the economic downturn, as common sense would suggest. However, in Russia, Ukraine, or Republika Srpska, local government budgets rely predominantly on grants and shared taxes, but still this has not prevented them from declining. On the other hand, those in the Czech Republic, Romania, or Poland did not suffer too much. Since there is no obvious correlation of this effect with the GDP decline in 2009, we may conclude as a hypothesis that it is not the sheer reliance on transfers that insulate local budgets from the effects of the crisis, but probably a good combination of sources and the strength of contractual arrangements defining the intergovernmental finance: multiyear and formula-based transfers appear to offer more stability (as well as more accountability) to local communities, which is the case in the Czech Republic, Poland, and Slovakia.

Figure 5.
Trends by Type of Local Revenue in 2009 and 2008



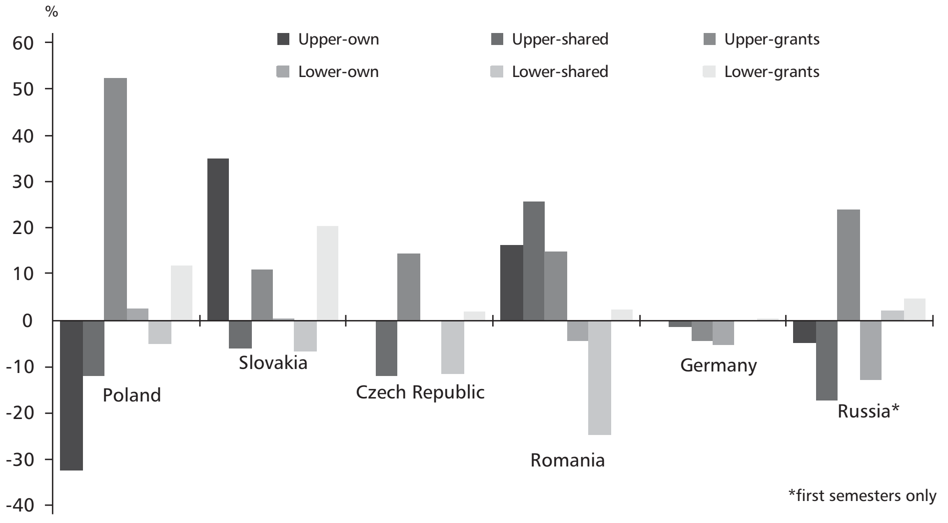
There is little surprise in the results displayed in Figure 5: the trends by type of local revenue follow more or less what the theory predicts:

- Local business taxes and the shares of the corporate profit tax fell quickly at the beginning of 2009 (Germany, Poland, Czech Republic, Russia, Serbia, Finland), unless they were tied to lagging indicators (Hungary), in which case the effect was delayed. The regions suffer most from this volatility (as Figure 6 also shows), since CIT shares tend to be a source assigned to this tier.

- Proceeds from the VAT shares (or other sales taxes), common in the ex-Yugoslav states (Croatia, Serbia, Republika Srpska) also marked a steep decline.
- Personal income tax proved to be more resilient in the first stages of the crisis, with the notable exception of the Baltic states, where unemployment shot up and this was reflected in the public budgets. If Europe will avoid a massive surge in unemployment, this would be especially good news for local governments: not only that social expenditure will be contained, but an important source of general-purpose funds (PIT) will continue to provide resources, helping to preserve not only the size of the budgets as such, but also some margin of manoeuvre at the local level. However, toward the end of 2009 the PIT yield declined in Central Europe, too (Poland, Czech Republic, Slovakia, Germany), which makes this trend an interesting one to be monitored in 2010.
- With the exception of some Balkan states, the property tax has held well in the crisis so far. However, there may be problems in the future with payments from companies, especially in countries where they are able to reassess the property value on their books (as in Romania): there is a strong temptation to do so when managers face a cash flow shortage, which creates tensions between businesses and the local government. On the other hand, in Russia and Ukraine there is evidence that the local governments proactively shifted the fiscal burden toward companies, by increasing the rates or the collection effort. Another problem may appear in those countries (UK) where a policy exists to help lower-income groups pay their taxes: while the tax collection may look good on paper, the yield incorporates a higher fraction of social support, also paid by the public authorities, and therefore the net gain is much reduced.
- Again, unsurprisingly, own revenues from the use of assets or other local sources (local fees and duties) went down almost everywhere.

Figure 6 differentiates the impact of the crisis by tier of subnational government. Again, we face the problem of the small number of countries in which the 2009 data allow such a breakdown. Nevertheless, the point made above about the greater vulnerability of upper tiers is confirmed: German *Länder*, Polish regions, and the Russian "federal subjects" were hit hardest in their own revenues, most likely because the mix of sources at this level makes collection more volatile. The same happened in Romania (though by not having regions, its upper-level local governments are not directly comparable with the others), and it may have happened in Slovakia, had the government not reassigned an important road tax to the regional level in 2009 (hence, the increase).

Figure 6.
Trends by Subnational Tier, 2009/2008



It is also clear that in most cases the central governments have indeed used grants to compensate losses at the local level, and this may explain to a large extent the relative resilience of local budgets in crisis visible in Figure 3. This happened obviously in Poland, Romania, and Russia; in Germany, the picture is not clear, with some help for the *Länder* and net cuts for lower tiers. What is important to note, however, is the fact that, depending on the strings attached to these compensation funds, the emergency transfers may imply a reduction in the decision-making autonomy at this level.

Another group of countries went the other way, cutting transfers for subnational governments: in Slovakia, because of the tax reassignment mentioned; in Ukraine, Hungary, or Bulgaria, probably due to the financial constraints at the central level. The data available so far do not allow us to tell if such examples are exceptions, or only announce a more general trend in 2010. In any case, local communities have fewer instruments to protect themselves against downturns and are very dependent on national policy changes. Therefore, further attention and monitoring are necessary to make sure that the financial burden of the crisis, which fell until now mostly on the shoulders of central governments, is not suddenly shifted toward local governments in the 2010 budget cycle or subsequently.

3. Local Capital Investments

3.1. Impact of the Economic Downturn on Municipal Investments

In assessing the consequences of the economic downturn for local government investments three basic questions will be answered:

i) How important are the local government capital investments in the public sector?

ii) What was the scope and trend of municipal capital expenditures during the past year?

iii) How did the local own source capital revenues change in this period?

3.1.1. Significance of Local Investments

Local government capital investments do matter for the economy. Including fixed capital formation and capital transfers, they represent 1.5% of GDP in the European Union member states. (Table 1.) However, this seemingly low share is more than half of the total general government capital investments.

There are obviously huge variations in the weight of local investments between countries (4%–77%), depending on the scope and form of decentralization and also on the actual methods of financing local capital investments. The first consequence of economic downturn is also visible: compared to 2007 the share of local investments declined from 60% to 56% in 2008. (This fall was occurred before significant government programs were launched.) It might be the reason why CEMR already called the national governments' attention to the need for empowerment and partnership with the regional and local governments.[7] The proposed "*local and regional new deal*" would mean protection of their financial bases, carrying out municipal social protection functions, and being involved in stopping the crisis.

3.1.2. Declining Local Capital Expenditures

Our survey in 2009 showed that fiscal austerity measures decreased subnational capital investments. Comparative data on local government capital investments were available from 13 countries. There are huge *variations in changes*: in some countries there was still

7 CEMR, The Athens Communiqué, 24 March 2009.

some increase (Finland: 7%, Luxembourg: 18%, Sweden: 8%, Croatia, Poland: 11%), while in most of the others contraction—from 6% (Ukraine) to 90% (Armenia)—was very visible in the first quarter of 2009. (Table 2.)

Table 1.
Local Investments as a Percentage of General Government Public Investment

	Country	2007	2008	Local in % of GDP (2008)
1.	Italy	78.3%	77.3%	1.7
2.	Netherlands	69.7%	72.7%	2.4
3.	France	72.7%	71.9%	2.3
4.	Portugal	65.2%	71.4%	1.5
5.	Ireland	72.7%	68.5%	3.7
6.	Finland	64.0%	68.0%	1.7
7.	Denmark	70.6%	66.7%	1.2
8.	Slovakia	57.9%	61.1%	1.1
9.	Germany	53.3%	60.0%	0.9
10.	Latvia	49.1%	59.2%	2.9
11.	Poland	61.0%	58.7%	2.7
12.	Sweden	54.8%	54.5%	1.8
13.	United Kingdom	55.6%	52.2%	1.2
14.	Austria	50.0%	50.0%	0.5
15.	Slovenia	48.6%	47.6%	2.0
16.	Hungary	44.4%	46.4%	1.3
17.	Romania	47.4%	46.3%	2.5
18.	Luxembourg	38.2%	46.2%	1.8
19.	Belgium	50.0%	43.8%	0.7
20.	Estonia	40.7%	42.9%	2.4
21.	Lithuania	32.7%	40.8%	2.0
22.	Czech Republic	46.8%	39.6%	1.9
23.	Bulgaria	37.5%	35.7%	2.0
24.	Spain	31.6%	28.9%	1.1
25.	Greece	20.0%	20.7%	0.6
26.	Cyprus	20.0%	20.0%	0.6
27.	Malta	5.0%	3.7%	0.1
	EU (27 countries)	**60.0%**	**55.6%**	**1.5**

Source: Eurostat, Government Statistics.

Table 2.
Changes in Local Capital Investments

1.	Albania	*Capital expenditures:*	Q1 of 2009/2008: 52% Q2 of 2009/2008: 152%
2.	Armenia	*Funds for capital investments:*	2008/2007: 73% Q1 of 2009/2008: 10%
3.	Bosnia and Herzegovina	*Capital expenditures:*	Q1 of 2009/2008: 91%
4.	Federation of Bosnia and Herzegovina	*Capital expenditures:*	Entity (2008/2007): 122% Municipal sample 39%-172%
5.	Croatia	*Capital expenditures:*	Q1 of 2009/2008 111%
6.	Denmark	*Capital expenditures:*	2009/2008 87%
7.	Estonia	*Capital expenditures:*	Q1 of 2009/2008 80% Q2 of 2009/2008 82%
8.	Finland	*Capital expenditures:*	Q1 of 2009/2008 106% Q2 of 2009/2008 106%
9.	Germany	*Capital expenditures:*	Q1 of 2009/2008: Local governments: 98% *Lander* (states) 217%
10.	Hungary	*Capital expenditures:*	Q1 of 2009/2008 78%
11.	Latvia	*Capital expenditures:*	Q1 of 2009/2008 61% Q2 of 2009/2008 72%
12.	Luxembourg	*Gross capital formation:*	Q1 of 2009/2008 118%
13.	Netherlands	*Capital investments:*	Q1 of 2009/2008 83% Q2 of 2009/2008 99%
14.	Poland	*Capital expenditures:*	Q1 of 2009/2008 103% Q2 of 2009/2008 111%
15.	Portugal	*Investments:*	Q1 of 2009/2008 97% Q2 of 2009/2008 108%
16.	Romania	*Capital expenditures:*	Q1 of 2009/2008 80% Q2 of 2009/2008 67%
17.	Sweden	*Gross capital formation:*	Q1 of 2009/2008 117% Q1 of 2009/2008 108%
18.	Ukraine	*Capital expenditures:*	Q1 of 2009/2008 94%

Source: Country reports.

However, these figures should be *interpreted with caution*. Only two years are compared at the very beginning of the economic downturn, so the trends might be influenced by special factors, like the election cycle. Local capital spending is usually higher in an election year. Also the murky relations with public utility companies in South Eastern Europe might affect the level of capital expenditures in the fiscal reports. The public utility companies are mostly financed by municipal grants, through special municipal contracts, and the service organizations receive subsidies from the line ministries or national public investment programs. These expenditures are connected to local services, but they are rarely consolidated with the municipal capital budgets.

3.1.3. Drop in Local Own Source Capital Revenues

Local capital expenditures are usually financed by municipal revenues, national budget transfers, and international development programs. Large-scale investments in local infrastructure, like utilities or roads, often do not appear in the local budgets. In the new EU member states, the local capital investments almost exclusively depend on the funds allocated through the various EU Operational Programmes. In other countries with rather centralized funding of local governments, the capital revenues are minimal and they are usually treated as residuals after the current budget expenditures are made.

The own source capital revenues are typically connected to *local government property*. In transition countries, after receiving the former state-owned assets or benefiting from privatization revenues, these own source capital revenues usually diminish. The cash-strapped local governments do not invest these cascading revenues, so they are often used for current budget purposes.

In the case of Armenia, one of the reasons for a sharp decrease in municipal capital investments was the decreasing revenues from the sale of municipal land. In the period of 2004–2006, state-owned land located in the administrative territory of the municipalities was transferred to the municipalities. Sale of these assets was the main source of municipal capital budgets in 2007 and 2008, so by now only a small fraction of these assets remained.

Local capital revenues are rarely separated from the current budgets and it is not clearly regulated which should be considered as a capital revenue (e.g., the construction land fee in Serbia). The concept of distinct local government development funds is being introduced in some countries only in recent years, as in the case of the former Yugoslav Republic of Macedonia in 2008.

The surveyed countries report declining municipal capital revenues (mostly lower asset sales). (Table 3.)

Table 3.
Changes in Local Government Capital Revenues

	Country	Capital revenues, period compared	Percent Change
1.	Armenia	Asset sale 2008/2007: Q4/Q1 of 2008:	 85% 69%
2.	Bosnia and Herzegovina	"Income on the ground of capital" (asset sale) 2008/2007: Q1 of 2009/2008:	 347% 123%
3.	Bulgaria	"Other non-tax revenues[8]" 2008/2007:	 81%
4.	Croatia	"Revenue from non-financial assets" Q1 of 2009/2008:	 61%
5.	Czech Republic	Capital revenues 2008/2007:	 128%
6.	Estonia	Property sale Q1 of 2009/2008:	 56%
7.	Georgia	Capital revenues 2008/2007:	 96%
8.	Germany	"Other capital related revenues" Q1 of 2009/2008: Local government: *Länder* (state):	 92% 45%
9.	Hungary	Sale of assets, shares Q1 of 2009/2008:	 96%
10.	Poland	"Revenues from local government property" Q1 of 2009/2008: Q2 of 2009/2008:	 93% 84%
11.	Romania	Capital revenues Q1 of 2009/2008: Q2 of 2009/2008:	 31% 40%
12.	Russia	Q1 of 2009/2008: Property sale: Capital transfers:	 51% 25%
13.	Slovakia	"Other capital revenues" (asset sale) Q1 of 2009/2008: Q2 of 2009/2008:	 47% 33%
14.	"the former Yugoslav Republic of Macedonia"[9]	Capital revenues (asset sale) 2008/2007:	 101%
15.	Ukraine	"Revenues from capital transactions" Q1 of 2009/2008:	 40%

Source: Country reports.

[8] Sales of property, rents, dividends, interests, concessions, donations, penalties, sanctions.

[9] Sample of five cities.

In countries with high *remittances*, the transfers from abroad could be important sources of local investments. Workers come home for the summer holidays and they pay their local taxes only in that period. They usually invest in housing, which would require basic amenities, sometimes helping municipal infrastructure development. According to past experiences, the remittances might increase in the first period of the economic crisis, when returning emigrants bring home their savings. So they could increase the investments and spending on local infrastructure.

3.2. Launching Stimulus Programs or Coping with Restrictions?

In Europe—both in the Eurozone and in the EU 27 countries—the GDP decline was 2.5% in the first quarter of 2009 compared to 2008. It was even higher compared to the last months of the previous year, when the growth rates were negative: -1.6% in the euro area and -1.5% in the EU27.[10] The American economy showed the same decrease in this period. National fiscal policies have to respond to this decline for two basic reasons: firstly, because public spending is an important factor of economic development and secondly, simply because of the shrinking tax revenues the former expenditure targets cannot be met.

As the OECD survey in 2009 showed that in the developed countries significant *economic recovery programs* had been started by the governments.[11] In the period 2008–2010, the budget impact of the average stimulus packages totaled of 2.5% of the GDP, mostly concentrating on fiscal year 2009. The Economic Recovery plan of the European Union also targeted a coordinated fiscal impulse of the member states' budget (1.2%) and of the EU funding (0.3%) for the year 2009.[12]

These fiscal measures are usually directed at both public spending and public revenues. The majority of the OECD member countries launched supportive fiscal packages for the period of 2008–2010. Almost half of the measures will be implemented in the fiscal year 2009. The fiscal policies target *government spending,* which is planned to be increased (1.5% of GDP in 2008), but *tax revenues* will decrease (an estimated 1.9%) as well. On the expenditure side, the fiscal programs typically focus on infrastructure development and active labor market measures are introduced. On the revenue side of the budget, a reduction of the national tax burden, primarily personal income taxes, is planned.

10 Eurostat (STAT/09/70) report.

11 OECD Economic Outlook, 2009, Interim Report, Chapter 3. The Effectiveness and Scope of Fiscal Stimulus.

12 A European Economic Recovery Plan (COM(2008) 800 final), 2008.

However, some countries might not benefit from these fiscal policy actions. When their economy is dependent on exports then the economic boom in their partner countries is what really matters. If there is a high budget deficit coupled with a current account deficit, then the room for these domestic fiscal policy measures is limited. High external debt would require also public sector restrictions and leave no space for economic stimulus programs.[13] So the fiscal measures very much *depend on* the overall economic and fiscal *status of the country*.

Also it is widely accepted that the increase in spending should be *short-term and focused*. The "automatic stabilizers," such as the social benefit programs, will create demand, but should phase out with economic recovery.[14] The OECD already started to communicate the importance of the exit strategy after the crisis. It is emphasized, that recovery measures could be made only according to the long-term fiscal policy objectives.

3.3. Local Options for Increasing Capital Investments

Local governments in the period of economic downturn are faced with two types of challenges in the area of capital investments:

(i) Whether they are involved in the economic stimulus programs at all?

(ii) How they can cope with the consequences of restrictions in the general government budget?

Local governments might face these two different problems at the same time, when the special countercyclical national funds, the new allocation mechanisms of these grants, are combined with the overall reduction in the usual sources of capital investment financing. Municipal responses to these two challenges were diverse in the countries studied, because the systems of intergovernmental finances, the level of local government autonomy and the extent of economic downturn vary.

In evaluating the local responses, the following options will be discussed in greater detail:

a) Competition for the available resources in the public budgets.

b) Benefits of the external public funds, like the EU or other donors' assistance.

c) Increase in own source capital revenues, including funds received through various forms of public-private partnership (PPP) schemes.

---

13 K. Ott (2009) *Fiscal Destimulation Instead of Fiscal Stimulation*. Zagreb: Institute of Public Finance.

14 A. Kraay and L. Serven (2008) *Fiscal Policy Responses to the Current Financial Crisis: Issues for Developing Countries*, Macroeconomics and Growth Research, The World Bank.

d) Municipal borrowing.

e) Improving local project preparation and management.

f) Introducing indirect measures to create a favorable environment for local investments.

3.3.1. Competition for Public Funds

In some countries, the system of intergovernmental finances has *built-in, automatic mechanisms* to protect the local governments' unified budgets from sudden and unexpected changes. In the case of Hungary, "the former Yugoslav Republic of Macedonia," and Slovakia, the set rules of PIT or VAT sharing stabilize the local revenue flow. The local governments' share is either legislated by the act on local government finances or there is a long-term political consensus on the "fair" share of local budgets. Sometimes the lack of accurate data also explains the delay; for example, in Hungary no exact information on PIT revenues is available in the period of fiscal planning (t-1), so revenues are shared with a two-year-delay (based on the actual PIT revenues in year t-2).

Special national funding schemes and public investments programs might also limit the scope of the national government's discretion. The institutional interest of the agencies managing public investment programs (e.g., the funds allocated through the National Investment Plan in *Serbia*) or a special anticrisis commission allocating the available funds (*Armenia*) could be significant built-in breaks for restrictions. The national associations of local governments could also protect their members' interest during the budget negotiation process to avoid leaving their members out of the economic recovery programs (*Bulgaria*).

In the more developed economies of Western Europe significant economic stimulus programs have been launched. In *France,* the new finance law for 2009 legislated a recovery program equal to 1.3% of GDP. Local governments benefit from these extra funds by receiving compensation for the VAT on new local capital investments; loans are provided for local government projects or for public-private partnerships and special programs (e.g., digital schools in rural municipalities). In *Norway,* local governments received one-third of the 20 billion krone national package mostly for capital investments in infrastructure. The *UK* government funding for local authorities aimed primarily at increasing employment and housing development.

All these funding mechanisms might be subject to competition for public revenues. Rearrangement and centralization of public sector revenues is always an option for the national governments. In Serbia, where the cutback in local grants was severe (37% in the middle of the fiscal year), there is a competition for the potential revenues from privatisation of local public utility companies. These companies manage marketable assets (like land, buildings), so they could raise one-time capital revenues for the future owners.

But local governments also follow similar policies toward their service organizations by lowering their subsidies or forcing them to borrow for funding capital investments (without issuing local government guarantees).

3.3.2. Better Access to External Resources

In countries eligible for European Union structural and cohesion funds or other programs available for candidate countries or external partners, the EU is a significant source of financing local capital investments. Several nonmember countries reported new activities in *information sharing and awareness raising*, which would improve the local governments' access to IPA funds in the Balkans and other twinning, cross-border, and national government cooperation programs (e.g., TAIEX) as well.

In the case of the new member countries, *EU structural and cohesion funds* are the single largest sources of future municipal capital investments. (Table 4.) The new EU member states developed various methods for efficient use of the EU funds. Special *intermediary funds* were set up in Bulgaria, and Estonia, and the application and purchasing *contracting procedures* have been simplified (Estonia and Romania). In Poland, the government is committed to supporting the prefinancing of EU projects and accelerating the funding of large local infrastructural programs. In Greece, a special nonprofit organization has been set up to assist those small municipalities that do not have the appropriate skills for preparing projects for EU structural funds.

The European Commission has also accelerated the implementation of the programs financed by the structural funds. The funds for prefinancing of EC projects has been increased and member states should enhance the part financed by the Community and should bring forward the implementation of major investment projects, simplifying the treatment of advances paid to the beneficiaries.[15] New calls for proposals will be launched in four areas: (i) energy; (ii) infrastructure, transportation, and water (iii) green technology, and (iv) Internet infrastructure. The national authorities should pay their suppliers on time (in 30 days). Restrictions on State Aid will be temporarily eased.

It is critical to improve the EU fund *absorption capacity* of the national administrations. The secondary regulations are often stricter and more complicated than those of the European Union, partly because the national governments want to protect themselves from corruption charges. However, in reality the more complicated rules increase the risk of corruption.

15 A European Economic Recovery Plan (COM(2008) 800 final), 2008.

Table 4.
Actions to Improve Access to EU Funds

1.	Federation of Bosnia and Herzegovina	IPA, Taiex, Twinning programs: awareness raising, capacity development, decrease cofinancing, easing project requirements, adjusting local projects to IPA requirements.
2.	Bulgaria	Fund for Local Authorities and Governments (FLAG), partially funded by EBRD loan to assist EU project design and implementation.
3.	Estonia	EU Funds reallocated through special funds for countercyclical purposes. Application process eased and accelerated.
4.	Greece	Establishment of the DEMOS S.A., a nonprofit organization to assist the municipalities in preparing proposals for EU structural funds offer. Preparation of 4-year action plans for the municipalities with populations below 10,000.
5.	Hungary	EU funded projects' construction work tenders are up by 57% in Q1 2009, compared to Q1 2008.
6.	Ireland	Significant reductions in tender prices; delivering large part of the National Development Plan of 2007–2013 within the envisaged timescale.
7.	Poland	Simplification of procedures, assisting the small municipalities to submit proposals.
8.	Romania	Making public procurement procedures more efficient (in managing complaints, shortening the process).
9.	Serbia	IPA Funds redirected to national budget.
10.	Slovakia	EU Funds are major sources, but planning and project design capacity varies; regions and cities have qualified staff.
11.	Ukraine	Further decreasing cofinancing requirements for CBC programs (2004/2006: 10%); pressure for high quality projects within the consortia; lack of fiscal regulations for accounting and managing EU funds.

Source: Country reports.

3.3.3. Increasing Own Capital Revenues

Most of the countries reported declining or stagnating local government capital revenues. (Table 3.) Asset sale and privatisation does not work in the crisis period, when there is an overall lack of investment funds and the property prices are declining.

Private contribution to public sector investments has stopped as well. Despite the advantages of PPP deals there is a general resistance toward this earlier much-praised method of financing infrastructure and urban development. One-quarter of globally surveyed PPP projects are facing difficulties, either being delayed or canceled, despite the fact that they were at an advanced stage of raising finance. This trend is expected to continue; however, some countries like France reported no long-term reduction in the number or volume of public private partnership. There is a demand for these innovative projects, but the share of the public sector has to be increased, when the private sector has limited access to funds.[16]

3.3.4. Local Borrowing

Loan financing of capital investment projects is regarded as one of the feasible options to keep local government infrastructure development afloat. Studies of the possible ways to recover from economic crisis showed that in countries with low public debt the municipal borrowing might be a fast response with high multiplier affect for stimulating economic growth through fiscal expansion.[17] Subsidized loans might further help specific investments (e.g., for energy savings) as well.

However, as the present crisis originated from the financial sector, the loans are not easily available on the market. The traditional communal banks were also hit by the crisis.[18] Despite this situation some of the surveyed countries still showed considerable increase in local government borrowing (Table 5).

Interestingly the new EU member countries actively used this method of financing, partly to raise funds for cofinancing and prefinancing the projects funded by the EU. These are the countries, which already have proper regulations on municipal borrowing and the rules of potential consolidation for defaulting local governments are set and tested. In *France,* a special company for financing the French economy (SFEF) provides guarantees and loans for local governments. Consequently, in the last quarter of 2008, municipal borrowing increased by 4.9%, while loans in general only grew by 1.4%. *Ukraine* reported amendment of borrowing regulations, making the sale of securities possible and relaxing debt limit regulations.

The forms of local government borrowing have been transformed as well. The former bank loans are being gradually supplemented by a new wave of *bond issuance.* It has been actively promoted in transition countries for many years, but now urban local governments have started to use this instrument again. Large cities in the Czech Republic, Hungary, and Poland issue bonds more actively, because no public procurement

16 P. Desilets (2009) *PPPs Projects and Financial Crisis: Short-Term Impacts and Medium-Term Trends.* Institute for Public-Private Partnerships, Inc.

17 In the case of China, the East Asian crisis was partly managed by lifting the constraints on subnational borrowing through allowing municipal loans with a size of 1% of GDP. http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTPROGRAMS/EXTMACROECO/0,,contentMDK:22058212~pagePK:64168182~piPK:64168060~theSitePK:477872,00.html#Notes_7.

18 Like Kommunalkredit (Austria), Kommunalkreditt (Norway), or Dexia. See CEMR survey in March 2009.

regulations apply and there is a stable market for private placement (usually by the local governments' own commercial banks). Other countries like Serbia are in the process of developing supportive regulations for municipal bond financing.

Table 5.
Changes in Local Government Borrowing

	Country	Period compared	Percent change
1.	Bosnia and Herzegovina	2008/2007	164%
2.	Bulgaria	2008/2007	54%
3.	Croatia	Q1 of 2009/2008 Local government borrowing	55%
		Local government lending to public utility companies	246%
4.	Czech Republic	Municipal debt: 2008/2007	101%
5.	Denmark	2009/2008	37%
6.	Finland	Loans Q1 of 2009/2008	112%
7.	Hungary	Q1 of 2009/2008	463%
8.	Poland	New debt Q1 of 2009/2008 Q2 of 2009/2008	 66% 280%
9.	Romania	Loans Q1 of 2009/2008 Q2 of 2009/2008	 125% 700%
10.	Serbia	Debt service Q1 of 2009/2008	 126%
11.	Slovakia	Loans and credits Q1 of 2009/2008 Q2 of 2009/2008	 96% 540%

3.3.5. Improved Project Preparation and Management

The EU fund allocation mechanisms through the *Operational Programmes* forced local governments to prepare capital investment projects, which fit into the hierarchical structure of regional development plans. This planning process was started well before the EU accession, so by now local governments, in addition to having general urban and regional development plans, have designed a variety of projects, which can be easily adapted to the national funding priorities.

In the non-EU member countries, the various *donor programs* have prepared the new municipal projects. They are funded by a combination of revenues, including donor support, special credit lines, and support to domestic development banks. For example, in Serbia the Standing Conference for Towns and Municipalities has developed a web-based information system assisting municipalities to develop the documentation for accessing development funds (SLAP).[19] It is a database of infrastructure projects and requirements for financial support. SLAP enables municipalities to fill in data online, creates a scoring system, and makes project selection for the donors more transparent. The EU recovery plan puts a great emphasis on *financial management*. Timely payment of public sector contractors and accelerated public procurement procedures (decreasing the time limit from 87 days to 30) for an interim period of the coming two years might speed up the implementation of the new projects.

3.3.6. Indirect Measures for Improving Local Investments

Local governments in the transition countries are actively involved in economic development. In the period of economic downturn, when large-scale foreign direct investment also slows down, more attention is paid to small- and medium-size enterprises. Local governments are able to do a lot to promote these businesses and keep the flow of inward investments steady.

Following the traditions of the former planned economy, municipal officials are actively involved in developing the local business environment. Obviously the regulatory framework is set by the national government. But there are municipal techniques that could have an impact on SME development: e.g., through a slight shift in funding from infrastructure projects to SME development (Hungary), subsidized interest rates for SMEs (Serbia), or government guarantees for SME loans (Republika Srpska/BiH).

3.4. In Search of New National Policies

As can be seen from our survey, national governments are trying to develop new policies to minimize the impact of economic crisis at the local level. These measures are partially justified by the high share of local capital investments in the public sector and by the multiplier effect of local investments. The national government's influence is limited by the overall fiscal constraints, which decrease the resources available for local governments in the form of transfers and shared and own source revenues.

---

19 http://www.misp-serbia.rs/en/slap.php.

Consequently, the local government responses to the declining revenues are very much defined by the *forms and stage of decentralization* in a specific country. In this respect, the most important factors are: (i) the scope of local government spending, (ii) the role of the national state in capital investment planning and financing, (iii) the availability of external official development assistance and the EU funds, and (iv) the municipal capacity to borrow and to manage debt.

In the period of economic crisis and fiscal restriction, the most a democratically elected municipal leadership can do is to *adjust local fiscal policies to the voters' preferences* by responding to the local priorities. Since 1980 three basic strategies have crystallized: (a) increasing public revenues through higher taxes, (b) cutting expenditures, and (c) improving service efficiency, primarily by focusing on cooperation with the private sector and using market-based incentives. This latter strategy resulted in the worldwide movement of alternative service delivery arrangements—starting from contracting out to complex forms of concessions—and the adaptation of the new public management to local public service provision and administration.

Currently, however, there seems to be an overall move away from these methods. It is claimed that more power has to be allocated to the state as an owner, not just as a regulator; the market is regarded as a mechanism creating monopolies, further increasing social inequalities. Following these arguments there are high hopes that stronger governments will be more effective and fairer.

But, as some development economists argue, this would require a more transparent and less corrupt public sector.[20] The desire for a "new deal" between different tiers of governments should be based on a combination of institutional reforms. The way local governments will respond to the present economic downturn does not really depend on short-term emergency measures. It is defined more by the strength of the local governments, and the institutions and procedures developed under the slowly evolving decentralization framework.

4. Improving Efficiency

4.1. Introduction

Making the most of more limited resources is likely to be an ongoing challenge. Improving the efficiency and effectiveness of local government expenditure has many manifestations.

---

[20] Kaufmann, http://www.thekaufmannpost.net.

Country observers' reports detail many efforts by individual local governments to reduce costs. These mainly apply to administrative overheads and include cuts in overtime, bonuses, official entertainment, and telephone usage, while purchases of vehicles and furniture have been deferred and staff vacancies have been frozen. In Serbia, GPS systems have been fitted in municipal vehicles so that both drivers and town halls know where they are. Most are local initiatives, but some have been imposed. In the case of Romania, some efficiency measures have been mandated by government as conditions for national budget support by the European Union. In Latvia, municipal employees have shared a national 15% cut in public service pay, while Hungarian staff are losing their 13th-month bonus, and UK employees face a two-year pay freeze.

Justified as they may be, these are temporary or one-off savings that do not greatly affect longer-term efficiency. This requires more fundamental examination of the practical ways in which services are run.

4.2. The Role of Benchmarking

There are three good examples of "value for money" approaches and performance audit systems developed over the last three decades under the umbrella of New Public Management:

- "Value for money" assessments of individual authorities and services are undertaken on a voluntary basis by the Danish Local Government Association, based like their British equivalents on disseminating the practice of those municipalities which perform well in a comparison of unit costs.
- Benchmarking individual service and administrative service costs carried out in Bulgaria by the Open Society Foundations in collaboration with the National Association of Municipalities, described in Annex I.
- Performance standards measured by the Benchmarking Club of Hungarian water company managers, with the consultant help of the Regional Centre for Energy Policy Research at the Corvinus University of Budapest. The comparisons look at range of both technical and management issues. A fuller description is in Annex II.

These are all voluntary systems based on peer review. A "top downwards" approach has been adopted for over two decades by the English Audit Commission and parallel bodies in Scotland and Wales, which have developed comprehensive assessments of local government efficiency, although their recommendations are not binding on local authorities. The Russian Federation now requires local authorities to report annually on a range of performance measurements.

All these measurement systems have achieved substantial improvements by some if not all authorities. The standard criticism is that they focus undue attention on certain easily measurable aspects of performance at the possible expense of other aspects of quality.

4.3. Performance Audit

During the 1980s and as part of New Public Management reforms, several Western European countries extended their audit of both national and local government from a preoccupation with legality to the promotion of performance and efficiency. After 1989, a number of Central European states like Hungary and Poland did the same.

In 2006, the Local Government and Public Service Reform Initiative surveyed the audit of local government in 12 Eastern and South Eastern European states. It found that most states had an adequate legislative framework, much of it newly enacted with EU assistance, but implementation so far was weak:

- Qualified auditors were in short supply in the public sector and as a result actual external audits infrequent. Inevitably the situation was worse in countries with large numbers of small authorities. (Only 84 out of 7,455 Romanian local government final accounts had been audited).
- Audit was still largely concerned with legality and conformity with required procedure; performance and efficiency, though within its terms of reference, were rarely examined. Audit training in these aspects was often inadequate.
- Public interest in audit findings was generally low, not aided by the customary opacity and circumspection of published reports.

The Council of Europe has been helping to develop performance audit capacity in a number of countries such as Bulgaria, Russia, and Serbia. The financial downturn emphasises the need.

4.4. Efficiency in Social Expenditures

In current economic circumstances, national and local policies seek to protect social expenditures, because of their heightened importance. Preserving present standards of social provision does not, however, mean preserving existing input levels or methods of spending; their efficiency should also come under review.

Local governments' involvement in the social sector varies enormously, as does its freedom of action. Sometimes the allocation of responsibility itself creates incentives to high cost provision. For example, in a number of countries such as Hungary and

Ukraine, responsibilities for residential care for the elderly and infirm and hospital care lie with upper tiers of local government, while the municipalities provide domiciliary and primary health care. Funding of the upper-tier service may well be based on the numbers housed or treated. These arrangements may provide strong incentives to place social service clients in residential homes or patients in hospitals when it may be neither the most appropriate nor sympathetic response to their need. In most cases it is the more expensive solution.

The system of payment for services can also be a major source of inefficiency. Medical care costs, for example, can be inflated by a system of paying providers per admission or individual treatment. These can result in patients staying in hospital far longer than necessary or being subjected to inordinate numbers of blood tests. These perverse incentives are widely recognised and systems like DRG funding have been designed to reduce them. But such reforms have not been universal and the crisis underlines their importance.

Other examples of excessive social sector costs abound. Schools with declining pupil populations, for example, frequently retain previous numbers of teaching staff while mandated contact hours with pupil are generously low.

4.5. Regulation of Expenditure

Local governments that would like to cut costs are frequently debarred by national regulation prescribing inputs rather than outcomes. This applies particularly in the countries that distinguish between the "autonomous" and "delegated" tasks of local government and place the more expensive services like education, social service, and health care in the latter category.

The Ukrainian report states the following:

> Delegated services are often regulated by detailed standards of provision and local government management subject to close supervision by sectoral ministries. Local governments have very low discretion in allocating funds and administering respective programmes. Administrative decision-making (including facility-level budgeting) is subject to a rigid vertical structure of input norms, dictated by central line ministries. These norms are contained in ministerial guidelines dictating the amounts of staffing and other resources based on existing infrastructure inputs, but also in constitutional prohibition of closing facilities in healthcare and education. These norms are also the key principle behind budgeting at the facility level and negotiating these budgets with local governments. One consequence is imposition on local governments of vertically protected recurrent spending, including half of the total public wages. Some decisions on local approaches to service provision are also stimulated by incentives built in the transfer formula as described earlier. This input based budgeting, which permeates the system,

> creates strong negative implications for technical and allocative efficiency in key sectors, where the quality of service delivery is deteriorating at dramatic rates.

Ukrainian local governments cannot close any grossly underutilised schools or social and cultural institutions without the permission of national ministries, frequently withheld. Such institutions may well have lost their custom through changes in population or public preference.

The problem occurs more widely. It is typically exacerbated by the fact that the sectoral ministries concerned are not faced with the consequences of running uneconomic services, since the financing of delegated services is usually governed solely by ministries of finance.

Several national rapporteurs comment that failure to meet unsustainable service standards is widespread but tolerated. Others identify national insistence on observing the norms as a serious problem. Signatories of the European Charter should be ensuring that national ministries do not micromanage services entrusted to local government whether technically delegated or not.

4.6. Delegating Institutional Management

The same principle applies to the relations between local governments and their own subsidiary agencies and institutions.

When budgets have to be cut, it is usually their managers who know best where waste is occurring. It is only the school head who will bother that lights are switched off at the end of the day and only if the school budget keeps the savings.

Delegating budgets and their managements to service institutions is another aspect of New Public Management which is now widespread; per-pupil funding of schools is now widely adopted, for example.

These solutions, though timely in a period of recession, need careful introduction, however. Budget allocations need to take full account of exogenous variations in cost. Population density and social background have major impacts on school expenditure, for example. Audit and other forms of accountability must match degrees of financial delegation.

4.7. Local Government Audit

In 2007, the Local Government and Public Service Reform Initiative commissioned reports on local government audit in 12 Eastern European countries. The countries covered were Armenia, Azerbaijan, Bosnia and Herzegovina, Croatia, Georgia, Moldova, Montenegro, Romania, Russia, Serbia, "the former Yugoslav Republic of Macedonia," and Ukraine. Their findings are briefly summarised in the following paragraphs and suggest the need for further reform before audit can play its full part in improving efficiency.

4.7.1. External Audit

Legal Requirements

External audit may be exercised by the following:

- National audit institutions examining local budgets in full.
- National audit institutions scrutinising the expenditure of earmarked state budget subsidies only.
- Private audit companies operating commercially.

In Bosnia and Herzogovina, Croatia, Romania, Serbia, and "the former Yugoslav Republic of Macedonia," local governments are subject to comprehensive audit by the national audit organisations answerable to Parliament. These are states that possess or aspire to EU membership and the arrangement arises from recent reforms designed to conform with *l'acquis communitaire.* In Montenegro and Serbia, local councils may also hire parallel audits by commercial firms. Similar provisions exist in Moldova.

In Russia and Ukraine, the federal/national and republican/*oblast* audit chambers have powers to audit use of State Budget earmarked subsidies but not "own revenue." There is also a vertical system of financial control within the executive hierarchy of finance departments—in Ukraine under the Chief Accounting and Audit Department of the Ministry of Finance (CCAD), which scrutinises local budgets in full. In Georgia, state audit only covers use of earmarked grants and elected council finance commissions are supposed to undertake or commission audit of the budget execution reports. Similar provision is made in Armenia but state audit extends to nonearmarked transfers, which effectively involves scrutinising all expenditure, since the source of funding cannot be distinguished.

In Azerbaijan, the national Chamber of Accounts may conduct an audit of an individual local government at the request of the Ministry of Justice, i.e., to investigate a specific complaint or suspicion of financial irregularity. Otherwise, local governments are required to arrange commercial audit of their budget execution reports.

The Practice

In several cases external audit is less satisfactory in practice than in law. The following are examples of apparently inadequate coverage at the time of the 2007 survey:

- Armenia: an average of 24 local governments audited annually out of 926.
- Bosnia and Herzegovina: coverage of the Federation municipalities by the Audit Office has declined from 18 in 2002 to 1 in 2006.
- Montenegro: 2 out of 21 municipalities audited to date.
- Romania: 84 budget execution reports audited in 2006 out of 7,455.
- Serbia: the State Audit Institution had not yet been constituted by Parliament.

A rotating national audit is covering approximately one-third of local government units per annum in Croatia and “the former Yugoslav Republic of Macedonia,” and one-half in Republika Srpska. In Georgia, the reorganised municipalities only commenced financial operations in 2007.

In Georgia and Serbia, institutional arrangements for audit are new and their adequacy remains to be proved. Inadequacy elsewhere has been ascribed to the time and cost involved in deploying sufficient qualified staff and, in countries like Armenia and Romania, the territorial fragmentation which creates large numbers of small units requiring full audit procedures, however small their budgets.

4.7.2. Internal Audit

Legal Requirements

Local government units are required to establish internal audit units in Armenia, Croatia (in municipalities over 35,000 inhabitants, running primary education or employing over 50 staff), Romania (for budgets exceeding €10,000 p.a.), Serbia, and “the former Yugoslav Republic of Macedonia” (over 15,000 inhabitants). In Russia and Ukraine, internal control sections form part of vertical hierarchies subordinate to the Ministry of Finance.

Elsewhere, Ministry of Finance regulations mandating internal audit are currently in draft in Moldova. In Bosnia and Herzegovina and Montenegro, some municipalities have established internal audit sections voluntarily.

In Croatia, Romania, Serbia, and “the former Yugoslav Republic of Macedonia,” ministries of finance have established central harmonisation units to integrate the procedures and standards of internal audit throughout the public sector, and organise associated training.

The Practice

As in the case of external audit, the practice in several cases fell short of the legal requirement at the time of the survey:

- By 2006, only 35% of Romanian authorities obliged to establish internal audit units had done so, and 85% of these had appointed only one staff member to them.
- In Serbia, few municipalities (mainly in Belgrade and Vojvodina) had formed internal audit units.
- In "the former Yugoslav Republic of Macedonia," 20 units have so far been set up out of 42 mandated.
- In Armenia, 34 out of 41 urban municipalities have established units but very few in rural areas.
- In Croatia, most small municipalities buy in the county internal audit service.

Provision in countries like "the former Yugoslav Republic of Macedonia" for smaller municipalities to establish joint internal audit units or to buy in the services of larger towns have been largely ignored.

Shortfalls in provision have been ascribed variously to the cost or nonavailability of qualified staff, but also to the apathy of elected members or executives.

4.7.3. Scope of Audit

In all countries surveyed, such audit as takes place is primarily concerned with issues of *regularity*, i.e., of the compliance of financial transactions with laws and official procedures, and of the conformity of revenues and expenditures to budgets and budget variations approved by legislative bodies.

In the Balkan countries, Georgia and, to some extent, Ukraine, audit is also expected, or at least authorised, to examine the utilisation of local budgets in terms of performance and *efficiency.* The country reports suggest that this mandate is largely ignored in practice. Audit staff and time are preoccupied with verifying regularity. Staff lack skills in scrutinising performance and efficiency, and there is little experience of doing so or popular demand.

4.7.4. Access to Audit Reports

Reports by state audit institutions are normally submitted to Parliament. In most cases, however, copies are sent to the councils under scrutiny or are available on websites.

The prime audience for *external* audit findings should be the elected council that approves the budget under scrutiny. It is less likely to pay attention to reports that are not specifically addressed to it, or where comments are lost in generalities applied to several or all local governments.

Ideally civil society should also have access to them since councils and their executives may well collude in mismanagement of public money. In practice, public access to external audit reports is more restricted in several of the countries surveyed. In Armenia, audit reports can only be accessed by application under the Freedom of Information law. In Azerbaijan, a list of audits undertaken is published on the website but results are not disclosed. In Russia and Ukraine, reports on budget execution are submitted to local councils but receive no publicity. There is no public access to reports in Moldova.

Internal audit reports are almost invariably confidential and submitted to the chief executive except where specifically prepared for the Finance Commission, as in Georgia.

4.7.5. Human Resources

Most of the country studies describe a formalised structure of training and qualifications surrounding the staffing and operation of external audit institutions, whether state or private. They increasingly include membership of INTOSAI and adherence to IFAC standards. An exception is Georgia, where accreditation requirements for private auditors were jettisoned in a general campaign for deregulation.

The state bodies vary, however, in the adequacy of trained staffing numbers. The Romanian county branches are 50% below establishment, while the Serbian State Audit Institution still awaits practical formation. The problems relate principally to recruitment since the required accounting skills are generally better rewarded in the private sector.

Internal audit presents a greater challenge. Only larger and more urbanised local governments can attract and afford graduate professionals. In Russia the smaller and more rural municipalities cannot even afford to send staff on the training courses that are available to them. In countries like Croatia, Romania, and "the former Yugoslav Republic of Macedonia," pre-accession reforms have inspired the creation of central units in the ministries of finance charged with "harmonising" standards of internal audit across the public sector as a whole. These are promoting capacity within local governments but the problems of affordability and career prospects remain.

4.7.6. Conclusions

Relatively strong legal frameworks for local government audit are now in place in most of the countries studied, particularly those in some stage of preparation for EU membership. Implementation, however, has barely started in Serbia and is weak generally. Many local governments have never seen an auditor, some only rarely.

Adequate audit is expensive, taking the time of staff who need to be well qualified and well paid to stay in the public sector and work honestly and independently.

Countries with fragmented local government systems find it particularly difficult to provide both external and internal audit to a large number of small, mainly rural local bodies; they may be spending little money but the control procedures are the same for large and small. It could be argued that the absence of audit matters less in rural communities where "everyone knows what's going on"; but the realities of village politics may well shelter officials from the consequences of their misconduct, however obvious. Persuading small municipalities to share internal audit services with neighbours, towns, or counties is one answer.

The conclusion of the Russian study is that much audit is carried out, but no one takes any notice of its findings. This may be because of a suspicion that the purpose of audit is to maintain vertical power and punish independent-minded mayors rather than protect the public.

Audit suffers from the legacies of the communist past when it was seen as an instrument of vertical intrusion, driven as much by interpersonal relations within the hierarchy as by concerns for integrity and efficiency. In a democratic society effective audit is essential, not inimical to local autonomy, because it plays a vital part in securing public trust.

Audit needs to gain perceived value. For this it needs to be regular, not an apparently random and punitive intervention. Its findings need to be accessible to elected members and to civil society including the media. And it needs to be concerned with more than misconduct or inaccuracy, giving positive help to the improvement of performance and efficiency.

4.8. Energy Efficiency

One field to receive a boost as a result of the crisis has been the promotion of efficiency in energy consumption.

The onset of the crisis coincided with lead-up to the 2009 Copenhagen Summit, when both governments and the public were acutely aware of environmental challenges and anxious to demonstrate their concern. As a result, much "fiscal stimulus" spending was directed to energy efficiency programmes. It helped that changing street light bulbs, insulating public buildings, and increasing use of renewable energy sources constituted "shovel ready" investment which could be started widely at relatively short notice. It also helped that such investment over the long term could save money as well as the planet.

5. Territorial Reforms as a Potential Response to the Economic Downturn

5.1. Introduction

Can reforming the territorial structure of local governments be one of the responses to the financial crisis in local governments? In several countries in Western and Central and Eastern Europe, there are numerous very tiny municipal governments, and numerous experts have pointed out the high cost of their functioning. The issue is by no means limited to the municipal tier. For example, in Poland the largest potential efficiency saving might be found on a county (*powiat*) level, where 380 units could be replaced by a smaller number (expert estimations vary from 150 to 300) of territorially larger, cheaper, and more efficient units. The same may apply to the meso or upper tier of subnational jurisdictions in other European countries. But for the time being, this chapter concentrates on a municipal tier, where the issue seems to be the most urgent and brings potential for the highest saving.

There are plentiful academic literature and expert reports demonstrating the relevance of economy of scale to local administration. Even though economy of scale is more visible in capital-intensive rather than labour-intensive sectors (and most of local government services belong to labour intensive), there are still examples of the "size effect" in municipal governments. An excellent review of recent research and theoretical arguments has been provided by Houlberg's chapter in one of the latest books produced by the Local Government and Public Service Reform Initiative (see Houlberg 2009).[21]

Leaving aside other services, on which arguments are more complex, there is no doubt that size is negatively correlated with spending on administration. As the 2002 study showed (Swianiewicz 2002), in several small Slovak, Hungarian, or Czech municipalities, administration consumes close to half of the operating budget, leaving not much for other functions. Houlberg (2009) demonstrates the economy of scale effect in administrative spending in Norway, which strongly affects municipalities with populations below 5,000. He quotes also Danish studies showing that municipalities can save as much as 10% of administrative expenses (or 1.5% of their total budget) if the municipalities are amalgamated so that the smallest municipalities have 18,000–25,000 inhabitants. Finally, he also provides arguments that, at least in Denmark, economies

[21] For extensive reviews of relevant literature, see also Baldersheim and Rose (forthcoming), and for the discussion of theoretical arguments on size and effectiveness of local governments, see King (1984), Sharpe (1995), Keating (1995).

of scale have been rising over the last 20 years. In Poland also, small local governments spend (per capita) considerably more on administration than larger jurisdictions. For example, in 2008 the median spending on administration for rural local government below 5,000 citizens was PLN 322, while the median for rural local governments over 10,000 citizens was PLN 210. A recent careful analysis of one Polish rural government that in 1998 split into two separate jurisdictions suggests that as a result of the split new municipalities spend every year at least 100,000 more on local administration (leaving aside other economic costs that more difficult to measure).

Of course, there is also an opposite phenomenon, i.e., diseconomies of scale, but none of the available studies show these appearing in the production costs of services below the population size of (at least) 25–30,000; this does not seem to be an argument in defence of very small municipalities. A negative impact of larger size may be more often found in arguments related to local democracy (as measured, for example, by interest in local affairs, electoral turn-out, citizens satisfaction, information about local affairs, etc.). But even in that case the negative impact of size is not quite a linear function, nor is it the obvious conclusion of all research. For example, Mouritzen (2009, forthcoming) on the basis of his studies of Denmark comes to the conclusion that the negative impact of size on local democracy is much lower than commonly believed.[22]

It all suggests that territorial reforms could be considered an interesting option for many countries as a response to economic downturn. But what is a "small size" for a municipality? There is no universal answer, only different conclusions from different studies of various sectors and countries. But it seems to be agreed that higher costs are generated *at least* by municipalities with less than 5,000 citizens, and that below the 1,000 threshold delivery of many functions becomes either next to impossible or extremely expensive.

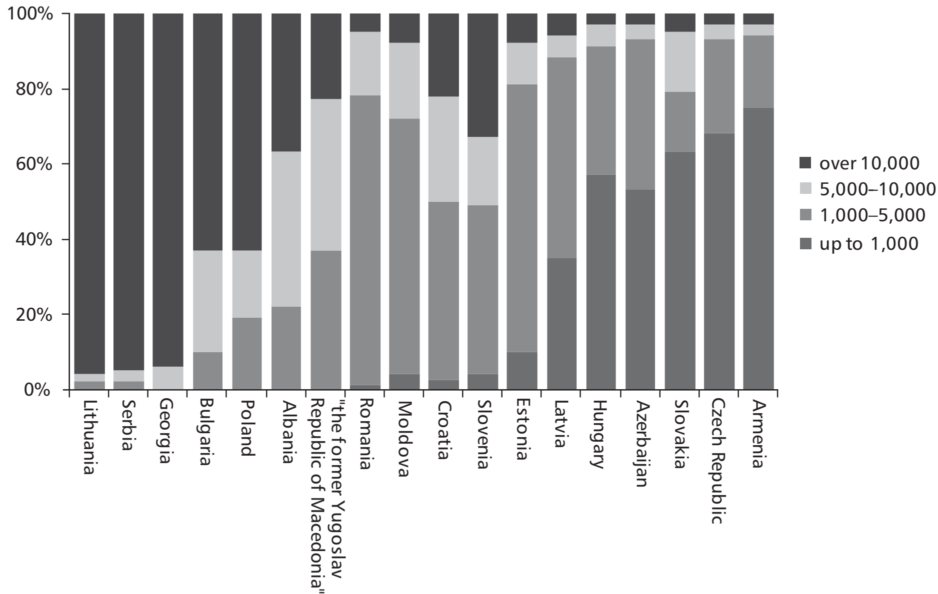
This simplistic measure is compared with the actual situation in countries of Central and Eastern Europe in Figure 7. The data suggest that territorial fragmentation of the municipal tier may generate considerable financial costs in all countries except Lithuania, Serbia, Georgia, Bulgaria, "the former Yugoslav Republic of Macedonia," and Poland (no data for Bosnia and Kosovo[23] is presented in the figure).

---

22 Although we should note that Mouritzen was comparing "mid-size" governments with larger local governments. His analysis did not involve very tiny (below 2–3,000 population) municipalities.

23 All reference to Kosovo, whether to the territory, institutions or population, in this text should be understood in full compliance with United Nations Security Council Resolution 1244 and without prejudice to the status of Kosovo.

Figure 7.
Distribution of Municipal Governments According to Their Population Size in Central, Eastern, and South Eastern Europe



Potentially there are several ways to deal with excessive territorial fragmentation of local governments:

- The most obvious is boundary reform through territorial consolidation (amalgamation).
- A frequently suggested alternative is developing voluntary or semivoluntary intermunicipal co-operation
- Less obvious and more indirect solutions may include the contracting out of services to private sector companies enjoying economy of scale or one local government purchasing services from another.

The first two solutions are discussed below.

5.2. Territorial Consolidation (Amalgamation)

Economy of scale arguments were at the heart of several territorial reforms introduced after the Second World War, mostly in northern Europe. Reorganisations introduced in Norway, Finland, Sweden, Denmark, Netherlands, and the United Kingdom throughout 1950s to 1970s may be provided as examples of this process. To a lesser extent the same argument was under consideration in more recent territorial reforms in Denmark, Germany, and Greece (see overview in Swianiewicz 2009).

After 1990 an opposite trend was often witnessed in Central and Eastern Europe. Territorial fragmentation was a common tendency present in the Czech Republic, Slovakia, Hungary, "the former Yugoslav Republic of Macedonia," and several other countries. After 1990 the promotion of decentralization and a paradigm of local autonomy were often understood as giving almost every settlement unit the right to become a separate local government, even if it was a very tiny village. An attempt to create (or to keep) larger territorial jurisdictions was seen as a violation of local autonomy. Very soon territorial fragmentation became mentioned as one of the major barriers to decentralization and the effective functioning of the local government system. With a different level of intensity, such voices could be heard in Albania, "the former Yugoslav Republic of Macedonia," Moldova, Hungary, Slovakia, Czech Republic, Latvia, Estonia, Ukraine, Armenia, Azerbaijan, Georgia, and perhaps also in some other countries. In a different context similar discussion has been conducted in Poland, where the size of upper tiers of subnational government—*powiat* and *województwo*—was discussed; likewise in Bulgaria, Montenegro, or Poland, bottom-up pressure to split existing larger municipalities has occasionally pushed toward the larger degree of territorial fragmentation but countered by arguments over cost and scale economy.

Territorial boundary reform is always politically difficult (and often risky for the central government) and brings considerable opposition from below. As a result, territorial reforms are very often discussed but relatively rarely implemented. In the postcommunist environment, one can only point to examples of territorial reforms in Georgia, "the former Yugoslav Republic of Macedonia," Latvia, and Lithuania—and even in each of these examples there are elements that make them distinct from classic amalgamation reforms.

The crucial question is whether the current financial crisis will provide a stimulus for territorial reforms. In theory, central governments should now be especially interested in such solutions, and opposition of small local governments experiencing financial difficulties should be weaker than in times of prosperity. Expected financial savings should sweeten the disadvantages of the reform. However, reports provided by country observers suggest this is rarely the case.[24]

[24] My analysis is based on national reports from following countries: Armenia, Bosnia and Herzegovina, Bulgaria, Estonia, Poland, Romania, Serbia, Slovakia, and Ukraine as well as reports from a few countries of "Old Europe": France, Finland, Norway. Reports from other countries (Albania, Croatia, Czech Republic, Georgia, Latvia, Lithuania, Moldova, Montenegro, Russia, Slovenia, "the former Yugoslav Republic of Macedonia").

There are a few countries in which territorial reforms are still discussed (for example, Armenia, and Slovakia), but the financial downturn has so far had no impact on this process. In some others the lack of discussion simply originates from the current scale of territorial consolidation, making the space for potential savings negligible (Bulgaria, Serbia).

There are, however, a few examples of countries in which the current crisis has had an impact. In Latvia, the number of municipalities has reduced almost fivefold. Most dramatically, Iceland has accelerated a process started in 1990 of cutting the number of local authorities from 7,200 to 76. In Estonia the discussion on territorial consolidation has been going on for many years, but the crisis put renewed pressure in this direction. In March 2009, the plan of consolidation was submitted, but it was soon rejected by coalition parties. Also, in Ukraine, territorial reform has been under discussion at least since the Orange Revolution (including the radical and never implemented Bessmertnyj proposals). In spite of political chaos in Kyiv, the crisis has been used by some pro-reformers as an occasion to exert more pressure for change. On 24 April 2009, the Ministry of Regional Development and Construction submitted a new draft law on territorial reorganisation, stating at the same time that the crisis is a proper and suitable time for reform. The draft is not very specific about a new map of the municipal tier (similarly to earlier Bessmertnyj proposals, it introduces a new name for the lowest level government—*hromada*—being a unit larger than individual village or a town), but states only general principles suggesting that consolidation is inevitable. It is more specific about the meso (*rayon*) level, stating that (with the exception of a very few specific situations in the most sparsely populated areas) the *rayon* should have at least 150,000 citizens, i.e., be approximately twice as big as the current *rayons*. It is difficult to say how likely its implementation is. The general political turmoil encourages skepticism about its chances in the near future.

Finland has introduced a "financial carrot" for mergers of municipal governments. It is expected that at least until 2013 amalgamation will have a voluntary character only. The reform has not been directly caused by the financial crisis, but it influenced its implementation. In France, the Ministry of Interior submitted in May 2009 a draft law which provides for transforming current intermunicipal institutions *Etablissements Publics de Coopération Communale* (EPCI) into so called "new communes." If the law is approved by the Parliament, "new communes" (with a wider set of functional responsibilities than the old, small communes) might—on a voluntary principle—replace old, very small local governments and allow benefits from economy of scale. The influence of the financial crisis on these changes is only indirect (the discussions on the reforms of territorial organization in France have been going on "forever"), but it may strengthen the process of change. Another country worth mentioning in this section is Ireland. Although there are no concrete plans of territorial reforms, a recent report commissioned by the Ministry of Finance has recommended the abolition of smaller local authorities and their merger with some larger ones. The aim of the report has been to identify possible savings, and territorial consolidation has been mentioned as one of possible options worth considering.

It is a bit surprising that the crisis has not renewed the discussions on territorial reforms in Norway, since the issue has been periodically debated in that country for many years.

5.3. Intermunicipal Co-operation (IMC)

Some politicians and experts claim that voluntary intermunicipal co-operation may be a useful alternative to territorial amalgamation. Since it avoids the high political costs of boundary reforms, and at the same time joint provision of services by a couple or more municipalities allows gains from economy of scale, so the financial savings effect may be similar. However, as Robert Hertzog suggests, joint provision of services often results in improved quality for the same price, rather than in absolute saving, since citizens of the municipalities involved demand an increase of the service quality to the standard of the best-off partner. More importantly, some authors (including Wollman 2007, Borraz and Le Gales 2005) express their doubts related to actual outcomes of IMC. First, opposite to what advocates of such a solution suggest, bottom-up IMC does not happen very often and is not unproblematic. The political difficulty of entering voluntary co-operation is often similar to that raised by consolidation. It requires compromises on the particular interests of the individual municipalities involved. The need for agreement on co-operation will sometimes affect the personal ambitions of local leaders. But there are also potential organizational and democratic problems related to IMC. The joint provision of functions, although frequently bringing financial benefits, involves transaction costs, associated with a complicated organizational-managerial setting. Complex intercommunal arrangements, including the necessity of debating issues by councils of the local municipalities involved, may also slow-down the pace of decision-making. The negative side-effect is sometimes that co-operative arrangements make accountability toward local citizens and the transparency of the decision-making process more problematic.

Nevertheless, one might expect promotion of intermunicipal co-operation to become a popular political option in times of financial crisis. Such a solutions have been successfully promoted for a long time in France and Finland, and in the last few years more and more popular (also thanks to the policies of respective central governments) in the territorially fragmented systems of the Czech Republic, Hungary, and Slovakia. Even in the UK, collaboration between neighbouring authorities is growing in fields such as procurement, IT, development control, and even education management.

5.4. Conclusions

The reactions of both central and local governments to the crisis have so far been schematic rather than innovative. Looking for savings through cutting some expenditures, enlarging budget deficits, or increasing taxes have been called upon much more often than policies aimed at increasing spending efficiency and effectiveness. Lack of interest in territorial reforms seems to be an example of such a missed opportunity. This situation may be strengthened by the fact that during the difficult economic period, central governments are especially afraid of unpopular decisions that might undermine their chances to win the next elections. Territorial reforms are rarely popular, especially because most people including local politicians are not aware of the potential benefits, while immediate political costs are clear to everyone.

6. Social Policy Connotations of the Economic Downturn

6.1. Changing European Societies

The current world economic downturn has turned the spotlight on the contradictions between the economic efficiency and competitiveness of the modern welfare state on the one hand, and on social rights on the other. Although the welfare state is one of Europe's most important cultural heritages and has received steadily growing significance since the 1990s when shaping EU policy, one key to resolving the economic crisis is seen—particularly by the institutions financing the recovery—in cutting public expenditure, principally social policy spending. In the newborn welfare states, the former state-socialist countries, this type of proposal tends to meet much less resistance than in the traditional welfare states. In the latter, the institutions of democracy and strong civil societies and interest protection organizations are ready to defend social rights, while in the former state-socialist countries these institutions are weak, and political discourse is centred on other issues.

The other disadvantage of the former state-socialist countries is that their welfare institutions are in a constant state of flux, evolving along the lines of trial and error, and there is little reliable statistical data available when attempting to analyze the effects.

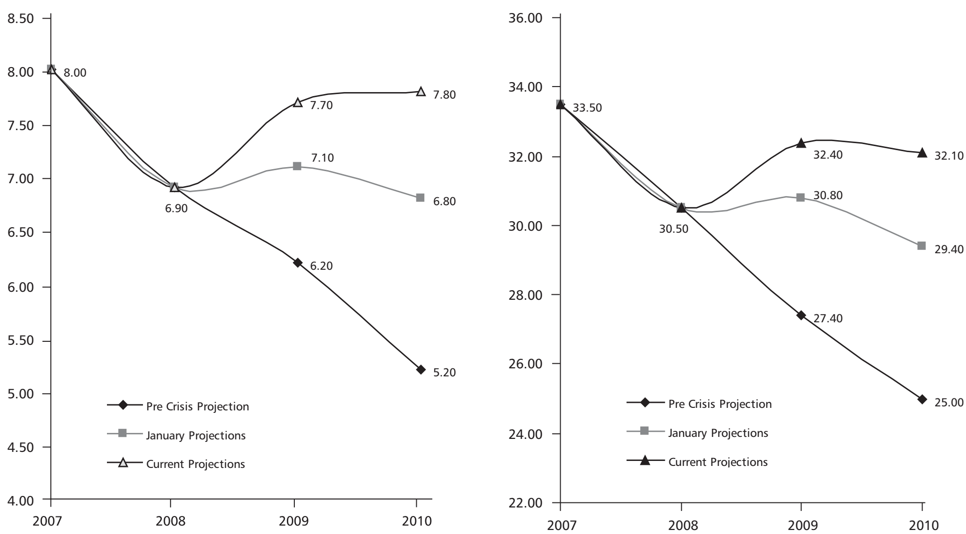
A PowerPoint presentation of the World Bank at a conference in spring 2009 contained the following:

"Social policy actions are a priority:

- The region has started to give back poverty gains of the last decade.
- Countries with weaker fiscal, financial, and social policies have been hit harder.
- Most countries in the region have social programs that can be strengthened and scaled up to provide targeted assistance.

ECA (Europe and Central Asia) countries were vulnerable, but there are also large differences across countries in the region—with seven months of the crisis, the region has started to lose poverty gains made over the last 10 years."[25]

Figure 8.
Poverty Rate Projections



Source: World Bank staff estimates.

The downturn has had differing effects on the various social groups and social welfare systems designed to support them have responded in different ways.

The general opinion is that the downturn has been felt first of all through the rise in unemployment.

[25] ECA Economic Briefing. Office of the Chief Economist Europe and Central Asia World Bank Spring Meetings 2009.

Table 6.
Seasonally Adjusted Unemployment Rates[26]

Geo\time	September 2008	September 2009
EU 27	7.7	9.2
Belgium	7.3	7.9
Bulgaria	5.2	7.6
Czech Republic	4.3	7.0
Denmark	3.4	6.4
Germany	7.1	7.6
Estonia	6.5	—
Ireland	6.7	13.0
Greece	7.5	—
Spain	12.4	19.31
France	8.0	10.0
Italy	6.8	—
Cyprus	3.5	5.9
Latvia	8.1	19.7
Lithuania	6.3	—
Luxembourg	5.1	6.6
Hungary	7.8	9.7
Malta	5.8	7.2
Netherlands	2.7	3.6
Austria	3.9	4.8
Poland	6.8	8.2
Portugal	7.8	9.2
Romania	5.8	—
Slovenia	4.1	5.9
Slovakia	8.9	12.0
Finland	6.5	8.6
Sweden	6.4	8.7
United Kingdom	6.0	—
Norway	2.5	—
United States	6.2	9.8
Japan	4.0	—

Source: Eurostat. Last update: 12.08.2009.

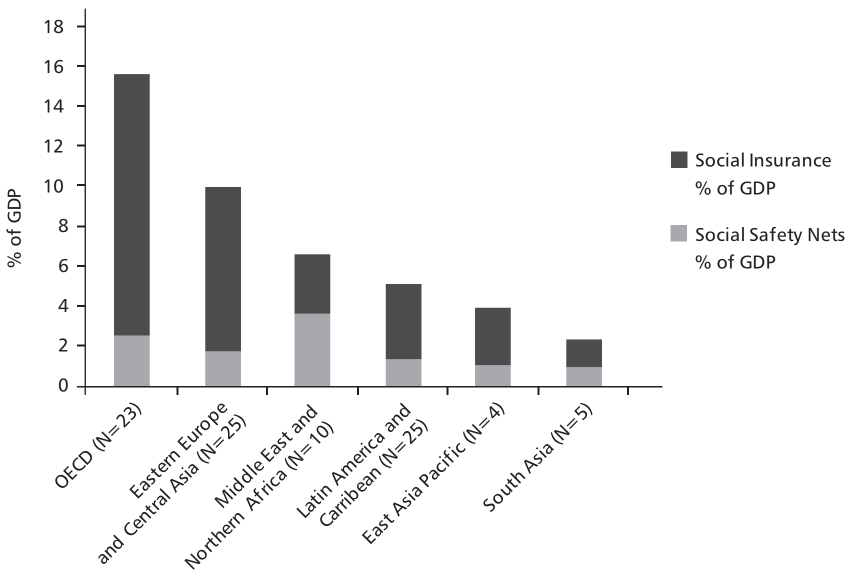
26 Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009.

While this is true for EU members, in Croatia, for instance, the minimum growth appears to have been triggered by seasonal fluctuations linked to the tourist season, at least for now.

In the first period of the downturn, the unemployment insurance system has had to treat this problem, but later people of active age will need to rely on the social assistance system and the poverty relief programmes.

Rarely do we discuss the situation of elderly people although problems concerning the maintenance of pension systems have become clear (e.g., Finland, Hungary). True, this goes beyond the competence of local governments. Nevertheless, they are faced with many tasks related to alleviating poverty among the ageing.

Figure 9.
Social Protection Spending, Regional Averages



Notes: Data on 69 countries taken from World Bank public expenditure reviews or other similar work. For OECD, data from the OECD.

"Safety nets are less suited for crises—ECA spends a lot on social insurance, but less on social assistance programs." This quote comes from the presentation already cited.[27] The wording tends to suggest the need to spend less on social insurance and block grants and more on aid, on means-tested programmes. These generalized conclusions are ignoring the differing characteristics of the European welfare states.

[27] ECA Economic Briefing. Office of the Chief Economist Europe and Central Asia World Bank Spring Meetings 2009.

Table 7.
Expenditure on Social Protection (as Percent of GDP[28])

	2000	2001	2002	2003	2004	2005	2006
EU 27	—	—	—	—	—	27.1	26.9
EU 25	26.5	26.7	27.0	27.3	27.2	27.3	27.0
EU 15	26.8	27.0	27.3	27.7	27.6	27.7	27.5
EA 15	26.7	26.8	27.4	27.8	27.7	27.8	27.5
Belgium	26.5	27.3	28.0	29.1	29.3	29.7	30.1
Bulgaria	—	—	—	—	—	16.0	15.0
Czech Republic	19.5	19.4	20.2	20.2	19.3	19.1	18.7
Denmark	28.9	29.2	29.7	30.9	30.7	30.2	29.1
Germany	29.3	29.4	30.1	30.4	29.8	29.7	28.7
Estonia	14.0	13.1	12.7	12.6	13.0	12.7	12.4
Ireland	13.9	14.9	17.5	17.9	18.2	18.2	18.2
Greece	23.5	24.3	24.0	23.6	23.5	24.3	24.2
Spain	20.3	20.0	20.4	20.6	20.7	21.1	20.9
France	29.5	29.6	30.4	30.9	31.3	31.4	31.1
Italy	24.7	24.9	25.3	25.8	26.0	26.3	26.6
Cyprus	14.8	14.9	16.3	18.4	18.1	18.4	18.4
Latvia	15.3	14.3	13.9	13.8	12.9	12.4	12.2
Lithuania	15.8	14.7	14.0	13.5	13.3	13.1	13.2
Luxembourg	19.6	20.9	21.6	22.1	22.2	21.7	20.4
Hungary	19.3	19.3	20.4	21.1	20.8	21.9	22.3
Malta	16.9	17.8	17.8	18.2	18.6	18.4	18.1
Netherlands	26.4	26.5	27.6	28.3	28.3	27.9	29.3
Austria	28.4	28.8	29.2	29.7	29.3	28.8	28.5
Poland	19.7	21.0	21.1	21.0	20.1	19.7	19.2
Portugal	21.7	22.7	23.7	24.1	24.7	25.4	25.4
Romania	13.2	13.2	13.4	12.6	15.1	14.2	14.0
Slovenia	24.2	24.5	24.4	23.7	23.4	23.0	22.8
Slovakia	19.4	19.0	19.1	18.2	17.2	16.7	15.9
Finland	25.1	24.9	25.6	26.5	26.6	26.7	26.2
Sweden	30.1	30.8	31.6	32.5	32.0	31.5	30.7
United Kingdom	26.4	26.8	25.7	25.7	25.9	26.3	26.4
Iceland	19.2	19.4	21.2	23.0	22.7	21.7	21.2
Norway	24.4	25.4	26.0	27.2	25.9	23.8	22.6
Switzerland	26+.9	27.6	28.5	29.1	29.3	29.3	28.4

[28] Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009, p.4.

Table 8.
Social Protection Receipts by Type (as Percent of Total Receipts)[29]

	General government contributions		Social contributions						Other receipts	
			Total		Employers		Protected Persons (1)			
	2000	2006	2000	2006	2000	2006	2000	2006	2006	2006
EU 27	—	37.6	—	58.9	—	38.2	—	20.6	—	3.5
EU 25	35.5	37.7	60.9	58.8	38.7	38.2	22.2	20.7	3.6	3.5
EU 15	35.6	38.0	60.9	58.9	38.7	38.3	22.2	20.6	3.5	3.2
EA 15	31.8	34.28	64.3	62.4	41.4	39.8	22.9	22.6	3.9	3.4
Belgium	25.3	27.7	72.1	70.8	49.9	49.3	22.3	21.4	2.5	1.5
Bulgaria	—	39.5	—	58.0	—	38.3	—	19.7	—	2.5
Czech Republic	25.0	18.8	73.8	80.3	49.8	53.9	24.0	26.4	1.2	0.9
Denmark	63.9	62.8	29.4	30.8	9.1	11.0	20.3	19.8	6.7	6.4
Germany	31.9	35.3	66.0	63.1	38.4	35.3	27.6	27.8	2.1	1.6
Estonia	20.6	19.5	79.2	80.4	79.2	80.1	—	0.3	0.2	0.1
Ireland	58.6	53.2	41.0	41.8	25.6	26.2	15.4	15.5	0.4	5.0
Greece	29.2	31.4	60.8	57.7	38.2	35.1	22.6	22.6	10.0	10.9
Spain	29.4	33.9	68.0	63.9	51.8	48.5	16.2	15.4	2.6	2.2
France	30.3	30.6	65.9	65.2	46.0	44.3	19.9	20.9	3.8	4.2
Italy	40.6	41.9	57.7	56.4	42.8	41.3	14.9	15.1	1.6	1.6
Cyprus	39.9	48.1	43.0	39.1	26.6	24.0	16.4	15.1	17.1	12.8
Latvia	34.6	35.5	65.4	63.9	49.4	47.1	16.0	16.8	0.0	0.6
Lithuania	38.9	38.5	59.6	61.0	53.7	54.9	5.9	6.1	1.5	0.5
Luxembourg	46.9	45.6	48.6	50.5	24.7	26.5	23.8	24.0	4.6	3.9
Hungary	31.6	40.6	59.7	53.8	47.0	38.6	12.8	15.2	8.7	5.7
Malta	29.8	35.2	67.6	62.0	46.6	43.3	21.0	18.7	2.6	2.8
Netherlands	14.4	20.1	67.5	69.5	29.4	31.8	38.1	37.7	18.1	10.4
Austria	32.3	33.3	66.3	65.3	39.2	37.8	27.1	27.4	1.3	1.4
Poland	32.5	33.3	55.3	48.0	30.5	25.9	24.8	22.0	12.2	18.8
Portugal	39.1	44.1	53.0	45.3	35.6	30.8	17.4	14.5	7.9	10.6
Romania	—	19.6	—	69.5	—	56.3	—	13.2	—	10.8
Slovenia	31.5	30.7	66.3	67.9	27.0	27.1	39.3	40.8	2.2	1.4
Slovakia	31.0	25.5	66.8	65.6	48.3	44.2	18.5	21.4	2.2	8.9
Finland	42.9	43.3	50.0	50.6	38.0	38.8	12.0	11.8	7.0	6.0
Sweden	45.9	48.9	49.9	48.7	40.4	39.9	9.4	8.9	4.3	2.4
United Kingdom	46.4	50.4	52.4	47.9	29.9	34.2	22.5	13.7	1.2	1.7
Iceland	51.4	31.6	48.6	30.6	39.5	24.8	9.1	5.8	—	37.9
Norway	60.5	52.9	38.4	47.0	24.4	32.0	14.0	15.0	1.1	0.1
Switzerland	21.0	22.3	60.4	62.2	29.3	28.7	31.1	33.6	18.6	15.4

29 Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009, p.10.

Expenditure on social protection as a percentage of GDP was 26.9% in this period but differences from one country to the next in the EU 27 are as much as twofold.

While there is only a 0.6% difference between the new members and the EU 15 in social protection spending when compared to these countries' GDPs, there are significant differences in the actual amounts used to support people in disadvantaged circumstances.

There are also significant differences from one country to the next in the sources of funding for social protection. For the duration of the downturn, the amount of social insurance contributions depends primarily on how strong the labour market is and how extensive the clandestine economy proves to be. Tax revenues are highly dependent on the ability of the public to consume, given the role played by the consumption tax.

Different countries have markedly different systems for financing social protection, depending on whether they favour social security contributions or general government funding. Government contributions in Denmark, Ireland, the United Kingdom, and Norway are particularly high when compared to the social insurance-type inflows. "The differences are historical and due to the institutional rationale behind social protection systems. Northern European countries, where government funding dominates, are steeped in the 'Beveridgian' tradition (in this type of system, it is sufficient to be a resident in need in order to be eligible for social benefits). Other countries are strongly attached to the 'Bismarckian' tradition, in which the system is based on the insurance concept (in the form of contributions). However, the gap/difference between European countries is gradually narrowing, with more funding from tax revenue in those countries where it used to be low (France, Germany, Italy, and Portugal, for example), on the one hand, and with more coming from contributions in the countries with high levels of government funding, on the other."[30]

In all countries, the largest single expenditures on social protection are pensions and health care, but here, too, there are major differences from country to country. The range of pension-type expenditure as a proportion of GDP goes from an average of 11.9% to a high of 15.5% (Italy) and a low of 5.5% (Estonia). In health care the average is 7.5%, and ranges from a high of 8.7% (France, and Netherlands) and a low of 3.5% (Latvia).

[30] Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009, p.10.

Figure 10.
Structure of Social Protection Expenditure in EU 27, 2006[31]

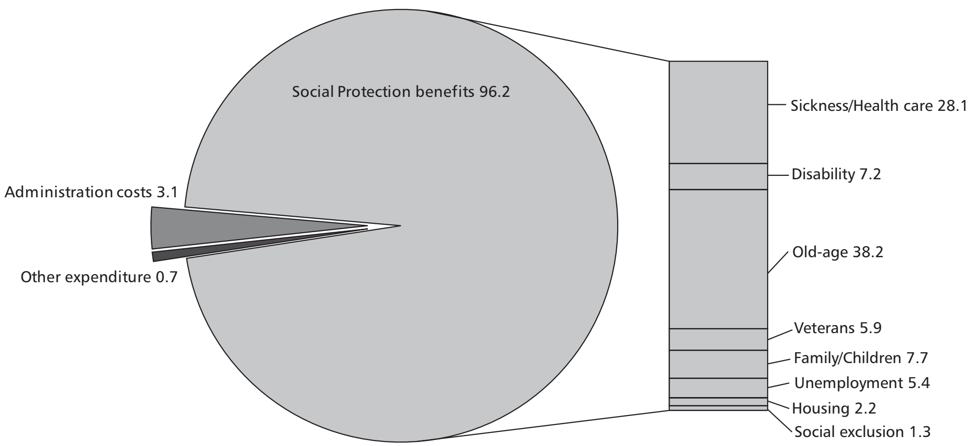


Table 9.
Changes in Social Benefits Between 2000 and 2006

Number of benefits affected by the changes	Country
1 significant increase	Greece, Czech Republic, Denmark, Netherlands, Belgium, Italy, Malta, Portugal, Germany, Slovenia
2 significant increases	Estonia, Latvia
3 significant increases	Latvia, Spain
4 significant increases	Cyprus, Hungary, Luxembourg
5 significant increases	Ireland, Romania
1 decrease	Belgium, Netherlands, Austria, Malta, Romania, Slovenia, United Kingdom, Estonia, Latvia
2 decreases	Poland, Denmark, Sweden
3 or more decreases	Germany, Slovakia

While expenditure for social protection grew overall among the European Union members between 2000 and 2006 (2.6% in the EU 25, there were differences between countries. In Romania (11.0%) and Ireland (10.3%) the growth in welfare

[31] Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009, p.5.

expenditure was particularly high. However, a look at the various social benefits yields a much more diverse picture. The structure of the benefits and the proportion of the changes reflect very different welfare state policies. While Ireland and Romania increased their expenditure significantly more than average in all aspects of social benefits, Germany and Slovakia introduced significant cuts in all areas except pensions. Some countries increased certain benefits while others cut them.

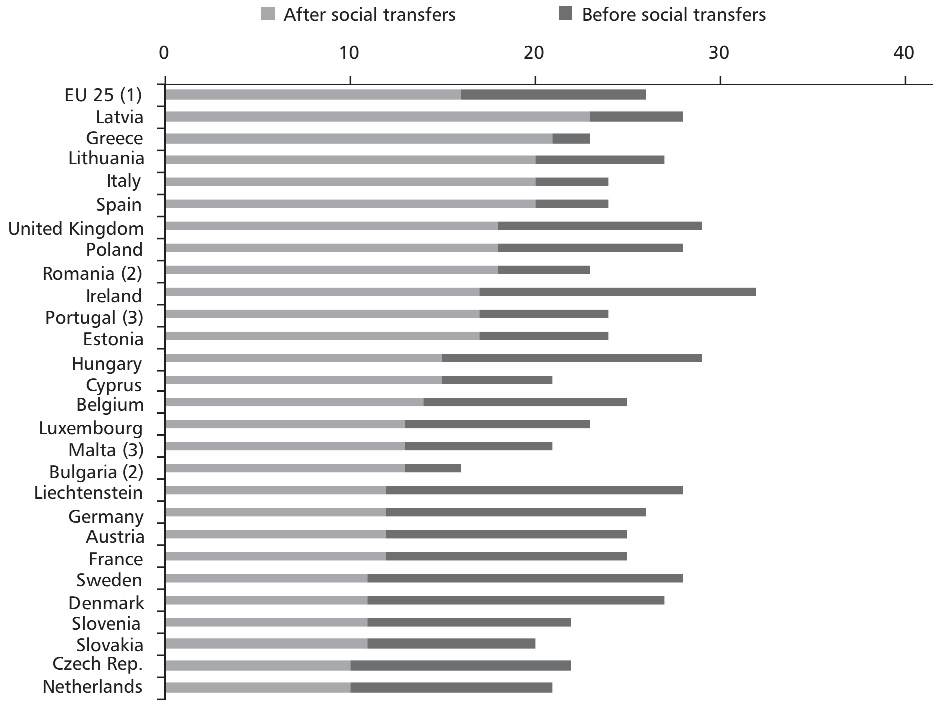
Table 10.
Changes in Social Benefits from 2000 to 2006

	Old-age and veterans	Sickness/ health care	Disability	Family/children	Unemploy- ment	Housing and social exclusion
Particularly high growth	Cyprus, Estonia, Greece, Hungary, Ireland, Romania	Ireland, Hungary, Latvia, Romania	Czech Republic, Cyprus, Denmark, Estonia, Ireland, Lithuania, Luxembourg, Hungary, Romania	Cyprus, Estonia, Ireland, Latvia, Luxembourg, Hungary, Netherlands, Romania, Spain	Belgium, Cyprus, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Portugal, Spain	Germany, Luxembourg, Romania, Slovenia, Spain
Reduction		Germany, Slovakia	Austria, Belgium, Germany, Netherlands, Poland	Germany, Malta, Slovakia	Denmark, Germany, Poland, Romania, Slovenia, Slovakia, Sweden, United Kingdom	Denmark, Estonia, Lithuania, Slovakia, Sweden

Pension expenditure increased everywhere, but two countries reduced health care expenditure, four cut benefits for people with disabilities, three brought down benefits related to maternity and children, and eight diminished jobless benefits. The largest increase in the EU 25 was in funding for assistance, but in contrast with Romania, where growth was exceptionally high (35.5%), five countries cut their assistance spending.

Of itself, the amount of funding for assistance yields little information on the effectiveness of the aid, and on whether their primary goal—to alleviate poverty—was achieved.

Figure 11.
Persons at Risk of Poverty, 2006 (Percent of Total Population)[32]



Source: Eurostat (tsisc020 and tsisc030).

Note: (1) Estimates calculated population-size weighted averages of national data. (2) Source: National data (HBS 2006). (3) Provisional.

There was a sharp decline in poverty in 2006 in Ireland, Hungary, Finland, Belgium, Germany, Austria, France, Sweden, Denmark, Slovenia, Czech Republic, and the Netherlands, while the social assistance provision system was expressly poor in effectiveness in Latvia, Greece, Lithuania, Italy, Spain, Romania, Cyprus, and Bulgaria. The graph shows that the most effective way of alleviating poverty is not through assistance, for if we look at welfare expenditure, there appears to be no connection between the amount of funding devoted to assistance and poverty reduction as an outcome. (There are countries devoting both more and less than average to this end among the ones with effective poverty reduction programmes as well as among the ones where outcomes are poor.)

We have to conclude that given the vast differences in systems, uniform solutions appear impossible, while at the same time it is particularly important to increase the efficiency of protection systems given the pressures of the economic downturn.

32 *Key Figures on Europe*. 2009 edition. Eurostat Pocketbook, p.90.

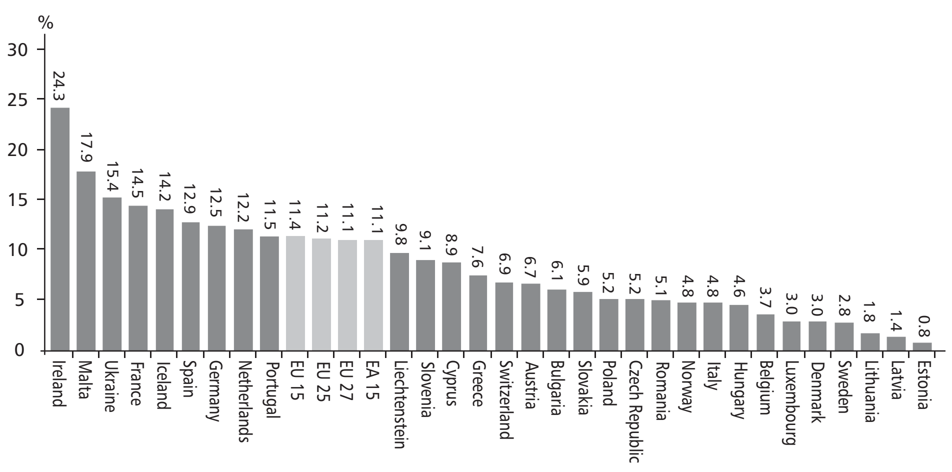
6.2. Social Assistance Systems and Responses to the Crisis

The European social assistance systems differ widely, not only in whom they target but also in their poverty-alleviating effects and the size of budget funds they employ. One very significant difference from the point of view of our subject relates to whether they have any general basic form of assistance dependent only on the size of family incomes (e.g., Romania, Bulgaria, Serbia). Another significant difference is whether the institutional system operates with central government funding and the aid is provided by a deconcentrated body (as Bulgaria, Serbia, Bosnia and Herzegovina, and Armenia do) or it is decentralised. In the latter case, alternatives range from local governments simply distributing the central funds, through operating in a decentralized system with resources coming from the central government but with local governments making the decisions (e.g., in Hungary, the Czech Republic, Italy, Iceland) to local governments not only making the decisions but also providing the lion's share of the funds (Sweden, and Slovakia).

These differences are significant regarding responses to the downturn, for they determine the actors that have to deal with the distress.

When considering ways to improve targeting, we often believe that community resources should be limited to people in real need, and often the large systems financed through taxes and contributions (social security, health care, maternity, and family benefits) provide support to people who would otherwise be able to mobilize their own resources.

Figure 12.
Means-tested Social Benefits, 2006 (as Percent of Total Social Benefits)[33]



Source: Eurostat.

Note: The percentages in this figure are calculated out of data expressed in euro.

33 Antonella Puglia (2009) "Population and Social Conditions." *Statistics in Focus* 40/2009, p.9.

Many people see the way to overcome negative effects in expanding the circle of means-tested benefits. In all EU member states, people in need of assistance can access the vast majority of welfare benefits without means testing. In some countries means testing—including income and assets—is a requirement not only in determining aid to alleviate poverty, but also in granting other types of entitlements. For instance, in Serbia entitlement to family allowances is means tested.

Poor targeting cannot be reduced to the problem of leaky funds. In the countries where many people are poor, the other side of the targeting—that not all people who need it can receive social assistance—is a huge problem.

Many features of the social protection systems can lead to good or poor outcomes. "Where social assistance programs are not fully funded, as is the case for the vast majority of programs, errors of exclusion will occur because of the caps put on enrollment to keep programs within budget allocations."[34] Lack of information and high transaction costs (such as the stigma attached to applying for assistance) lead many people who would be entitled to assistance to fail to apply for it. "In a study of Eastern Europe and Central Asia cash transfers, child allowances, and social pensions (…), the mean coverage rate of the first quintile is 42 percent. A study reviewing experience in a small number of Organization for Economic Co-operation and Development (OECD) countries was able to model take-up more closely among eligible individuals, and concluded that take-up rates typically are between 40 and 80 per cent for social assistance and housing programs."[35]

Relying on available international statistics and responses of national specialists to a questionnaire, we can conclude that in most countries local governments have not seen any substantive moves being taken to alleviate the social outcomes of the downturn. This is true even though, for instance, the Committee of the Regions[36] wrote: "the financial crisis and its negative impact on economic growth and employment will increase demand for assistance, social aid, public services preferential tariffs, and local and regional authorities are in the front line regarding these expectations...."

The initial phase of the crisis was apparent primarily in a vast increase in the number of people applying for unemployment benefits. Only after these benefits expire will the effects be measurable on the level of the aid system and the local governments.

---

34 Margaret Grosh, Carlo del Ninno, Emil Tesliuc, and Azedine Ouerghi (2008) *For Protection and Promotion: The Design and Implementation of Effective Safety Nets*. The World Bank, p.90.

35 Conditional cash transfers reducing present and future poverty. Ariel Fiszbein and Norbert Schady with Francisco H.G. Ferreira, Margaret Grosh, Nial Kelleher, Pedro Olinto, and Emmanuel Skoufias (2009) *The International Bank for Reconstruction and Development.* The World Bank, p.73.

36 Resolution of the Committee of the Regions on the financial crisis (2009/C 76/13).The committee of the regions. The Official Journal of the European Union of 31.03.2009. 23. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:076:0063:0065:EN:PDF.

The crisis can have two different effects on public welfare expenditure. On the one hand, reductions are recommended to manage public finance shortfalls, while on the other, increases are needed since the number of people who need assistance is bound to rise.

As far as the amount of social spending is concerned, there have been no significant changes in any country.

Table 11.
Changes in Social Protection Expenditure

Social protection expenditure		
No downturn linked changes in general	Changes were introduced, but indications are only of cost-cutting and more careful spending	Changes were introduced—mainly proactive (including possible budget tightening)
Armenia, Czech Republic, Estonia, France, Poland, Romania, Slovakia, "the former Yugoslav Republic of Macedonia"	Bulgaria, Hungary, Russia	Finland, Hungary, Ireland, Russia, UK

In Russia, for instance, the federal government in its April 2009 resolution provided for an additional 34 billion rubles to be allocated to Russian Federation subjects as unemployment support while at the same time decisions were taken to cut the budgets of several cities and local government bodies have been asked to develop antirecessionary measures.

Ireland is clearly attempting to expand its resources. It seeks to alleviate the effects of the downturn principally by reshaping the jobless benefit system. "Nationally, the cost of social benefits has risen sharply—the budget for 2009 is already 20% more than what was spent in 2008. Total gross spending on social welfare is expected to account for 29% of gross total government expenditure in 2009" (National expert).

In Slovakia: "The Parliament enacted the new law on social services in October 2008 which forces local governments to increase social expenditures. This trend set up by the government is not sustainable so they changed some terms of entering some parts of law into force (they postponed some terms to 2013). We do not consider this approach as responsible even though the government's social expenditures were comparably lower than those of local governments. Postponing of the term of entering a law into force is not a systematic approach" (National expert).

At the same time, we rarely see a case in the countries under investigation when a general cut in social expenditure or a reduction in a specific form of welfare expenditure becomes a tool to achieve macroeconomic equilibrium. Hungary, however, cut its central budget expenditure on social services by 6%.

In some countries, local governments, particularly in cases when social service funding comes from the central budget, have tried to pressure central governments to increase resources. In Poland, for instance, "representatives of Polish cities asked the central government to prepare an anti-crisis package for local governments," but failed to receive it.

Table 12.

Changes in Financing of Social Assistance and Social Services

Change in social assistance only —increased (spending)	Croatia, Finland, France, Poland, Romania, Russia, Slovakia
In services only, new/expanded	Estonia
In both—increase	—
Negative reaction: fewer resources for aid	—
Negative reaction: fewer resources for services	Armenia, Hungary
No change	Bosnia and Herzegovina, Bulgaria, Luxembourg

Some countries (Estonia, Bosnia and Herzegovina, Serbia, and Ukraine) responded to the downturn by slowing down or postponing scheduled reforms in their social systems.

During a crisis, the ratio of poor people who can access the support, in other words, the take-up rate, is very important.

Table 13.

The Method of Allocation and Prioritising the Needs of the Poorest Households

Priorities-targeting	**Obstacles to poor households receiving social assistance**		
Priority (stronger) to poorest households —due to the crisis	No (no need, works satisfactorily)	No, bad targeting	Yes, mentions reasons
Estonia, Ireland	Finland, France, Luxembourg, Poland	Bosnia and Herzegovina, Romania, Serbia, Ukraine	Bosnia and Herzegovina, Estonia, Finland, Romania, Russia, Serbia, Ukraine

Traditional welfare states have responded to the social challenges of the downturn by operating existing systems of institutions. As the Finnish expert noted when responding to our questionnaire: "The legislation of the social sector is working properly and there is no need to update it in this phase. There have been lately several updates to indexes to make allocations better, usually by 3–5% rise." As the expert from Luxembourg wrote: "Well-targeted, no need for special measures."

However, there have been no changes in the assistance system even where there are serious problems in targeting, such as in Bosnia and Herzegovina, Romania, and Ukraine. In Russia, the main problem according to the national expert is not that the assistance does not reach the poor, but that the resources evaporate.

When asked to mention a reason why it is hard to get the aid to the poor, the Estonian expert saw the most important problem in entitlement conditions. (The local government may refuse the assistance, if the applicant refuses work offered). In Bosnia and Herzegovina, administering the application causes problems in remote areas. The Finnish expert referred to the usual waiting time, while the Russian expert noted the long queues for documents when applying for cost-of-living support.

Regarding social services, there are even fewer noticeable positive or negative changes. Estonia is the only country where we know of proactive tools, where there are more social work places and meals on wheels. Hungary was the only country to cut expenditure (minus 6%), while in Armenia, the national expert cited the consequences of the devaluation of the national currency.

The NGOs can play roles in distributing services either from their own resources or as the contracted partners of the local self-governments. There is no indication in the country reports that central or local governments willingly choose this method of crisis management which involves shifting responsibility. The French expert is quite explicit: "Numerous associations in France aim to fight poverty by legal means. A number of them benefit from subsidies and request public funding but they have never been used by government or by local authorities to reduce the costs of social services."

In several countries that have transformed their social welfare systems in recent years, the development of NGOs and their provision of services are still in their infancy (for instance: Bosnia and Herzegovina and Ukraine).

"Ukraine's government continued to develop reforms in social service provision (to strengthen the role of community services) at the routine speed, without specific response to crisis-related pressures" (National expert).

In Slovakia, the NGOs have taken unique action—they are calling for EU funding to cover the build-up and more powerful role of the sector.

6.3. Workfare and/or Welfare?

A key to the sustainability of the European welfare states as well as to boosting their competitiveness and bolstering their social cohesion is increasing the number of people with jobs as well as the proportion of the working population. Unquestionably, the most effective way to alleviate poverty is for people to have work.

There are three buzzwords in use to describe employment promotion, albeit with slightly different content. They are "activation policies," "workfare," and "welfare-to-work."

"*Activation*" as a socio-political labour market strategy is an umbrella concept. "The term is broad and refers to a wide range of policies that, i.e., are targeted at people receiving public benefits, and/or in danger of being excluded from the labour market (…). Goals and measures may differ; the goals may be (re)entrance into the labour market, the development of work related skills, etc., while the measures may vary from voluntary training to obligatory work programmes. Other instruments may be job creation, wage subsidies and financial incentives."[37]

The essence of this concept is to replace passive labour market tools (such as various cash supports) with measures to improve job skills.

The workfare[38] ("work-for-your-welfare") model rests on the assumption that when people of active age receive aid, the outcome is welfare dependency. The belief is that they no longer want to work because they receive the aid without doing anything. This approach, which originated in the United States, sets conditions (such as training courses, rehabilitation, mandatory community service or taking a communal job) as the prerequisite to receiving a minimum subsistence level of social support. Since the belief is that the biggest obstacle to work for this group is the attitudes of the jobless themselves, workfare advocates use the social assistance system to put pressure on the people outside the workforce to accept any job opportunity. This attitude differs from the traditional tenet of the welfare state in that it does not consider provision of minimum subsistence conditions as basic right of all citizens.

The *welfare-to-work* concept was introduced to Europe by the UK, where it was part of Tony Blair's "New Deal" programme. While it offers a wide range of human capital development tools to unemployed people of various ages to promote success on the job market, it is similar to workfare in that refusal to participate can result in a loss of benefits.

All three concepts employ both the carrot and the stick, but to different extents and with differing consequences.

The activation approach relies primarily on labour market and employment policy means, while workfare and welfare-to-work connect labour market and income maintenance tools.

"Another feature of European welfare policies is the general trend of the reforms; towards active measures rather than passive, sanctions rather than incentives, duties rather than rights. Further trends include the approval of a public contract approach

---

[37] Nanna Kildal (2001) *Workfare Tendencies in Scandinavian Welfare Policies*. Geneva: International Labour Office, February 2001, p.2. http://www.ilo.org/public/english/protection/ses/download/docs/workfare.pdf.

[38] US terminology uses the word "welfare" as a synonym for social assistance.

rather than a rights-based approach and an emphasis on selectivity rather than universality. (…) Thus, there seems to be a kind of convergence both in the interpretation of political challenges and in the political answers, irrespective of national institutional preconditions. This tendency towards convergence in national welfare policies is, it is true, mixed with divergent trends in other respects."[39]

We did not have the capacity to conduct extensive research for this study, in that we were unable to study the legislative environments and systems of institutions of each country. Therefore, we were forced to rely on the MISSOC database and the isolated comments included in responses of experts to the questionnaire. Our overview of the occurrence of the various ways of managing social assistance is therefore incomplete.

Table 14.
Orientation of the Activation Measures Directed to People on Social Assistance

Focus is more on heightening capabilities	Focus is more on employment policy
Czech Republic, France, Georgia, Iceland, Ireland, Luxembourg, Slovenia	Denmark, Finland, Hungary, Slovakia

As already mentioned, the activation measures can include training and retraining, provision of work experience, or participation is one form or another of community or public work, as well as the capability development solutions that rely on social work tools. The difference—among others—lies in the nature of the organizations responsible for the activation. Are they exclusively or primarily employment services or does some social institution also play a substantive role? Another factor behind differing work methods and interests is that employment services are for the most part large and centralized institutions operating within hierarchies and maintaining uniform orders of procedure, while social services are generally within the purview of local governments that attempt to ascertain the specifics of individuals and work with them in mind. Their clients are families, not just working-age social assistance recipients.

One form of aid that has been introduced in a growing number of countries is the conditional cash transfer (CCT). The "condition" is not necessarily work-related. In some developing countries for instance, it is connected to major social policy goals such as sending children to school or the fulfilment of health care requirements. "Many social policy analysts also see a parallel in the move to CCTs in developing countries and the welfare-to-work agenda in the United States and Europe, as embodied by reforms that led to the Revenu Minimum d'Insertion in France, the Temporary Assistance for

[39] Nanna Kildal (2001) *Workfare Tendencies in Scandinavian Welfare Policies.* Geneva: International Labour Office, February 2001, p.2. http://www.ilo.org/public/english/protection/ses/download/docs/workfare.pdf, p.1.

Needy Families (TANF) reforms in the United States, and the New Deal in the United Kingdom. Like CCTs in the developing world, all of these programs require 'desired behaviour' in exchange for income support. In settings with highly informal labour markets, the conditions on children's health and schooling are easier to monitor than job search and work requirements and thus are sensible adaptations of the basic notion of linking social assistance to positive behavioural change."[40]

Methods like this, which limit personal and family autonomy, are nontraditional in the European welfare states, but they do crop up from time to time. In Hungary, for instance, although statistics show that irregular school attendance is negligible, and although there are institutional ways of achieving adherence to the statutory obligation of attending school, some local governments would like to link assistance to the verified school attendance of children. Another example is Latvia, where there is a requirement for "Acceptance of medical treatment and rehabilitation (for example, in the case of alcohol or drug abuse) and participation in measures promoting employment (for example, retraining, paid temporary jobs, etc.)."[41]

Table 15.
Activation and the Safety Net

Stick		**Carrot**
Aid may be halted completely if recipient does not accept activation measures	Aid may be reduced if recipient does not accept activation measures	Aid is withdrawn in gradual increments if recipient gets a job
Bulgaria, Estonia, Hungary	Denmark, Sweden	Cyprus, France, Georgia, Hungary, Ireland, Latvia, Malta, UK

Many analysts see the main reason why living on assistance is a counter-incentive to taking a job is the poverty trap, that is, that the income coming from work is not appreciably larger than the amount received as aid, while taking a job increases expenditure. The problem can be resolved by gradually reducing but not eliminating the benefit, when cutting it off completely might jeopardize subsistence or by gradually tapering off the benefit once a person begins to work. There are several examples of the latter in Europe.

40 Ariel Fiszbein and Norbert Schady, with H.G. Francisco Ferreira, Margaret Grosh, Nial Kelleher, Pedro Olinto and Emmanuel Skoufias (2009) *Conditional Cash Transfers, Reducing Present and Future Poverty*, The World Bank, p.33.

41 MISSOC database. Mutual Information System on Social Protection http://ec.europa.eu/employment_social/spsi/missoc_en.htm.

Workfare, which pulls the social safety net out from under recipients, which punishes people who do not or cannot participate in activation programmes along with their families who are not responsible for rejecting the activation programmes, clearly casts doubts on whether social rights exist at all. Denial of the aid punishes not only the person from whom it is withdrawn, but, for example, all children living in the family as well. The intensity with which this type of sanction is applied varies. In some places the amount of assistance is reduced, while elsewhere it is completely cut off for longer or shorter periods of time.

In the United States, when workfare was introduced, the majority of welfare recipients were African-Americans. In Europe today, Roma (in Hungary, Romania, Bulgaria, and Serbia) and immigrants from ethnic minority groups are overrepresented among the targets of activation measures. This strongly suggests that efforts to introduce workfare are racist in motivation. Even if they are not, when evaluating the method, we cannot ignore the extent to which they affect different ethnic groups.

The reasons some people are unable to break into the labour market are more than personal ones that could be remedied through employment policy and social means. The operation of the labour market itself and its workforce needs also play roles. Activation measures are different when they include job opportunities even for people with low education levels and no skills, when flexitime is widespread, and when there is a social economy as against where and when there simply is no place to reintegrate the jobless.

In times of downturn, with narrowed-down labour markets and growing unemployment, the question becomes particularly acute: can a phenomenon that is economic and structural in nature be blamed on the individual? Studies by experts in the countries under scrutiny simply suggest that there has been a rise in the number of aid recipients, that spending on assistance has increased, but fail to mention whether any system-wide changes had been introduced, even temporarily.

6.4. Lessons

To date, most countries have not attempted to alleviate the budget ills caused by the downturn by cutting social expenditure.

Information received to date suggests that no country has introduced system-wide measures to alleviate the social effects of the crisis. Nor have we found any example of a country taking advantage of the crisis-induced situation to implement hitherto postponed structural reforms. Instead, we tended to see the suspension of planned or barely begun reforms in welfare systems.

Obviously, the drop in employment exacerbates problems with financing social security-based pension systems. In countries where there has been a sizable rise in unemployment, it is still a bit early for the aid systems to feel the hit they have taken.

In strongly centralized social assistance systems, government measures alone determine the amount of funding available and the circle of possible beneficiaries. Big government bureaucracies are slower to move and less able to introduce differentiated solutions than decentralized systems in which local communities can calculate the situations of individual groups in shaping their systems and regrouping their resources. However, the decentralized systems also can find themselves in trouble, for it is easy to blame the local government if central financing does not keep up with the change in the number of applicants. In countries where local decision-makers enjoy a high level of discretion in awarding the assistance, growing public dissatisfaction can be dissipated by excluding ethnic minorities, which in turn can lead to ethnic conflict.

Setting conditions on receiving benefits, particularly if the conditions are aimed at testing willingness to work, that is, deservingness, is very risky when it is obvious that under the conditions of the economic downturn there is no chance of any long-term reintegration into the workforce.

The pilot study on which this analysis rests is quite adamant in pointing out that often the statistical data collection systems used to ascertain the social circumstances and welfare supply systems of the public are inaccurate and slow. Thus, they are incapable of providing sufficient reliable information on which to make well-founded decisions.

Annex I

Bulgarian Experiences in Promoting Municipal Efficiency

Introduction

In the last 10 years, Bulgaria has gained some experience in the assessment of municipal services from the point of view of efficiency. Several pilot projects funded by the USAID and the Open Society Institute–Sofia were carried out, which drew some experience from the international academic research but the concrete task was practically oriented—to provoke a policy debate on municipal efficiency by demonstrating that municipalities face a wide variety of unit costs.

The projects found out that there were wide variations in unit costs for different services across municipalities in Bulgaria. For each variety in the unit costs, there may be some reasonable explanation, but what is sure is that it needs to be explained. In the Bulgarian case the idea was not to use a very complicated methodology, to keep the conclusions simple and suitable for a policy debate.

Two attempts for comparative assessment of efficiency carried out by the Open Society Institute–Sofia built upon previous work funded by USAID. USAID supported the elaboration of a special Manual for Evaluation of Local Service Performance (Markov and Tafradjiiski 2007). The pilot project collected empirical data to check the methodology described in the manual. For this purpose four typical local services were selected: Street Cleaning, Solid Waste Collection and Transportation, Landscaping and Street Lighting. The Manual was developed by Angel Markov from the Local Government and Public Service Reform Initiative and Borislav Tafradjiiski from Club Ekonomika 2000. The project was carried out in six Bulgarian municipalities: Kardjali, Razgrad, Sliven, Mezdra, Karlovo, and Dobrich.

The manual uses the concept of service performance, which is very close to the usual concept of municipal efficiency but is based more on the target of achieving certain benchmarks defined as standards for the provision of the corresponding service.

When overseeing the service improvement strategies, the manual uses the concepts of efficiency and effectiveness, trying to integrate them into a single framework of analysis.

The following questions were asked to outline the understanding of the two basic concepts:

- Effectiveness—is the quality of the existing service measurable and good?
- Efficiency—are the available resources used in the best possible way?

The manual develops also some basic tools for full costs accounting and programme-based budgeting for local authorities.

Some Pilot Municipal Efficiency Experiences from Bulgaria

The next important step in developing the methodology for assessment of municipal efficiency was a pilot survey carried out in fifteen Bulgarian municipalities. It was organized by the Resource Centre for Decentralization and Municipal Development[42] to determine and compare the unit costs for four local municipal services: garbage collection, street cleaning, planting, and street lightening and two delegated services. The main factors analyzed are the scope and quality of the services. The main target of the project is to make the services in the different municipalities comparable, set benchmarks based on the best cost-benefit ratio, and initiate a discussion on how these benchmarks can be met.

The monitoring of municipal services based on predetermined efficiency and effectiveness factors allows the tracking of different processes taking place at the municipal level, especially those related to their financial situation and the management of the services. These indicators allow a better understanding of the challenges that the municipalities may face in the provision of services.

Participation in the monitoring was on a voluntary basis, which guarantees the reliability of the information provided. Fifteen Bulgarian municipalities participated in the project: Pleven, the town of Dobrich, Kardjali, Pazardjik, Troyan, Mezdra, Tervel, Zlatograd, Stara Zagora, Gabrovo, Kozloduy, Belene, Kneja, Koprivshtitsa, and Tryavna. The survey included four local option services (financed by the municipalities own revenues)—garbage collection and transportation, street cleaning, landscaping and street lighting—and two delegated services (services mandated by the central government)—mainstream schools and kindergarten. The survey uses data for 2006 and 2007.

The services were assessed against preliminarily defined indicators of efficiency and effectiveness, which allowed tracking different processes taking place at the municipal

42 The Resource Centre for Decentralization and Municipal Development is an organization comprising the Open Society Institute–Sofia and Partners for Effective Solutions Ltd.

level related to the financing and management of services. These indicators highlight the main challenges faced by municipalities in the provision of the corresponding service.

Collecting comparative information on the provision of services across municipalities is an important step toward their better understanding. This also is a way to improve quality and coverage and make expenditure more transparent. Such comparisons also allow municipalities to set strategic priorities through benchmarking.

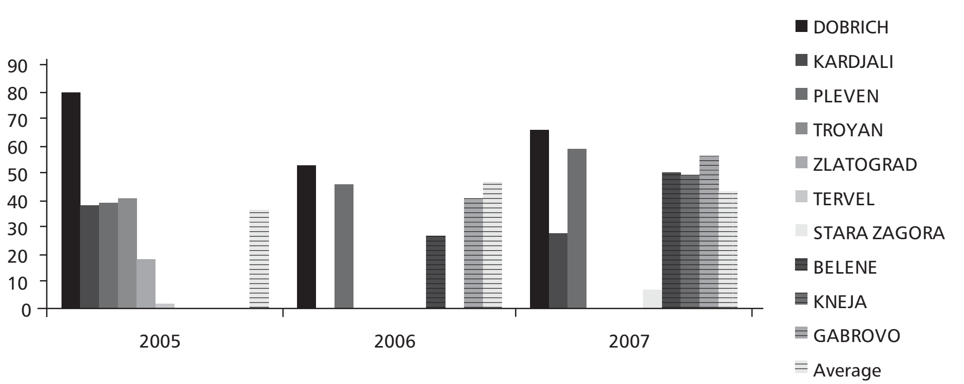
The main indicators for each service were listed and defined and a data collection form with a manual of explanatory notes was made. The main focus of the project was on the presentation of the data and the dissemination of good practice.

Below we give the list of the main indicators used for each service:

Street Lighting

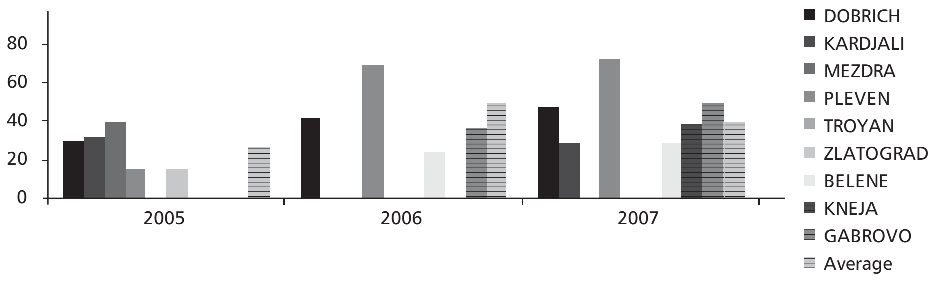
Indicators of Effectiveness

Figure 13.
Operational Costs/Total Number of Lights



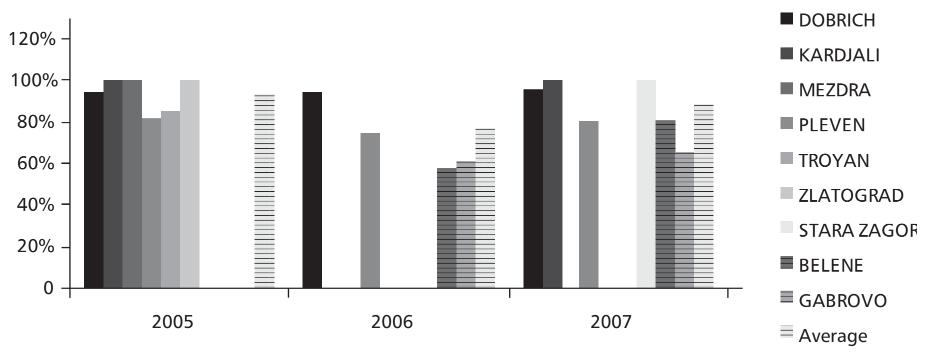
This indicator shows how much an illuminant costs to the local government. This is a typical unit costs indicator, which shows how cost efficient is the provision of street lighting in general.

Figure 14.
Energy Costs/Total Number of Working Lights



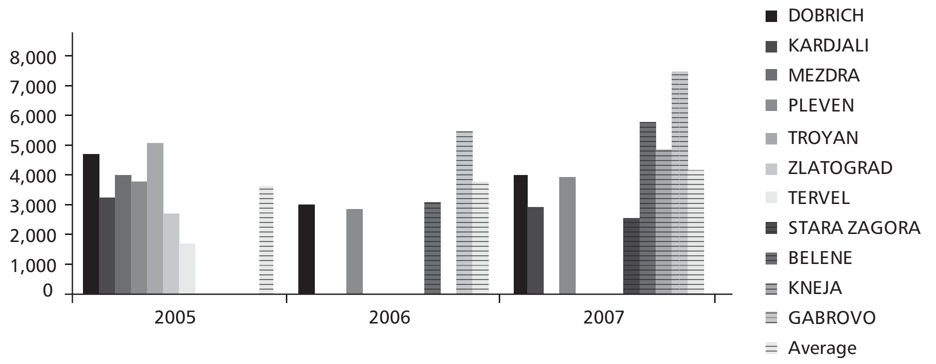
This indicator shows how much the municipality pays for electricity per illuminant. It is a unit cost indicator, which shows specifically how energy efficient is the street lighting.

Figure 15.
Energy Saving Lamps as a Percent of the Total Number of Lamps



This indicator shows to what extent the local authority provides the service in a more technologically advanced way and to what extent it has invested in technological improvement.

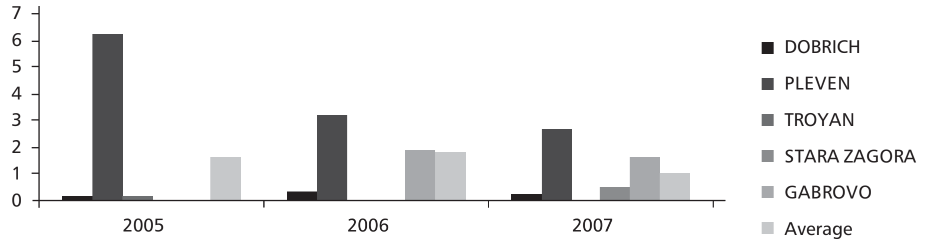
Figure 16.
Street Lighting Costs per 1,000 Inhabitants



This is a unit cost indicator, which shows how efficient the local government is in providing the service to each inhabitant. But the indicator does not tell about the quality of the service.

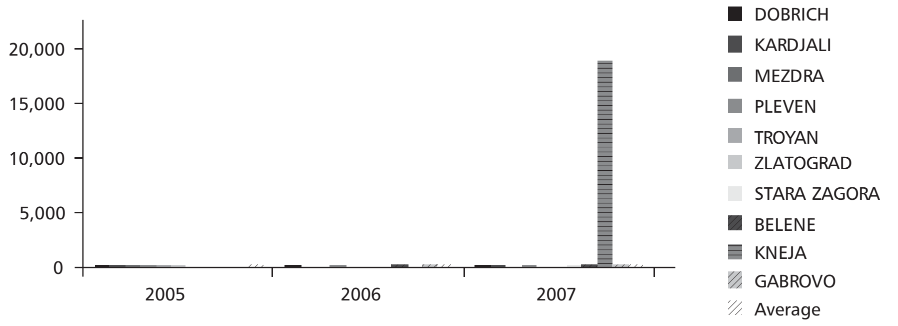
Efficiency and Quality Indicators

Figure 17.
Number of Complaints/1,000 Inhabitants



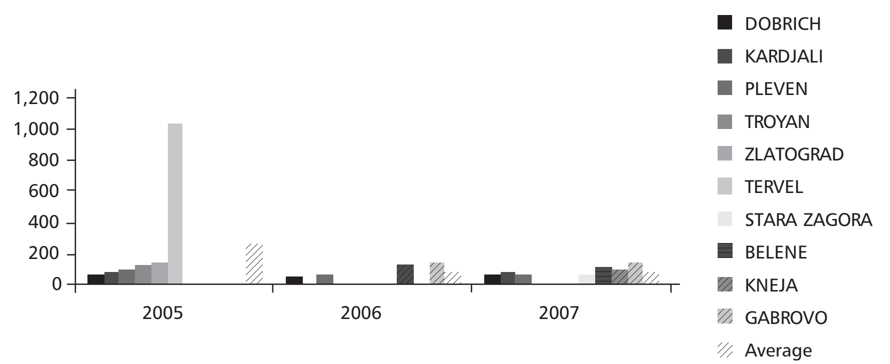
This is a typical consumer satisfaction indicator, which should demonstrate how dissatisfaction of the population drops.

Figure 18.
Illuminated Street Network as a Percent of the Whole Network



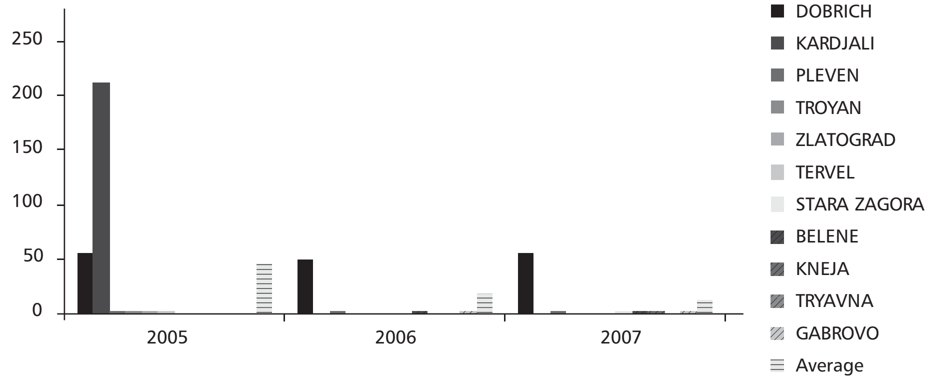
This indicator measures the quality of the service. More illuminated streets mean better quality but higher costs. So it is important to use this and the next indicator in conjunction with the unit cost indicators to guarantee that what appears to be efficiency does not come in the shape of very poor quality of the service.

Figure 19.
Number of Lights/1,000 Inhabitants



This indicator like the previous one measures the quality of the service. It has to be used together with the unit cost indicators. It can be used with almost any local service.

Figure 20.
Number of Lights/Total Surface of the Populated Area

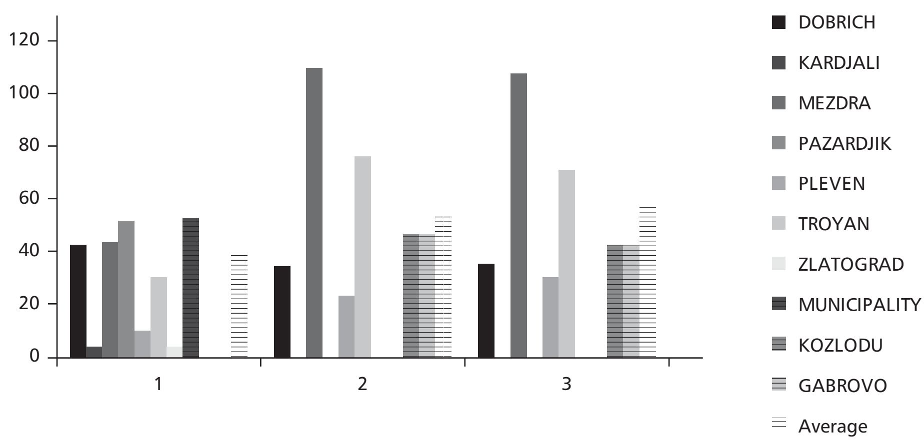


This is an indicator of technical efficiency, which shows how efficiently the lighting of a territory is organized. But it does not tell if this is a result of good design or just of poor quality of the service—too few street lamps. So this indicator has to be used together with some quality indicators like beneficiary satisfaction.

Garbage Collection

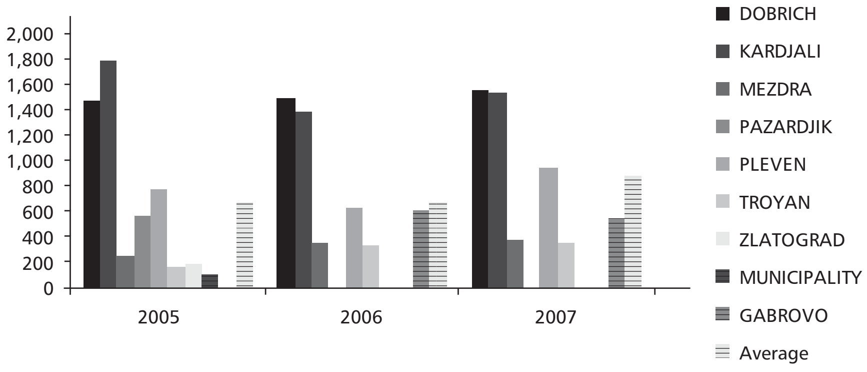
Indicators of Effectiveness

Figure 21.
Operational Costs/Collect Waste (Tons)



This is typical unit cost indicator, which indicates the overall cost efficiency of garbage collection so it should be used in conjunction with the previous indicator.

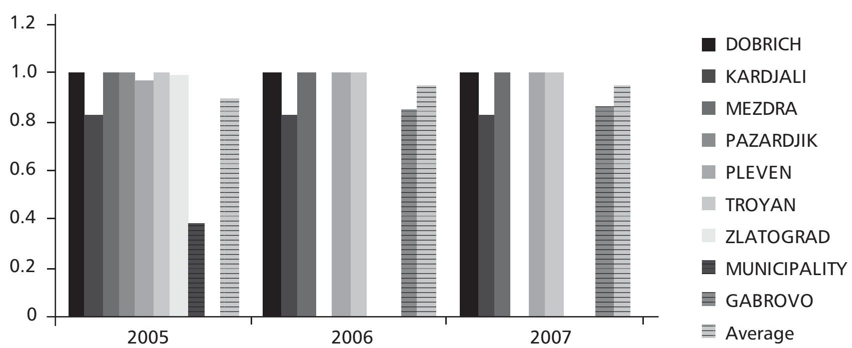
Figure 22.
Operational Costs/Total Volume (m^3) of the Waste Collection Container



This is again a unit cost indicator, which indicates the cost efficiency in the management of available assets. But it does not tell if these assets are too big or too small.

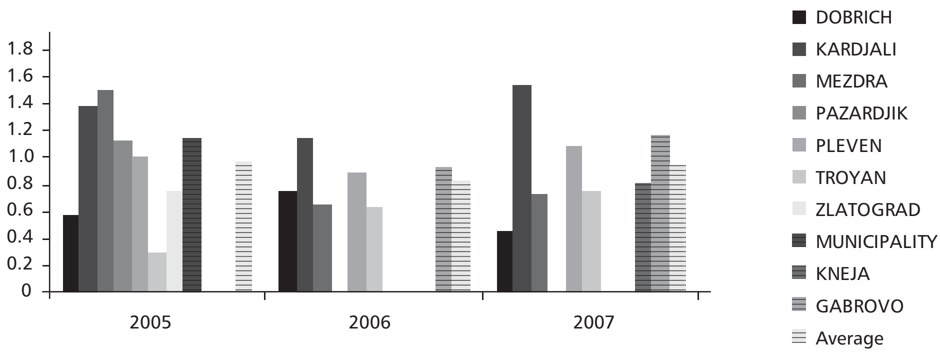
Efficiency and Quality Indicators

Figure 23.
Attended Population/Total Population



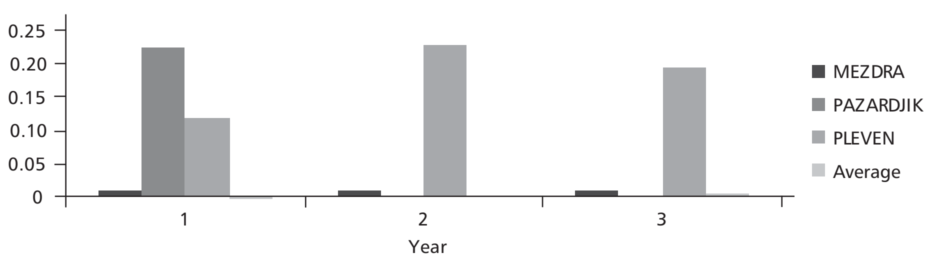
This is an output indicator which shows the scope and coverage of the service and its accessibility.

Figure 24.
Household Waste Fee Revenue/Cleaning Activities Expenditures



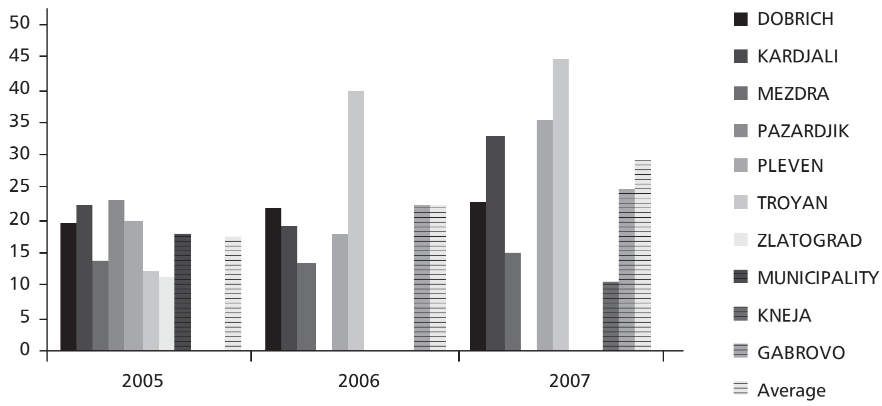
This indicator shows if the service is financially sustainable. If revenue is much lower that the expenditures this may be due to a high rate of subsidizing the service or to very low cost efficiency. This indicator can be misleading if used as a stand alone but quite revealing in a package with other indicators.

Figure 25.
Recycled Water (Tons)/Total Collected Waste



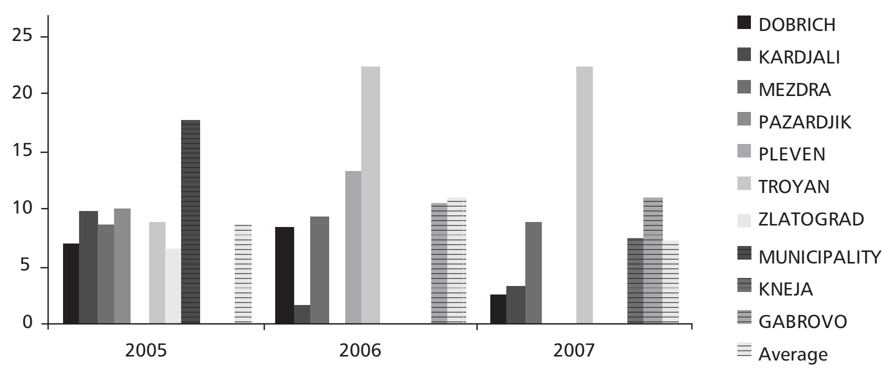
This is an indicator of the quality of the service in terms of reducing the ecological damage and other positive externalities.

Figure 26.
Household Waste Fee Revenue per Inhabitant



This indicator shows how "expensive" the service is to the inhabitants. It is a unit price indicator (or a proxy for a unit cost indicator), which has to be used together with quality indicators.

Figure 27.
Household Waste Fee Revenue from Physical Persons per Inhabitant

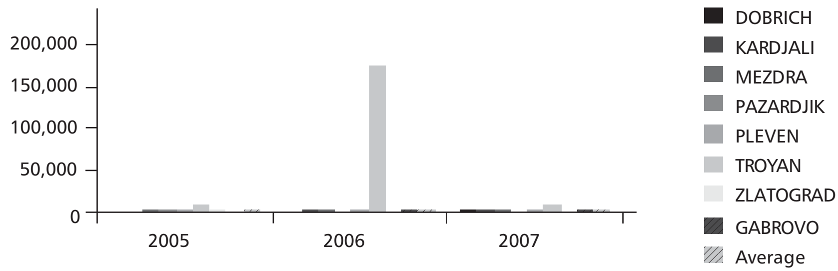


This is the same indicator as the previous one but excluding legal entities (businesses, etc.).

Street Cleaning

Indicators of Effectiveness

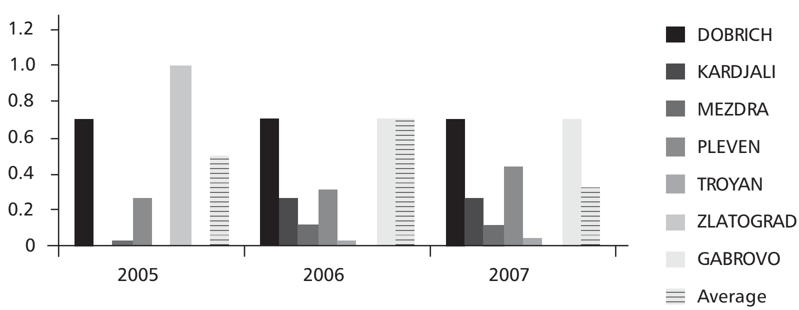
Figure 28.
Operational Costs/Cleaned Areas



A typical unit cost indicator using natural units. It shows the overall cost efficiency of the service production.

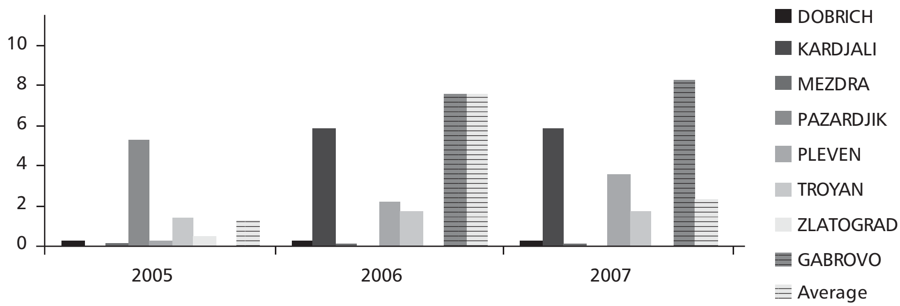
Efficiency and Quality Indicators

Figure 29.
Kilometres of Cleaned Street/Total Kilometres of Street



This indicator shows the quality of the service. More cleaned streets mean a larger scope of service and can be even regarded as a better quality if we take the cleaning of the city to be an integral task. So it is important to use this indicator in conjunction with the unit cost indicators to guarantee that what appears to be efficiency does not come in the shape of very poor service quality.

Figure 30.
Decares Cleaned Streets per Year/Total Number of Working Days

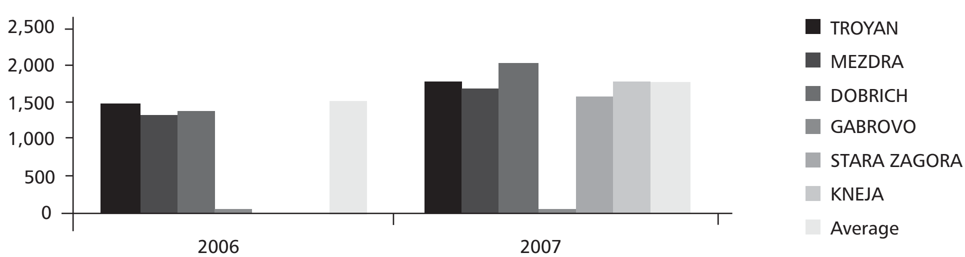


This is indicator of technical efficiency, which shows how technologically advanced the production of the service is. It may also show, other things equal, how well the service is managed and whether there is redundant staff.

Kindergarten

Expenditures

Figure 31.
Per Child Costs in Kindergarten



Maintenance costs of the kindergarten per child

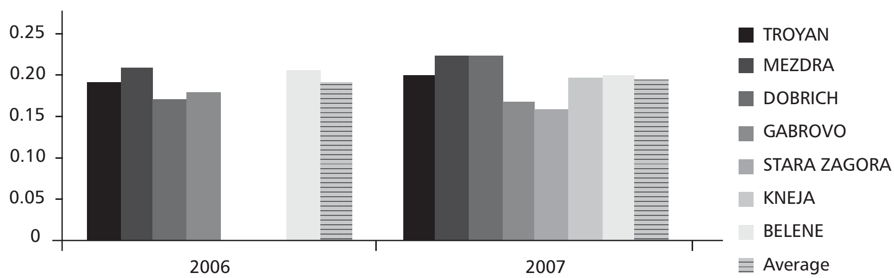
- Share of the maintenance costs of the kindergarten in the total current costs
- Share of the labour costs of the kindergarten per child
- Share of the labour costs of the kindergarten in the total current costs

- Costs for additional provision of pedagogical services per child in the kindergarten
- Share of the costs for additional provision of pedagogical services in the kindergarten in the total current costs
- Capital costs in the kindergarten per child
- Share of the capital costs in the kindergarten in the total costs

These are indicators of the overall service provision and of specific aspects of cost efficiency. These indicators should be used together with quality assessment indicators and interpreted with care. For example, a high share of the labour costs and low share of maintenance and capital costs may indicate that there are too many teachers per child or that the service is underfunded.

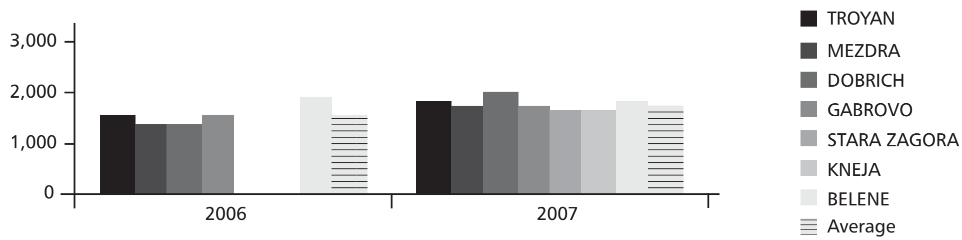
Indicators of Effectiveness

Figure 32.
Number of Children per Employee in Kindergarten



This is an indicator of technical efficiency. Like all similar indicators it should be used together with quality assessment indicators to guarantee this high technical efficiency does not come at the expense of overcrowded classes and poor teaching. In the above case not just the pedagogical but the whole staff is considered.

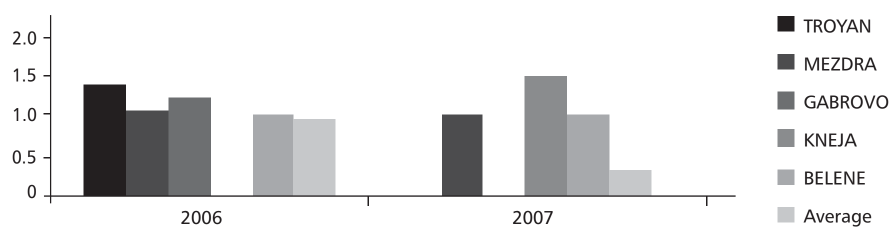
Figure 33.
Current Costs per Child in Kindergarten



A typical unit cost indicator focusing on operational costs. Low operational costs per child again may be a sign of good management but can also be a result of underfunding if they come at the expense of an essential deterioration of the quality of the service.

Efficiency and Quality Indicators

Figure 34.
Share of Kindergarten-age Children Who Attend Kindergarten
in the Total Number of Kindergarten-age Children

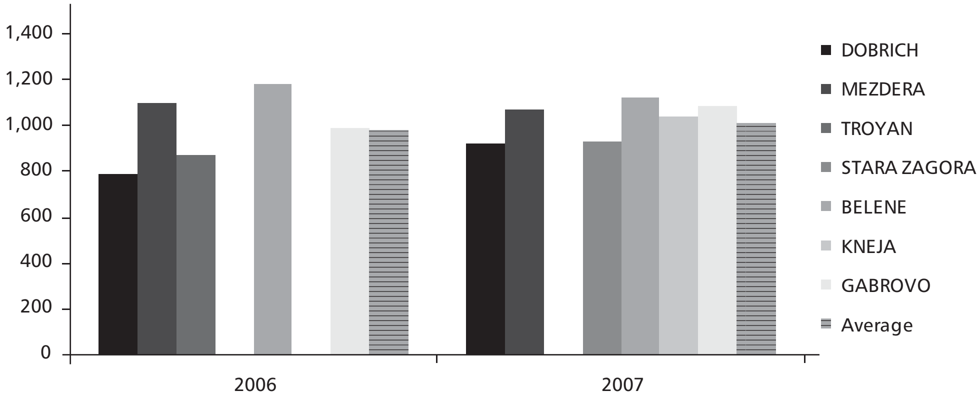


Enrollment rates are a key indicator of the quality of educational services, as well as of access and equity. So they should always be used together with cost efficiency indicators.

Schools

Expenditures

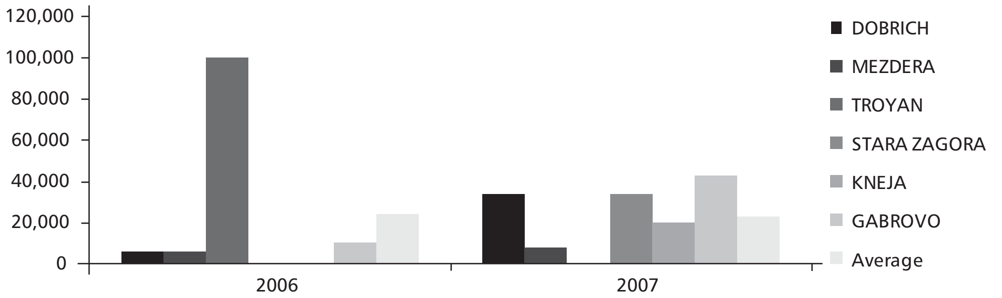
Figure 35.
Total General Secondary School Expenses per Student



This is the classical cost efficiency indicator in education.

- Share of the labour expenses of the general secondary schools per student
- Share of the labour expenses of the general secondary schools in the total current expenses
- Share of the expenses for additional pedagogical services (including free choice subject) in the general secondary schools in the total current expenses
- Capital expenses of the general secondary schools per student
- Share of the capital expenses of the general secondary schools in the total expenses

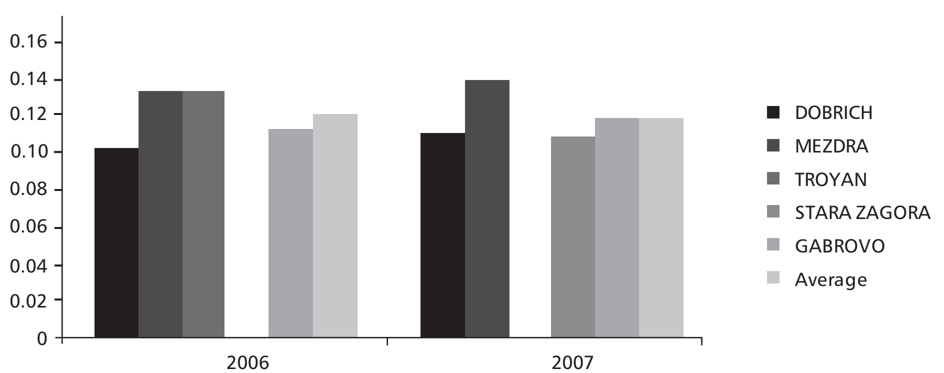
Figure 36.
Capital Expenses per Student



As in the case with kindergartens, these indicators should be used together with quality assessment indicators and interpreted with care. For example, a high share of the labour costs and low share of maintenance and capital costs may indicate that there are too many teachers per child or that the service is underfunded.

Indicators of Effectiveness

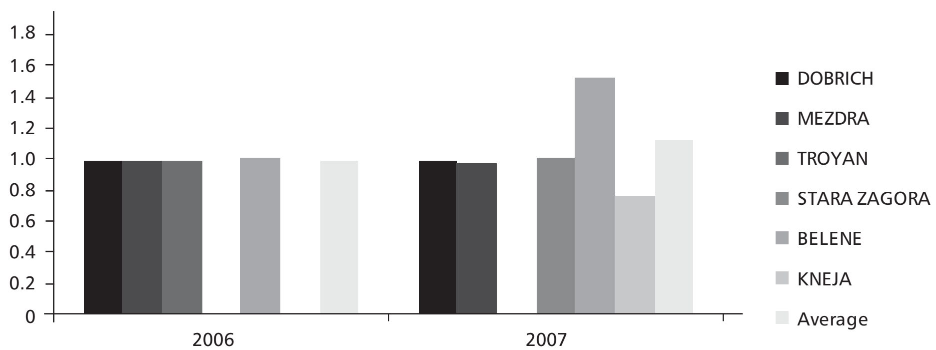
Figure 37.
Number of Students per Employee in the General Secondary Schools



This is an indicator of technical efficiency. Many indicators of technical efficiency show if a certain service is produced with more or less physical inputs measured in natural units. Usually technical efficiency translates into cost efficiency, although there are exceptions. The teacher/student ratio is one of the most closely monitored indicators in education. In this case again, efficiency gains have to be weighed against quality benefits. A low teacher/student ratio may sometimes be a sign of too low workload for the teachers but it may also be a chance for more individual work with the students and better student outcomes.

Efficiency and Quality Indicators

Figure 38.
Share of the School-age Children Enrolled in Schools
in the Total Number of School-age Children



Enrollment rates for school-age children are one of the major indicators of how the education system performs. No cost efficiency indicator should be used without checking it against the potential impact on enrollment rates. For example, the recent abrupt introduction of per student funding at very low rates lead to the closure of more than 300 (more than 12% of all) schools in Bulgaria in a single year. But this cost efficiency dividend came at too high social cost, abruptly decreasing enrollment rates.

The results from the survey were discussed at a roundtable with the participating municipalities to have their feedback on the interpretation of results. Then the final document was presented to the administration of each municipality by highlighting the main relevant findings, especially the areas where, according to comparative benchmarking in the corresponding municipality, there is room for improvement.

Another example of an analysis of municipal efficiency from Bulgaria focuses on the revenues and expenditures of the large cities, which function as territorial governments. Five-year time series (2003–2007) of main revenue and expenditure budgetary items were collected and analyzed for four large cities—the capital Sofia, Plovdiv, Varna, and Bourgas. Plovdiv is the second biggest city in Bulgaria after the capital located in the south-central part of Bulgaria. Varna and Bourgas are the third and fourth biggest cities in Bulgaria both located on the Black Sea cost. The analysis demonstrated that the revenues of these largest municipalities grew at the same pace as the rest of the municipalities in Bulgaria with the exception of the municipality of Varna, but it was due mainly to an increase in their own revenues with constant or decreasing subsidies from the central government.

Figure 39.
Consolidated Budget Revenues of the Municipality of Sofia 2003–2008

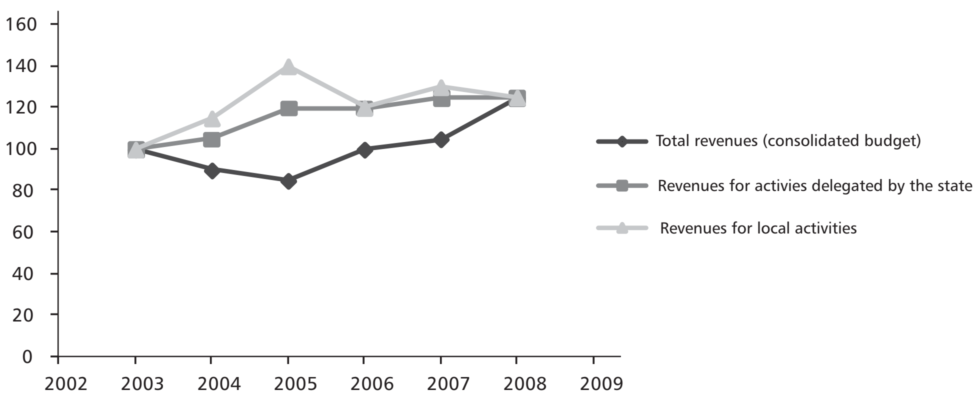
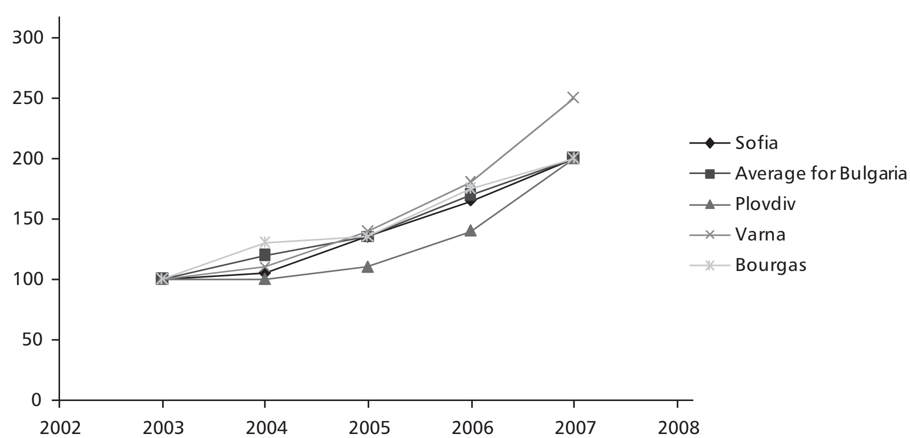


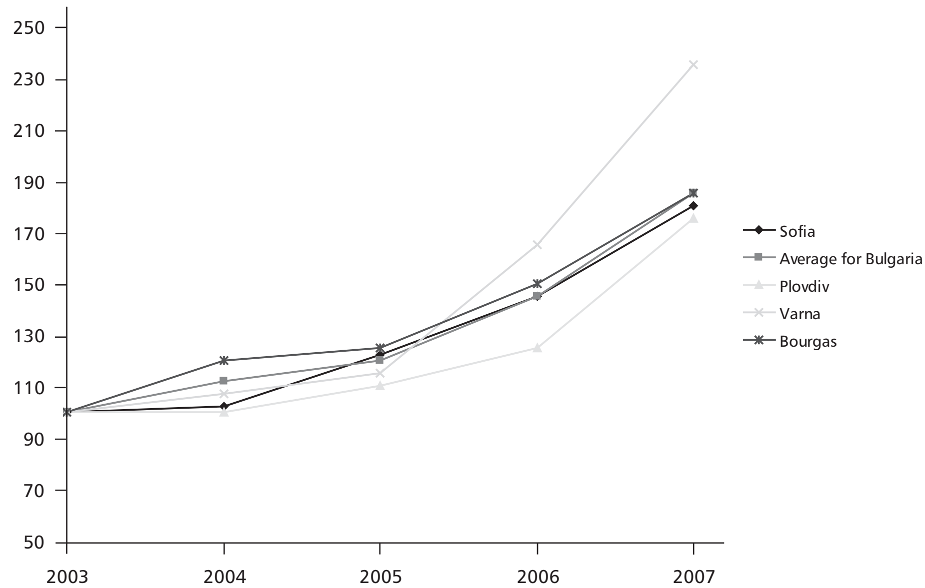
Figure 40.
Consolidated Budget Revenues 2003–2007
(Four Cities and Average for Bulgaria)



The biggest decrease was in the transfers for capital investment.

On the expenditure side again the four biggest cities were no different from the average municipality in Bulgaria in terms of per capita expenditures and expenditure growth.

Figure 41.
Consolidated Budget Expenditures 2003–2007
(Four Cities and Average for Bulgaria)



Policy Alternatives

The difference between what was done before the crisis and what will likely be the priorities now in terms of municipal efficiency can be illustrated by the following matrix of policy options. To keep things simple, the matrix is two-dimensional, containing only generalised input and output. Both the input and the output side can, of course, be broken into lower order items.

Input	Output		
	Compromise	Same	Increased
Reduced	X (1)	X (2)	O/X (3)
Preservation		Business as usual	O
Increased			O

Notes: O—before the crisis, X—during the crisis.

Inputs in this case refer to all resources, which are used to produce an output. This includes all operational costs and investments. Outputs are local goods and services. For the sake of simplicity and clarity both growing output volume and improving quality count as increased output.

When we discuss the policy approach to efficiency the usual dilemma is whether we should be concerned mostly with inputs or outputs.

The usual target in less turbulent times is to improve the quality of the services even if this is related to increasing costs or making additional investments. In times of crisis as budgetary constraints become tighter, inputs will likely become the major priority. So the main concern of those responsible for the funding, organization, and delivery of services at the local level will now become how to keep costs from rising or how to reduce them without too much compromise. Any increase of inputs whether in the form of additional costs or new investment is quite unlikely.

During a crisis there are three options:

Option 1.
Minimize the compromise on outputs resulting from forced expenditure cuts and thus reduce the social cost of the crisis. This is the most typical situation when decisions have to be taken under pressure, when budgetary constraints have started to work already. The main question is how to reduce costs without making too much of a compromise with quality. This can be achieved through wrapping up less essential services or cutting the costs, which will marginally have a lesser effect on the volume and quality of the services provided.

Option 2.
Keep the quality and reduce costs. The reduction of some costs may not affect the volume and quality of the services at all. Such costs are unnecessary but in affluent times there is sometimes little incentive to look for them. Identifying which costs can be reduced harmlessly is a matter of performance measurement. The identification of such costs usually requires comparative studies across local authorities using benchmarking or unit cost analysis.

Option 3.
Reduce costs and improve quality. There are some cases when it is possible to improve quality and reduce inputs at the same time. This is usually related to technological improvement and requires a substantial investment, which takes some time to pay back. This is hardly the first thing that anyone would risk doing during a crisis. But still if a countercyclical intervention can be combined with efficiency gains in the long run, it might work well during a crisis. In some cases, however, the mere improvement of the management of services, identifying and propping cost "leakages" through performance evaluation, can produce a similar effect.

Annex II

Benchmarking Water Supply Management in Hungary

The Benchmarking Club of the Hungarian Waterworks Association was founded in 2007. While water and wastewater service providers had for some time already been planning to start process benchmarking in Hungary, the impetus came after the International Benchmarking Network for Water and Sanitation (IBNET) survey was successfully completed and participating companies could start to compare their performance to that of their peers.

The IBNET survey in Hungary was carried out by the Hungarian Environmental Economics Center (abbreviated in Hungarian as MAKK). MAKK cooperated with the Hungarian Waterworks Association in order to identify water and wastewater utilities which would properly represent the water utility sector in Hungary. The sample included mid-sized and large utilities from all seven regions of Hungary, with a mix of government-owned regional utilities, local-government-owned utilities, and privately operated companies.

Water utilities in Hungary have long been contributing data to a wide range of surveys, including mandatory data provision to government agencies and authorities, and voluntary participation in industry surveys and chamber of commerce data collections. The companies, however, rarely received a structured feedback with analysis of the collected data. As part of the IBNET exercise, they were promised a report describing the results of the survey, and each participating company would also get a set of diagrams showing the performance of the company in specific areas compared to the whole sample.

Twenty-two companies decided to take part in the survey, while data on two privately operated companies, which refused to participate, were collected from public sources, including their websites, annual reports, and media articles. The experts of MAKK created an English language report to accompany the data sent to the World Bank, and produced, in Hungarian, a report as well as the company specific diagrams. The results of the IBNET survey were also presented at the annual gathering of the chief financial officers of the main water utilities of Hungary.

The feedback from the IBNET survey was appreciated by the participating companies as well as the officers of the Hungarian Waterworks Association. Besides receiving useful results, the IBNET benchmarking exercise also served as an example showing how a benchmarking process can be executed in practice.

The IBNET survey was a good start, but some of the companies wanted to go even further. They sought to collect additional data, some of it rather country-specific, compute additional indicators, and start an actual exchange of best practices. Thus, in early 2007, the Benchmarking Club was founded.

Participating Companies

While the Benchmarking Club operates under the aegis of the Hungarian Waterworks Association, membership in the Club is optional to its members. At the beginning, 18 companies chose to participate, while additional utilities indicated that they would consider membership after the first year of operation. In early 2008, two more utilities signed up for membership.

Member utilities provide about 60% of all drinking water service, and collect a little over 25% of all wastewater generated in Hungary. There is substantial diversity among members. The smallest utility sells about 1.3 million m^3 of water annually, while sales at the largest one exceed 150 million m^3/year. Some of the companies operate in a major town—with or without serving neighbouring smaller communities—while seven of the participating utilities serve smaller settlements, with the average number of inhabitants below 2,000 per settlement.

Hungary has flat as well as hilly terrain. Again, there is substantial geographical variation among members of the Club. Some of the members serve just one or two larger towns in a flat terrain, while others serve dozens or even hundreds of small villages in hilly and mountainous areas. The source of water is also diverse for the companies; some get their water primarily from bank filtered wells, while others use deep strata water or carstic supplies.

The large diversity of conditions under which the companies operate is appealing when one would like to understand the operation of the whole water and wastewater utility sector of Hungary. Nevertheless, this variety also has a shortcoming; comparison of performance indicators among companies needs to be done with caution, carefully considering differences in operating conditions.

Rules of Operation

The Benchmarking Club has a management board with five members, who are elected for a period of three years and represent member companies. A mixed board of financial experts as well as engineers is preferred. The management board meets about six times a year, and its main responsibility is to make sure that the Club is operated smoothly and in a professionally coherent manner.

The following eight thematic working groups have been set up to define the data to be collected and the performance indicators to be computed.

1. Operating conditions
2. Water service
3. Wastewater service
4. Customer relations
5. Human resources
6. Investments
7. Corporate management/Strategy
8. Finance/Accounting

Each working group has four or five members, who are experts of the member companies in the field of interest to the group. The groups also provide whatever theme-specific assistance is needed within the Benchmarking Club.

The actual benchmarking process is carried out by independent experts. The Hungarian Waterworks Association decided to contract the same experts from MAKK who originally carried out the IBNET survey. Since these people have since moved to the Regional Centre for Energy Policy Research (REKK) at Corvinus University in Budapest, REKK was contracted to provide the professional services to the Club.

REKK, in cooperation with the thematic working groups, develops the data collection methodology, including an Excel-based questionnaire. The questionnaire is to be reviewed and updated annually in the spring, based on experience gained during the previous year. The questionnaires are filled in by the utilities during May and June and then they are returned to REKK, where the received data is screened for errors, and then inserted into a database. REKK then computes indicators and also compiles summary tables of those data of which indicators are not computed, e.g., information on the strategic planning processes applied by the companies. The companies receive the first results of the benchmarking exercise early in the autumn, just in time to use them for their annual fiscal planning.

An important rule within the Benchmarking Club is that of the confidentiality of individual company data. Within the Club only average figures are shared and the companies receive only their own individual indicator values, but not that of the others.

The main cost related to the operation of the Benchmarking Club is the consultant fee paid to REKK. Utilities pay a Benchmarking Club membership fee to the Hungarian Waterworks Association, and the Association will then pay for the services of REKK. Additionally, the Association provides the meeting rooms and other infrastructure needed for Club meetings, and assists in administrative matters, such as correspondence and keeping minutes.

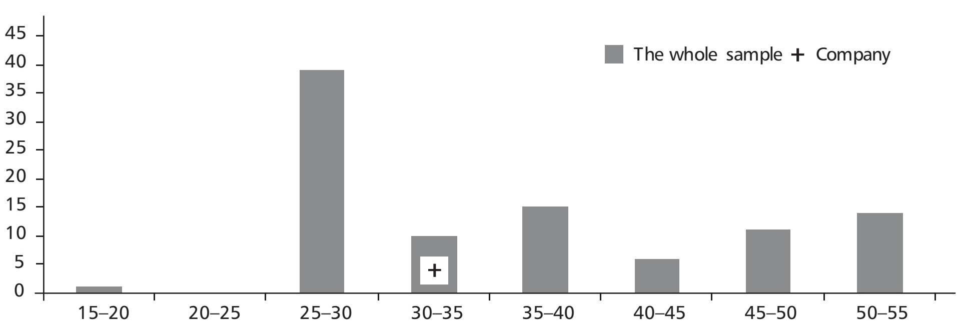
Annual Results

At the end of the annual benchmarking survey, member companies of the Club receive a company-specific document with over 200 charts and tables, illustrating the relative position of the company in comparison with the rest of the companies.

During the first year of the Benchmarking Club, 150 indicators were computed for two years of data. These indicators were designed by the working groups and the experts of REKK together, partly based on international experience (e.g., IBNET website, IWA publications). For financial indicators until now only nominal values were computed, but in the future inflation-adjusted real values will also be calculated. Indicators on the operation of wastewater treatment plants were computed separately for small, medium, and large plants, because of the differences in technologies and economies of scale. While the surveyed data was thoroughly defined in order to ensure consistency across the sample, the results showed that some of the data needs to be further defined, for instance, costs relating to maintenance vs. repairs, outstanding revenues, and the number of drinking water samples satisfying specific standards.

For each of the indicators, a chart depicted the distribution of the values of the whole sample as well as the company's own value, as illustrated in Figure 42. The document also included a table with the average and standard deviation figures for all indicators, as well as the company's own indicator values. This feedback provides utility managers a chance to observe the performance of their company in comparison with others, without seeing the individual indicator values of all the other companies, keeping with the data confidentiality rules of the Club.

Figure 42.
The Position of the Company Compared to the Distribution of the Indicator Values of the Sample



By mid-2008, three years of data was available (2005–2007) for many of the indicators, making it possible to generate time series in addition to annual indicator values.

Companies often prefer to compare themselves to a subset of the whole sample—utilities operating under similar conditions. Therefore, utilities are assigned to groups based upon specific criteria, and the indicator values for each of these groups and for all indicators are also computed. The table below includes the average values of selected groups for one of the indicators, the unit operating cost of water service.

Table 16.

Unit Operating Cost of Water Service in Selected Group

Group	Indicator value (HUF/m^3)
Average number of inhabitants per town —below 3000 (small towns)	224
Average number of inhabitants per town —above 3000 (larger towns)	170
Standard deviation of the altitude above sea level of the service area—above 30 meters (relatively hilly area)	237
Standard deviation of the altitude above sea level of the service area—below 30 meters (relatively flat area)	162
Volume of water sold per km of water network (m^3/km/year)—below 6500 (sparsely populated area)	220
Volume of water sold per km of water network (m^3/km/year)—above 6500 (densely populated area)	167
Population served with drinking water —less than 85,000 (smaller company)	207
Population served with drinking water —more than 85,000 (larger company)	179
Volume of delivered water —less than 10 million m^3/year (smaller company)	203
Volume of delivered water —more than 10 million m^3/year (large company)	180

Note: In March 2008 the USD–HUF exchange rate was at around 167.

Another type of output that companies receive is the distribution of the values of a given piece of data. For instance, a company may compare the age composition of its wastewater network to the average age composition of the sample companies, as illustrated by below.

Table 17.
Example for a Distribution Table

Age distribution of the wastewater network as of 31 December 2006	Average of the sample	Company
0–10 years	46.6%	22.2%
11–20 years	26.7%	31.0%
21–30 years	10.8%	2.8%
31–40 years	8.6%	7.1%
41–50 years	5.0%	33.5%
51–100 years	2.2%	3.4%
>100 years	0.1%	0.0%
Total	**100.0%**	**100.0%**

Lastly, information was collected about the practice of corporate management and the processes and tools used for strategic planning. This information, by its nature, is not numerical, and instead of computing indicators, summary tables were assembled showing, for instance, the number of companies using certain standards, or a list of the strategic objectives set forth by the management.

In addition to the company specific documents, an annual report is also compiled and shared among members of the Club. While this report does not include individual utility data, it contains all the average and standard deviation values, summary tables compiled from the responses of the companies, the methodologies used during the benchmarking exercise, and conclusions reached through analysis of the data. This document is available to all the members of the Club, but not to external utilities and organizations.

Results are used by the companies in a number of ways. The most typical is identification of areas where performance can be improved, i.e., where other companies with similar operating conditions operate more efficiently or at a lower cost. Benchmarking also provides feedback on the success of strategic initiatives—whether they ensured top performance among companies. Once time series of indicators are available, management can gauge the impact of changes in the company's operations, such as organizational or process reforms, new technologies, or acquisitions. One of the utilities mentioned that they used the results from the first year of the Benchmarking Club to justify the proposed tariffs when they had to be approved by the municipal owners of the utility. Another utility used the results to discuss the potential for cost reduction, again, with municipal decision-makers.

Sharing Best Practices

Getting information on the relative performance of a company is useful in itself, but knowing which companies are best in a field, and the reasons for their good performance is even more attractive. Since company specific data is handled confidentially, a mechanism was devised to unveil companies with good performance. For each indicator the three companies with the best indicator values were identified, and were asked if they were willing to disclose their identity. Since companies are not "ashamed" by their good performance, they usually agreed to reveal their names and indicator values.

After the list of good performance is compiled, it is shared with all member companies so that they can select those companies, the experience of which they would like to hear about, with regard to specific fields of operation. After the feedback from all companies has been compiled, it is the task of the management board of the Benchmarking Club to organize meetings where best practices are shared via presentations and discussions. The first such meeting took place in March 2008, and three topics were presented and discussed:

- Ratio of electricity costs among the operating costs of water production.
- Leaks and other technical problems of the water network.
- Cost savings and enhanced biological pollution reduction through improved wastewater treatment techniques.

Sharing of best practices may also take place on company grounds, especially when newly introduced technologies are displayed to the members of the Benchmarking Club.

Future Plans

The Benchmarking Club of the Hungarian Waterworks Association took a promising start in 2007. By the end of its first year, the Club had a thoroughly designed set of operating rules, a dedicated management board, thematic working groups which created and then refined the benchmarking survey and the indicators to be computed. The participating companies, for the first time ever, received a large set of data and charts illustrating their positions compared to all other water and wastewater utilities within the Club.

In February 2008, member companies adopted the 2008 work plan, which called for revision and more precise definition of some of the data to be collected, international cooperation, more active exchange of good practices, and initiatives to recruit additional member companies. Some of these items are detailed below.

In many ways 2007 can be viewed as an experimental or pilot year of the Benchmarking Club. The data survey was ambitious, and in the beginning it was unclear if certain pieces of data can be collected with ease or not. By now there is a good understanding of the data generating capabilities of the member companies, and subsequently, the survey can be adjusted and specific pieces of data will also be redefined.

Some of the companies expressed their desire to gain an international perspective of their performance. Therefore, in 2008 the indicator values of foreign utilities, especially other Central European utilities, were computed and used as part of the benchmarking exercise. The necessary data was gathered from international benchmarking surveys, such as the IBNET. There are also discussions of cooperating with other water utility associations in the region, with the vision of setting up an international benchmarking program.

One of the strategic goals of the Club, for 2008 and beyond, was to recruit additional members. This goal was partly driven by the desire to improve the statistical significance of results, and to allow advanced statistical analysis of the data set, which requires a larger sample size. A larger membership would contribute to wider application of prevailing good practices among Hungarian water and wastewater utilities.

Acknowledgments

This report has been compiled by an editorial group team comprising Kenneth Davey (Overview and Efficiency chapters), Sorin Ionita (Financial Analysis), Katalin Tausz (Social Protection), Boyan Zahariev (Efficiency), Gabor Peteri (Capital Financing) and Pawel Swianiewicz (Territorial Reform). Valuable comment has been provided by Jorgen Lotz.

The Regional Centre for Energy Policy Research, Corvinus University–Budapest, kindly agreed to the reproduction of the Annex to the Efficiency Chapter.

The group is also grateful for access to the Council of European Municipalities and Regions (CEMR) January 2009 survey of responses by national associations of local government, the papers submitted to OECD's conference on the crisis and sub-central fiscal policy on 12 June 2009 and EUROSTAT data.

The data for this research was supplied by the governments of the respective countries and with the assistance of the following team of country observers:

Country	Observer
Armenia	David Tumanyan
Bosnia and Herzegovina	Sabina Derviefendvic and Zdravko Miovcic
Bulgaria	Yana Kirilova
Croatia	Katarina Ott
Czech Republic	Vera Kamenickova
Estonia	Andres Vork, Katarina Rebane
Georgia	David Melua
Hungary	Gabor Peteri
Moldova	Viorel Furdui
Poland	Julita Łukomska
Romania	Otilia Nutu
Russian Federation	Galina Kurlyandskaya
Russian Federation	Irina Turgel and Elena Tselishcheva
Serbia	Dusan Vasilievic
Slovakia	Yaroslav Pilat
"the former Yugoslav Republic of Macedonia"	Marjan Nikolov
Ukraine	Yuriy Dzhgyr and Katerina Maynziuk

We would like to thank to the governments and CDLR members from Albania, Denmark, Finland, France, Germany, Greece, Ireland, Latvia, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, and the United Kingdom for providing the data used as reference for this report and for the valuable comments on the relevance of the policy options discussed.

List of Figures and Tables

(Excluding Annexes)

Figures

Tables

How have local budgets fared in the recession? And, more importantly, how are local governments across Europe coping with the prevailing fiscal crisis? What, if anything, can be done to minimise harm to the public services they perform?

These questions are addressed in this updated version of the report presented to ministers responsible for local and regional government at their 16th Council of Europe conference in Utrecht in November 2009. The analysis was prepared by a team convened by the Local Government and Public Service Reform Initiative of the Open Society Foundation (LGI) and the Council of Europe's Committee on Local and Regional Democracy (CDLR), as part of their established collaboration. This report is based on Eurostat end-of-year data for 2009 and a survey of policy responses conducted by observers in Council of Europe member countries.

How far the situation will improve and how quickly are far from certain. Threats of a double-dip recession are receding, but experience has shown that the worst impact of previous recessions has been felt by local budgets two to three years after general economic recovery as national governments try to restore their own fiscal fortunes and cut back on intergovernmental transfers. Local government is faced with the possibility of this happening again in 2011 or 2012. There is also the likelihood of long-term increases in expenditure arising from the ageing of European populations and measures to combat climate change.

This report was presented at the conference "Local Government: Responses to Recession across Europe" held in Strasbourg in October 2010, which brought together specialists from international organizations, governments, and local governments' associations of the 47 member countries of the Council of Europe.

The report discusses ways in which local governments are seeking to cope with continuing fiscal strain.

COUNCIL OF EUROPE CONSEIL DE L'EUROPE

Local Government and Public Service Reform Initiative

OPEN SOCIETY FOUNDATIONS

ISBN 978-963-9719-21-7