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**Report by OSI/LGI to the Council of
Europe:
"The impact of the economic downturn on
local government: what is happening and
what can be done about it?"**

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

Disclaimer:

The content of this report reflects the views of its authors and not necessarily those of the Council of Europe, the Open Society Institute and Local Governance and Public Service Reform Initiative.

Table of contents

List of tables, figures, abbreviations	5
Acknowledgements	6
List of contributors.....	7
CHAPTER I: OVERVIEW	9
1.1. Introduction	9
1.2. Impacts.....	9
1.2.1. The crisis	9
1.2.2. Current revenues: taxation and fees	10
1.2.3. Revenues: intergovernmental transfers.....	12
1.2.4. Current expenditure	12
1.2.5. Capital budgets	13
1.2.6. The overall impact.....	14
1.3. Responses	15
1.3.1. The need for policy responses	15
1.3.2. Reforms of intergovernmental financial relations	16
1.3.3. Improving accountability and efficiency	18
CHAPTER II: COMPARATIVE ANALYSIS OF EUROPEAN LOCAL BUDGETS IN CRISIS	24
CHAPTER III: LOCAL CAPITAL INVESTMENTS	33
3.1. Impact of economic downturn on municipal investments	33
3.1.1. Significance of local investments	33
3.1.2. Declining local capital expenditures	33
3.1.3. Drop in local own source capital revenues	36
3.2. Launching stimulus programs or coping with restrictions?	38
3.3. Local options for increasing capital investments.....	39
3.3.1. Competition for public funds	39
3.3.2. Better access to external resources	40
3.3.3. Increasing own capital revenues.....	42
3.3.4. Local borrowing.....	42
3.3.5. Improved project preparation and management.....	43
3.3.6. Indirect measures for improving local investments	44
3.4. In search of new national policies	44

CHAPTER IV: IMPROVING EFFICIENCY	46
4.1. Introduction	46
4.2. The role of benchmarking	46
4.3. Performance audit	47
4.4. Efficiency in social expenditures	47
4.5. Regulation of expenditure	48
4.6. Delegating institutional management	48
4.7. Local government audit	49
4.7.1. External audit	49
4.7.2. Internal audit.....	50
4.7.3. Scope of audit.....	51
4.7.4. Access to audit reports.....	51
4.7.5. Human resources	51
4.7.6. Conclusions	52
 CHAPTER V: TERRITORIAL REFORMS AS A POTENTIAL RESPONSE TO THE ECONOMIC DOWNTURN	 53
5.1. Introduction	53
5.2. Territorial consolidation (amalgamation).....	55
5.3. Inter municipal co-operation (IMC)	57
5.4. Conclusions	57
 CHAPTER VI: SOCIAL POLICY CONNOTATIONS OF THE ECONOMIC DOWNTURN	 58
6.1. Changing European societies.....	58
6.2. Social assistance systems and responses to the crisis.....	66
6.3. Workfare and/or welfare.....	70
6.4. Lessons	73
 ANNEX I: Bulgarian experiences in promoting municipal efficiency	 75
 ANNEX II: Benchmarking water supply management in Hungary	 92

List of Tables and Figures (excluding Annexes)

Table 1. Local investments as a percentage of general government public investment	34
Table 2. Changes in local capital investments	35
Table 3. Local government capital revenues	37
Table 4. Actions to improve the access to EU funds	41
Table 5. Changes in the local government borrowing	43
Table 6. Seasonally adjusted unemployment rates	59
Table 7. Expenditure on social protection (% of GDP)	61
Table 8. Social protection receipts (by type)	62
Table 9. Changes in social benefits between 2000 and 2006	63
Table 10. Changes in social benefits from 2000 to 2006	64
Table 11. Changes in social protection expenditures	68
Table 12. Changing in financing of social assistance and social services	69
Table 13. The method of allocation and prioritizing the needs of the poorest households	69
Table 14. Orientation of the activation measures directed to people on social assistance	71
Table 15. Activation of the safety net	72
Figure 1. Trends in local revenues (all tiers combined) and inflation	25
Figure 2. Stages of the crisis and local budgetary revenues	26
Figure 3. Trends in national and local revenues, Q1 09 / Q1 08, %	27
Figure 4. Trends by mid-2009	28
Figure 5. Financial autonomy in local governments: own revenues in total (2008)	29
Figure 6. Trends by type of local revenue, Q1 09 / 01 08	30
Figure 7. Trends by sub national tier, Q1 09 / Q1/08	31
Figure 8. Distribution of municipal governments according to their population size in countries of Central, Eastern and South Eastern Europe	54
Figure 9. Poverty rate projections	58
Figure 10. Social protection spending, regional averages	60
Figure 11. Structure of social protection expenditure in EU 27, 2006	63
Figure 12. Persons at risk of poverty, 2006 (% of the total population)	65
Figure 13. Means tested social benefits, 2006 (% of total social benefits)	66

Abbreviations (in the alphabetical order of acronyms)

AL - Albania	IE - Ireland
AT - Austria	IS - Island
BE - Belgium	IT - Italy
BG - Bulgaria	LT - Lithuania
CH - Switzerland	LU - Luxembourg
CY - Cyprus	LV - Latvia
CZ - Czech Republic	MT - Malta
DE - Germany	NO - Norway
DK - Denmark	PL - Poland
EE - Estonia	NL - Netherlands
EL - Greece	PT - Portugal
ES - Spain	RO - Romania
FI - Finland	SE - Sweden
FL - Liechtenstein	SI - Slovenia
FR - France	SK - Slovakia
HU - Hungary	UK - United Kingdom

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CHAPTER I: OVERVIEW

1.1. Introduction

Local government across Europe is bound to suffer from the prevailing economic crisis. But how much? How far are the impacts cushioned by national counter-cyclical grants or delayed by taxation time-lags, and for how long? And what, if anything, can be done to lessen the harm to the public services it performs?

These questions are addressed by this analysis, for consideration by the Council of Europe Conference of Ministers responsible for local and regional government and as a basis for discussion at its 16th session in Utrecht. It has been prepared under the auspices of the European Committee on Local and Regional Democracy (CDLR) by a team convened by LGI (the Local Government and Public Service Reform Initiative of the Open Society Institute) and the Council of Europe, as part of their established collaboration¹.

1.2. Impacts

1.2.1. The crisis

The World Bank expects the world economy to contract by 3% in 2009; OECD predicts a fall of 3.7% in its member states' GDP over the same period. EUROSTAT records a drop of 4.5% in the European Union over the year to March 2009, with performance differing radically between member states, from a decline of 18.6% in Latvia to a slight growth of 1.9% in Poland.

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 western European countries. This undermined banks who had provided mortgages too generously, again initially in the United States but soon infecting European banks who had bought into the sub-prime mortgage market. Bank failures and bailouts by national government dominated the first three quarters of 2008. Those banks which 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 through:

- 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.

¹ The team has been greatly assisted by observers in 32 countries who have supplied data on the financial performance of local governments up to the first half of 2009 and commented on the relevance to their countries of the policy options discussed below.

The collapse of housing markets has 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:

- Rising unemployment (17.9% in Spain, 40% in Kosovo²);
- 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%);
- A massive fall in foreign investment in Eastern Europe, forecast at 55% in 2009;
- Dramatic falls in remittance income to the labour exporting states which is estimated to provide 30% of GDP in Moldova, 15% in Bosnia Herzegovina;
- Large government budget deficits (14.4% of GDP in the United Kingdom, 10.6% in Spain) and resulting increases in public sector debt.

Inevitably this has subjected local governments to a ***budget squeeze*** between falling revenues and the rising costs of debt service and social assistance to affected households, or will do so sooner or later. The timing and magnitude of that impact depends however, on both 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:

- The severity of the downturn;
- The parallel fortunes and responses of national government;
- The nature of the 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 2009 are based on collections in 2007 (a similar delay occurring in Belgium) while business tax payments are assessed on turnover in 2008, leading to a one year delay 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 revenue from property taxes has been the least affected by previous economic downturns, personal income taxes moderately vulnerable, taxation of business turnover more responsive and of corporate profits the worst affected. These statistics confirm common sense expectations and are borne out by experience so far of the current recession.

² "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."

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 DC) where assessments are automatically indexed to changes in market values. This is not the case, however, in those European countries where property taxation is 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 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.

Property tax receipts are, however, vulnerable in times of recession to growing default and to pressure, particularly from business owners, for exemptions and reductions. The UK tax on commercial property is forecast to fall slightly in 2009/10. In France President Sarkozy has promised to abolish the *Taxe Professionnelle* which is assessed on the rental value of business assets. Rural municipalities in Poland have 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* (who are also faced with the major costs of social assistance). In Bulgaria revenue from this source in the first five months of 2009 has only reached 40% of the level over the same period in 2008. 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 and Switzerland.

Rising unemployment obviously hits PIT revenues, and those still in 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 already experienced an 11.6% fall in corporate profits tax shares in the year to March 2009, and Finnish municipalities expect revenues from their 22.3% share of this tax to be 24% lower in 2009. Polish regions have received 15.7% less from their share in the first half of 2009. Portugal reports reduction in Municipal Contributions (a surcharge on corporate profits tax).

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 municipal revenue in Bosnia and yields had already declined by 13.9% in the year to March 2009. A fall of 23% is forecast over 2009 in "the former Yugoslav Republic of Macedonia".

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. Albanian, British, Danish, Finnish, Norwegian, Polish and Swedish governments have compensated local governments for falling revenues and rising expenditures, partly through deliberate counter-cyclical policy and partly as an automatic result of equalisation formulae. Danish fiscal rules require general grants to be counter-cyclical. Norwegian grants have risen by 1.2 billion krone. The Ukraine Government has added 10% of corporate profits taxation to the equalisation pool. The Russian Federal Budget for 2009 includes a 36% increase in transfers to regional governments.

In contrast, Bulgaria has reduced its grant for mandatory services (education, social welfare, health service etc) by 10% in 2009. Serbia has reduced grants by 15bn dinars (equal to 8.5% of total revenue) in 2009. Estonia has reduced its Equalisation Fund by 20% in 2009 while grants for pre-school education and road maintenance have been eliminated in Latvia. The Irish Government has cut its general purpose grants by 9.6% in 2009. The Hungarian block grant has been cut by 2% in 2009, but levels of actual cash payments at the end of May were 18% down on the same stage in 2008. 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 IMF (International Monetary Fund).

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, is rising by 26% in 2009. The burden is particularly severe for those local governments which 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 within them in the severity of the crisis, but also because of great variations in the extent of municipal responsibility in the social assistance sector. 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:

- 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.

Social assistance costs to Polish local government increased 13% at the end of March 2009 (20% in rural municipalities), while costs to Danish municipalities of social assistance and employment initiatives have risen by 8%. Costs to Estonian municipalities have risen by an annual rate of 67%, mostly covered by transfer from state budget, but with a 3% increase in social costs to be covered from local revenues. Slovak local authorities spent 28.6% more on social welfare in the first half of 2009. 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. 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 highly 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 under Polish laws 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 downturn. Accelerated capital investment features prominently in counter-cyclical policy, protecting employment particularly in the damaged construction industry and stimulating consumption generally.

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

- 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% co-funded by recipients);
- Greece has established a €2.3 billion local investment fund jointly funded by Government, the European Union and local authorities;
- Norway is spending 4 billion krone on small local investments.

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 mostly have two common features. They are expected to finance projects that are "shovel ready" i.e. capable of immediate execution. Secondly they frequently have a strong environmental bias; e.g. energy saving modification of public buildings (and occasionally social housing), replacement of street lighting bulbs (Netherlands), 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 environmental development.

Coupled with this effort by national governments is some acceleration in the disbursement of European Union structural funds in new member states. This has involved some relaxation of the EU's own rules; the time limits for utilisation have been extended from three years ("n + 2") to four ("n + 3"), and provision of advance payments has been expanded. 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 pre-financing and non-eligible 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, pre-financing and non-reimbursable 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 preliminary data on the first half of 2009 shows absolute declines in local government revenue (compared to the same period in 2008) in 12 countries. These falls were sharpest (over 10% in real terms) in Estonia, Hungary, Republika Srpska, Serbia and Ukraine. Lower falls (up to 5%) were experienced in Croatia, Finland, Germany, Latvia, Moldova, Russia and Spain. 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 timelags. 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 counter-cyclical policy, a typical situation in western Europe.

In the Baltic States the recession grew rapidly from early 2008 and the impact on local budgets has already been severe. (Estonia expects local revenues to shrink by 16% in 2009, Latvia 23%). 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. Decline in Poland only commenced in the second quarter of 2009.

1.3. Responses

1.3.1. The need for policy responses

Every local government system in Europe is experiencing 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. Most forecasts predict a slow recovery of GDP beginning late in 2009 or 2010, and this is already apparent in France, Germany and the United Kingdom. The rate and extent of recovery, and whether the recovery will be V shaped, U shaped or even W shaped are matters of ardent speculation with no consensus. Everyone agrees that on past experience falls in unemployment, which affect local governments' incomes and costs, will lag behind; (OECD predicts an overall loss of 25million jobs in its member states). Commentators speak of recovery to a "new normal" marked by lower growth rates than recently experienced.

As we have seen, some local revenues will only feel the impact of current circumstances in one or two years' time. Inflation has halted (zero in May 2009 according to EUROSTAT) and construction costs have generally fallen, but 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, 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 G20 summit agreed on the need to sustain fiscal stimulus policies, but how long markets will allow governments to run spending deficits which have grown in the G20 states from 1.1% of GDP in 2007 to 8.1% in 2009, remains to be seen. 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 percentage of 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.

However bad the impact of the downturn on local budgets, that on national finances is generally worse. Country reports show national budgets contracting to a greater degree than local budgets in all except three countries (Serbia, Ukraine 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 co-funded by municipalities). This is rational since gross disparities in local revenue bases were spilling over into basic social provision, a clearly undesirable result. 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 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 which 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. On the other hand French *departements* and *communes* have 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 OSI/LGI 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. 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 which 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 Three outlines three such efforts which 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 which perform well in a comparison of unit costs;
- Benchmarking individual service and administrative service costs carried out in Bulgaria by the Open Society Institute 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.

Performance audit

In 2006 LGI 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 so far implementation has been weak. In particular:

- 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 7455 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) which 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 (its road test should start in late 2009) could be very effective in supporting the improvement of local governance.

Removing incentives to expensive service provision

Administrative and financial arrangements frequently encourage local government 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 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 formulae including the numbers housed or treated. These arrangements may well 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 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 demand 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 numbers while mandated contact hours with pupil are generously low.

Reviewing unsustainable norms

Local governments which would like to cut costs are frequently debarred by national regulation. This applies particularly in countries which 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 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 micro-manage 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 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.

Territorial re-organisation

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 70s 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. Proposals are under discussion to reduce the number of Estonian municipalities by a factor of ten, though these are still far from being accepted.

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 re-organisation, 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 inter-municipal 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 sub-regional 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.

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. LGI funded research 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.

The boundaries of the state

The severity of the crisis in some countries and its abruptness everywhere has 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 challenge 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 non-governmental 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 post-crisis 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 re-centralisation 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.

CHAPTER II: COMPARATIVE ANALYSIS OF EUROPEAN LOCAL BUDGETS IN CRISIS

In mid 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 and data on local budget execution are hard to produce in real time. Virtually all the figures presented here are based on information collected first-hand through a network of local operators and Council of Europe partners, in order to be able to illustrate the trends in the first half of 2009³. Second, sub-national 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 to the public, even among EU member states. As a result, the results should be regarded as still preliminary: the task to integrate everything into a comparative format is time consuming and successive revisions have been necessary as the team continued to receive information from the local operators.

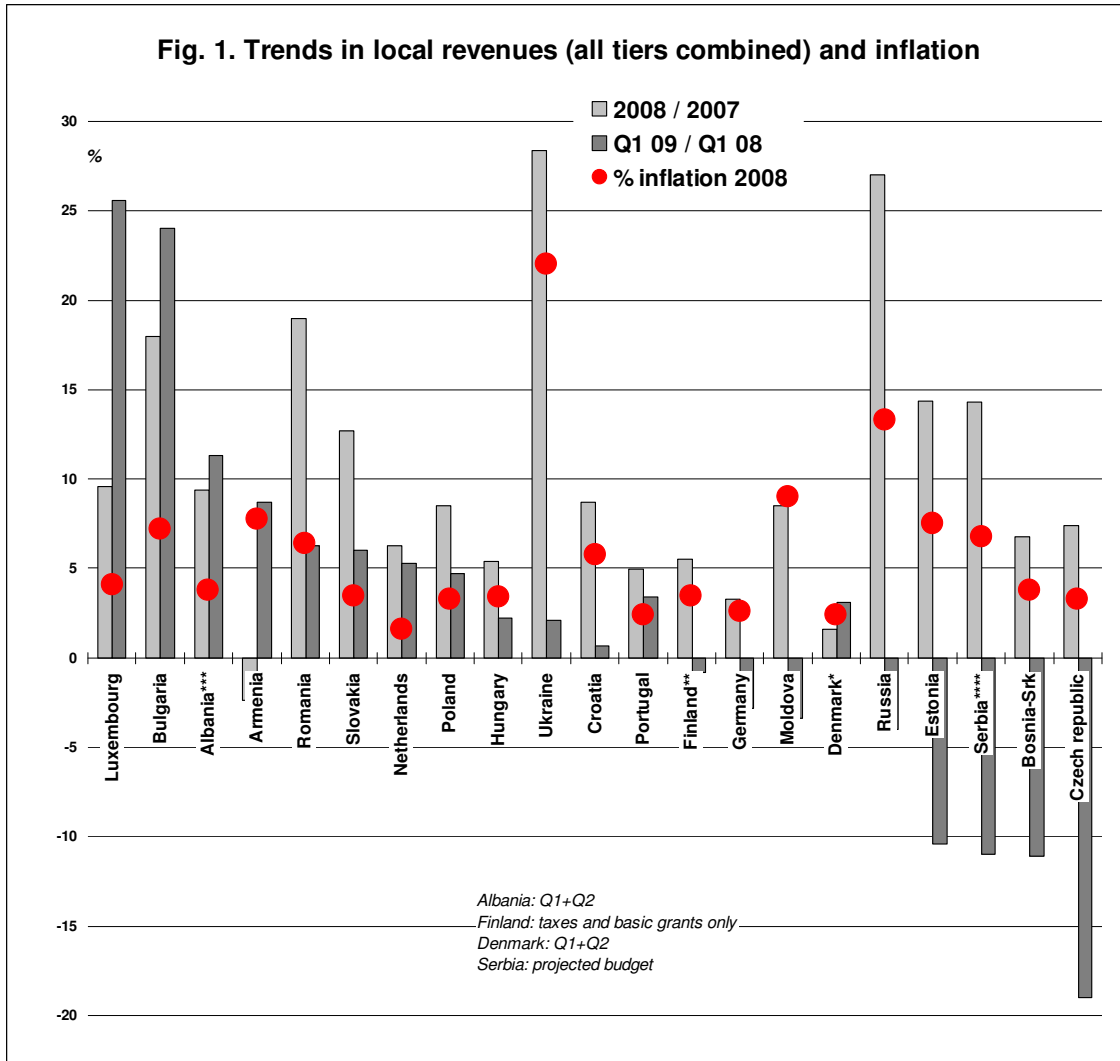
Nevertheless, a number of patterns seem to emerge that enable us to formulate tentative conclusions, most of which are summarized and discussed in the other chapters of this report. In spite of data scarcity on 2009 local budget executions from old EU member states (time lag in reporting and no consistent centralization requirements), it seems that the financial crisis was felt earlier in the public budgets of some Western countries than in the Eastern parts of the continent. While Germany, France or Finland were looking to a decrease in the course of 2009 (which is visible indeed for those of them that made available the budget execution data for the first part of the year), in most Central and Eastern countries local revenues have continued to increase in nominal terms, at least in the first quarter of 2009 (Fig. 1).

Second, it seems that the crisis has not produced a real financial disaster in the European local budgets (with the notable exception of a few small countries in the Baltics and the Western Balkans; Czech Republic, registering a drop in the first quarter of 2009, rebounded spectacularly in the second one). There are two competing explanations for this: the happy scenario is that local finance will survive the crisis better than expected, due to the resilience of the local revenue sources and the timely compensation transfers introduced by central governments (part of the explanation in the Czech case, for instance).

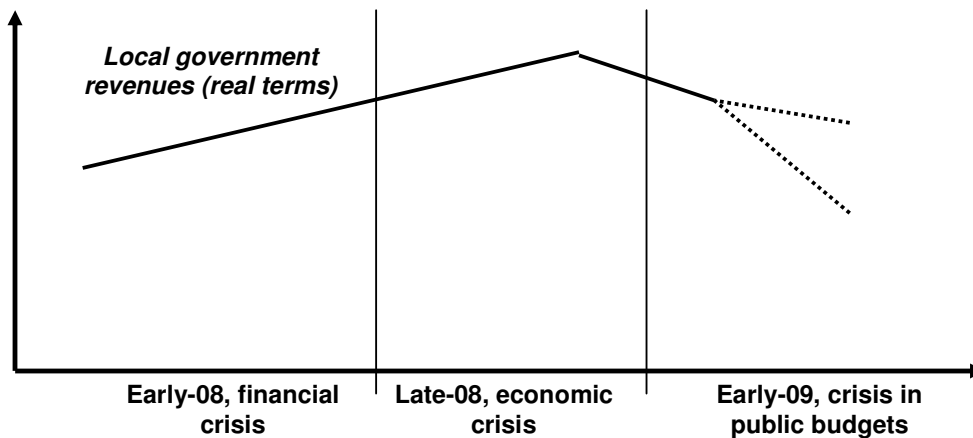
The alternative, unhappy scenario is that there may be only a time lag between the moment the crisis hits the local economy and the moment when this is felt in the local tax collection:

- many own or shared taxes are tied with indicators reflecting last years' performance, and therefore the yield will decline in subsequent quarters (eg property, personal income tax or local business tax in countries such as Luxembourg, Hungary, Slovakia and Romania);
- real estate transaction fees, a source that presumably reacted quickly to the crisis, in synchronisation 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 more information in the second part of 2009.

³ Data was collected from 32 countries from the EU, SEE and CIS in a format designed to allow comparative analysis of trends.



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 is not in sight, in spite of the recent positive signs of recovery in industry; the few data we have at this point from the second quarter of 2009 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 (Fig. 2).

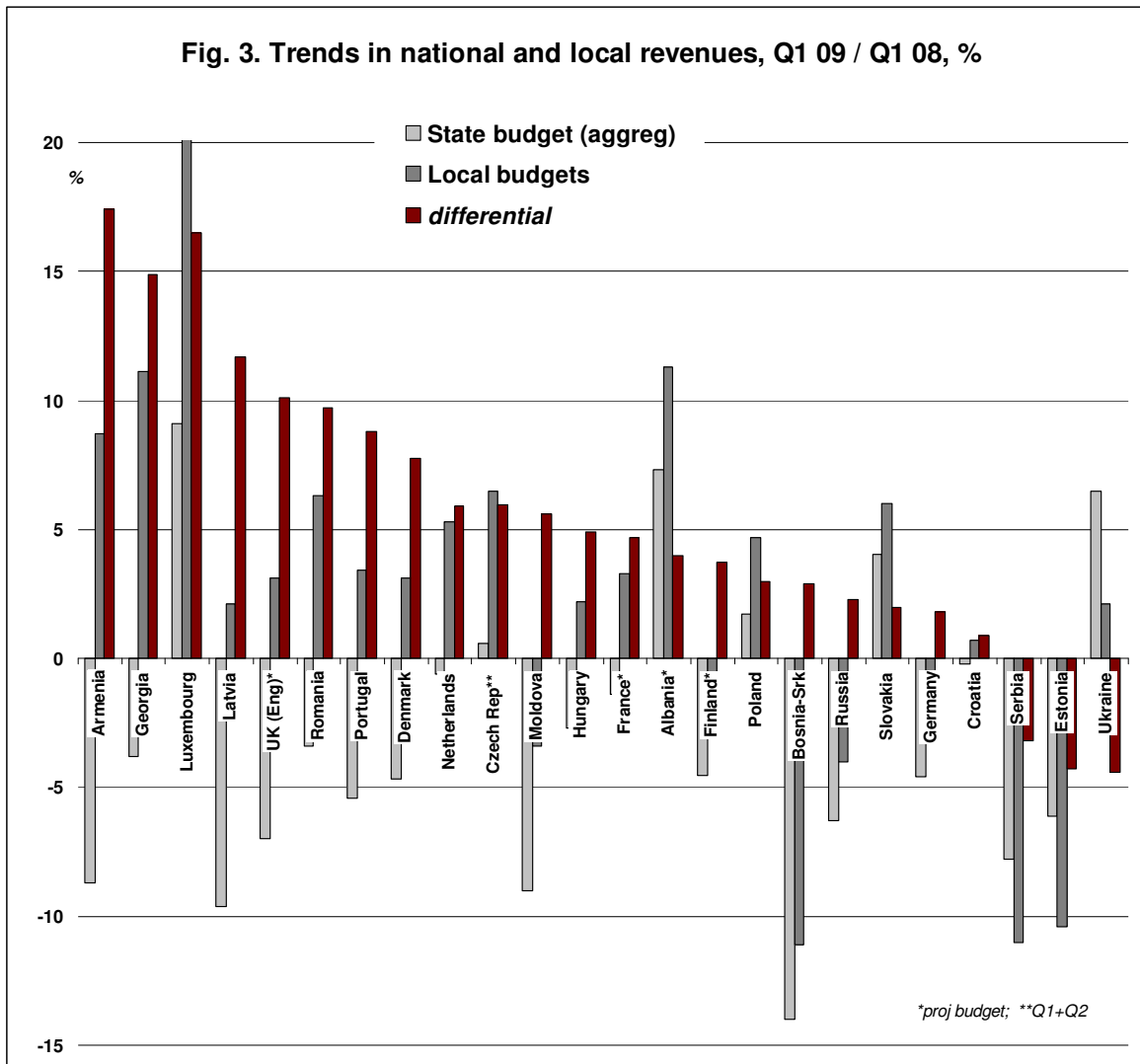
Fig. 2. Stages of the crisis and local budget revenues

Going back to Fig. 1 and analyzing it into 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 Baltics (Estonia) and some West Balkan states, with nominal decline in revenues of more than 10%. To a less extent, this is true for the Republic of Moldova and for the upper tier of the Russian sub-national authorities (the “federal subjects”). However, these are nominal figures.

If we also take into consideration the inflation rate for 2008, the general situation looks much worse: the loss in real terms in Ukraine is dramatic. In fact, the countries where local revenues increased in real terms in the first quarter of 2009 are very few. 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 – 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 all the countries included in this analysis (Fig. 1), only a few months later the picture changed completely 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, too.

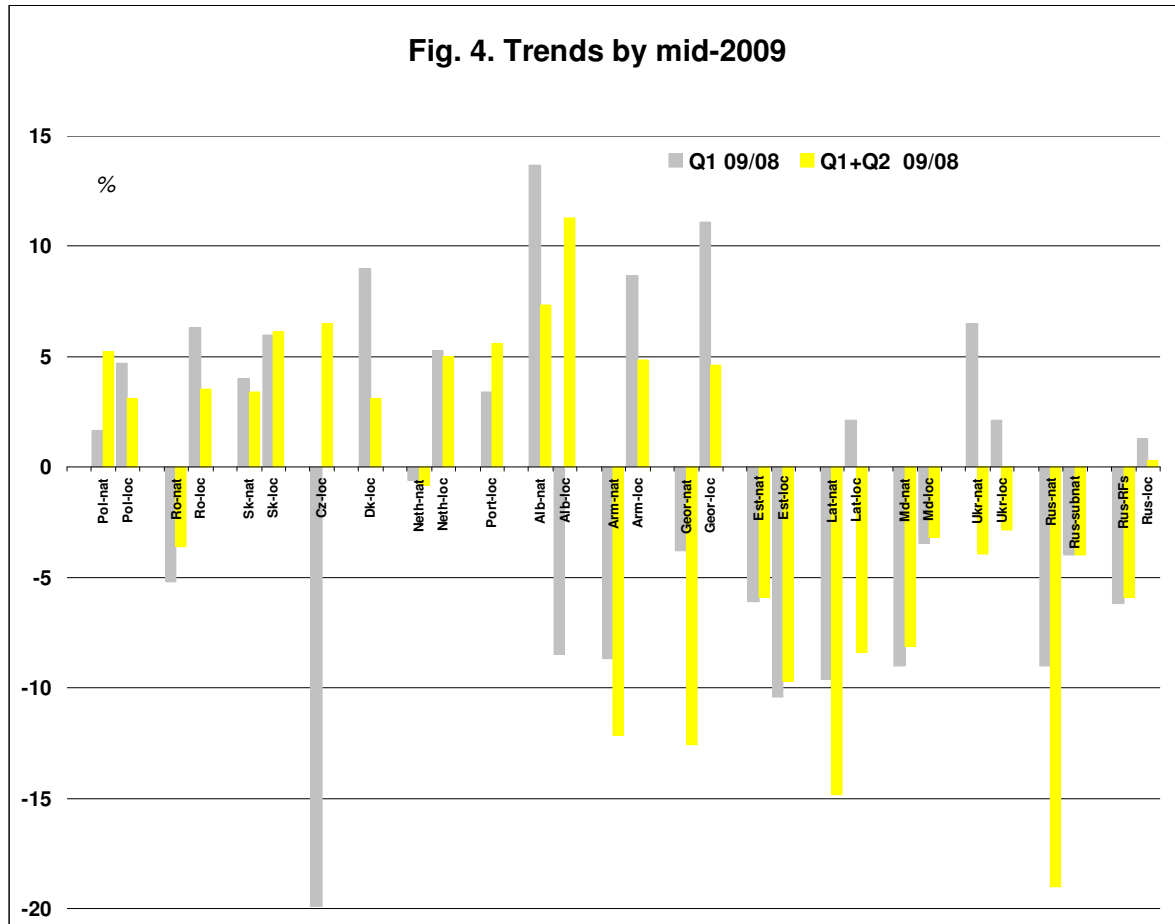
On the one hand, this change may help focus the attention on efficiency and performance management, objectives often honoured more often in words than in deeds. With less resource available, decision makers have now to face the tough choices they might have avoided in the years of plenty. In this sense, 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.



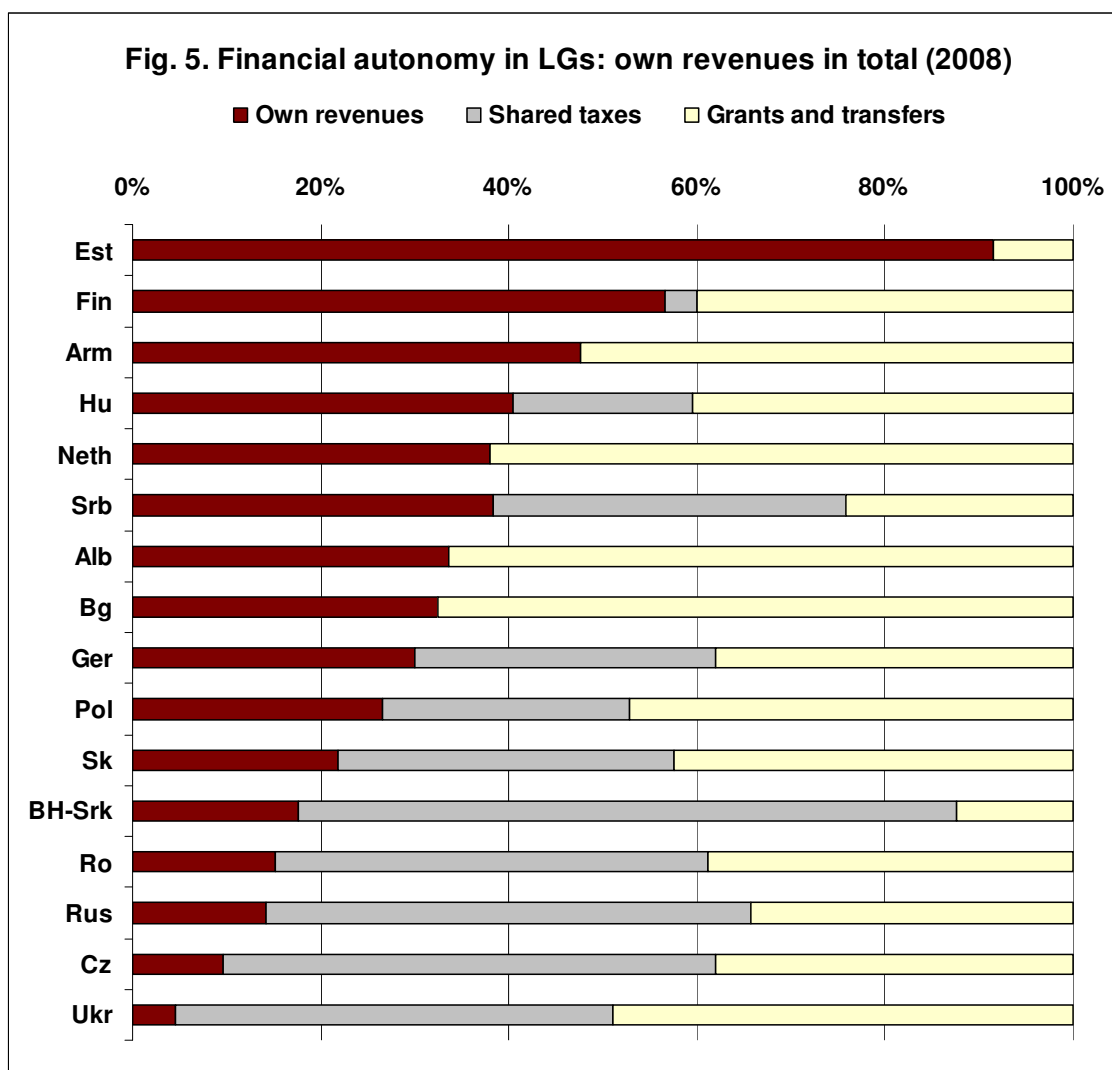
There are reasons for optimism in local communities due to the fact that in most of the countries surveyed the budget crunch at the beginning of 2009 did not affect them disproportionately. With the exception of Serbia, Estonia and Ukraine, the central government was hit hardest and local budgets comparatively less, as Fig. 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 (Denmark, Portugal, Netherlands, Hungary, Romania, Croatia and even the hard-hit Latvia and Moldova; or France and 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. Or it may be just that revenues at the central level are by comparison more volatile.

Both explanations may be true: there is evidence that in most places the central transfers were indeed bolstered, as the charts below show; and 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:

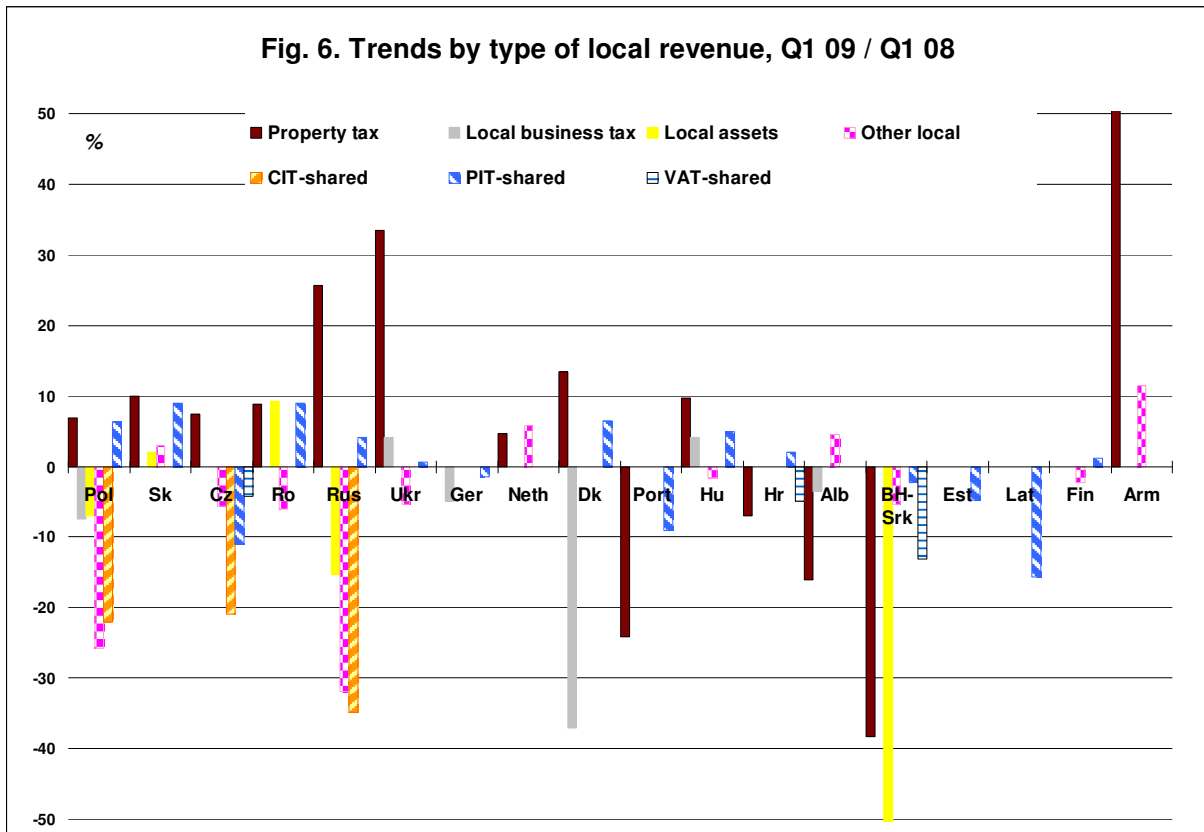
- The local revenues may decline later on (the time lag effect mentioned);
- Even when central governments manage to over-compensate losses at the local level (transfers larger than the drop in revenues), these extra funds are usually earmarked. As a result, the local budget may be larger, but the autonomy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



The data available at this point do not allow us to draw a reliable picture of the situation in mid-2009. Only 15 countries provided information on budget executions in the second quarter, all but three of them from Central and Eastern Europe (Fig. 4). A downturn is obvious in large countries like Ukraine and Russia: both at the central and local levels in the first case; especially at the federal level in the second. Otherwise, by and large the local budgets followed the trend from the first quarter of the year, growing at a slower pace (Netherlands, Denmark, Poland, Romania, Russia) or faster (Portugal, Slovakia, Armenia). This happened both in countries where the GDP held steady (Poland) and in those where a severe contraction is predicted (Romania, where a -8% is expected). In Russia, if the upper tier of sub-national 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. In Slovakia, Czech Republic and Albania, substantive policy changes occurred after the start of 2009 make the situation in the first two quarters hard to compare (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, as Fig. 5 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 and Republika Srpska local government budgets rely predominantly on grants and shared taxes, and 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 forecast for this year, 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: multi-year 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, Slovakia, Hungary.



There is little surprise in the results displayed on Fig. 6: the trends by type of local revenues 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, Russia, Denmark), unless they are tied to lagging indicators (Hungary), in which case the effect is delayed. The regions suffer most from this volatility (as Fig. 7 also shows) since CIT shares tend to be a source assigned to this tier;
- Proceeds from the VAT shares, common in the ex-Yugoslav states (Croatia, Serbia, Republika Srpska) also marked a steep decline; the same happened in the Czech Republic;
- Personal income tax proves to be more resilient in the first stages of the crisis, with the exception of the Baltic States, where unemployment shot up and this was reflected in the public budgets. Its yield also dropped in the Czech Republic and Portugal, but rebounded in the second quarter of 2009. 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;

- With the exception of some small West Balkan states and the Iberian peninsula, the property tax holds well in crisis. However, there may be problems in the future with payments from companies, especially in countries where they are able to reassess the property value in their books: 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 towards companies, by increasing the rates or the collection effort. Another problem may appear in those countries (UK) where a policy exist 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.

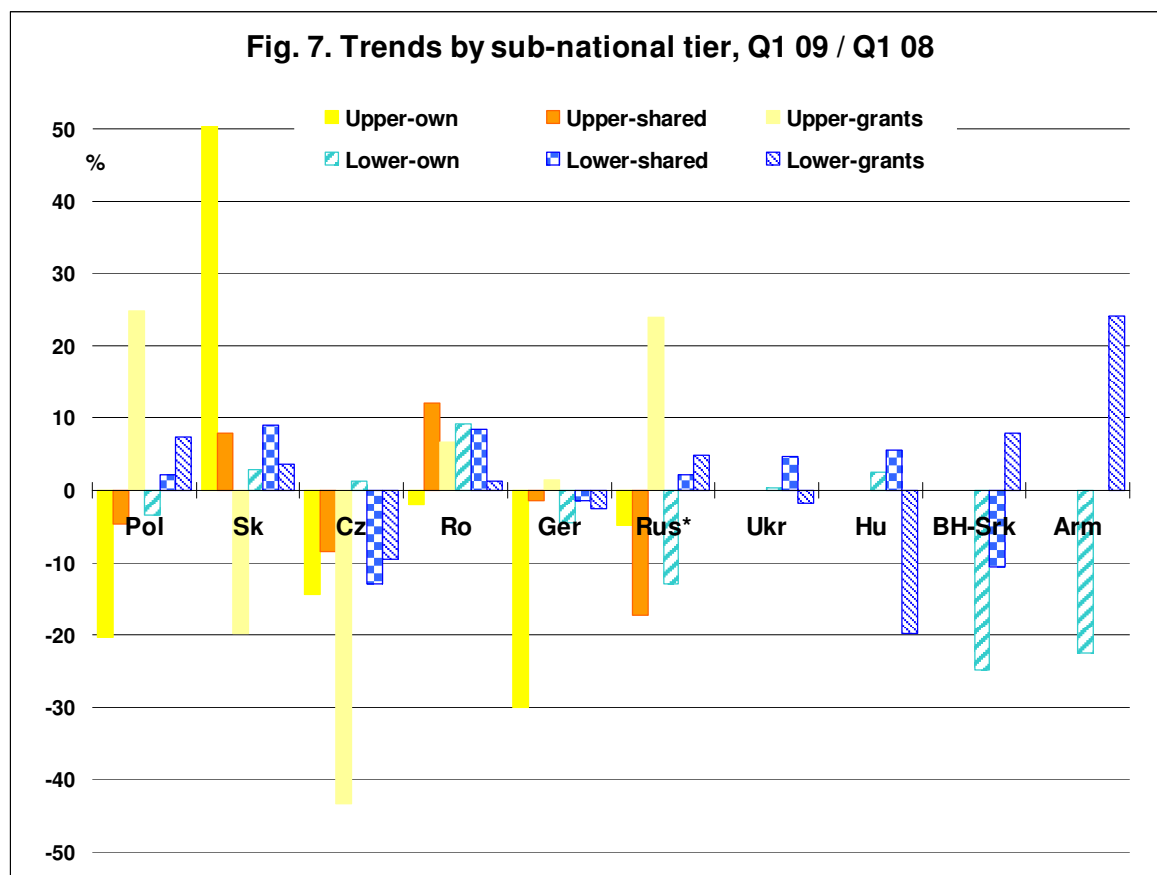


Fig. 7 differentiates the impact of the crisis by tier of sub-national government. Again, we face the problem of the small number of countries in which the 2009 data allow such a breakdown. Nevertheless, the point made above about the greater vulnerability of upper-tiers is confirmed: German Länder, Polish and Czech regions or 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 happens in Romania (though by not having regions, its upper level LGs are not directly comparable with the others) and it would most probably have happened in Slovakia as well, had the government not reassigned an important road tax to the regional level in 2009 (hence, the increase).

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 Fig. 3. This happened obviously in Portugal, Poland, the Czech Republic (allowing both tiers of local government to shift from an overall decrease in Q1 to an increase in Q2), Romania, 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 sub-national 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 the near future. 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 towards them in the 2010 budget cycle or subsequently.

CHAPTER III: LOCAL CAPITAL INVESTMENTS

3.1. Impact of 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 seen 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 governments⁴. 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 showed that fiscal austerity measures decreased sub-national 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 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.)

However, these figures should be *interpreted with caution*. Only two years are compared, 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.

⁴ CEMR, The Athens Communiqué, 24 March 2009

Table 1. Local investments as a percentage of general government public investment

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

Source: Country reports

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 benefitting 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 sharp decrease in municipal capital investments was the decreasing revenues from 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 recently 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.)

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 the 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.

Table 3. Local government capital revenues

1.	Armenia	Asset sale 2008/2007: Q4/Q1 of 2008:	85% 69%
2.	BiH/ Republika Srpska	"Income on the ground of capital" (asset sale) 2008/2007: Q1 of 2009/2008:	347% 123%
3.	Bulgaria	"Other non-tax revenues" ⁵ 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" ⁶	Capital revenues (asset sale) 2008/2007:	101%
15.	Ukraine	"Revenues from capital transactions" Q1 of 2009/2008:	40%

Source: Country reports

⁵ Sales of property, rents, dividends, interests, concessions, donations, penalties, sanctions

⁶ Sample of five cities

3.2. Launching stimulus programs or coping with restrictions?

In Europe – both in the euro area 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 EU27⁷. 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 recent OECD survey showed, in the developed countries significant *economic recovery programs* had been started by the governments⁸. In the period of 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 of 2009⁹.

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.

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 programs¹⁰. 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 recovery¹¹. 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.

⁷ Eurostat (STAT/09/70) report

⁸ OECD Economic Outlook, 2009, Interim Report, Chapter 3. The Effectiveness And Scope Of Fiscal Stimulus

⁹ A European Economic Recovery Plan (COM(2008) 800 final), 2008

¹⁰ Ott, K., 2009: Fiscal destimulation instead of fiscal stimulation. Institute of Public Finance, Zagreb

¹¹ Kraay, A-Serven, L. 2008: Fiscal Policy Responses to the Current Financial Crisis: Issues for Developing Countries, Macroeconomics and Growth Research, The World Bank

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 and/or
- (ii) how they can cope with the consequences of restrictions in the general government budget?

Limited governments might face these two different problems at the same time, when the special counter-cyclical national funds, the new allocation mechanisms of these grants are combined with 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 details:

- 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 schemes;
- 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. Impact of the falling public revenues might be delayed through the revenue sharing schemes. 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 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 anti-crisis 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 NOK 20 Billion 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. Presently 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 towards 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 non-member 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, Estonia; the application and purchasing, *contracting procedures* have been simplified (Estonia, Romania). In Poland the government is committed to support the pre-financing of EU project and *accelerate* the funding of large local infrastructural programs. In Greece a special a non profit organization has been set up to assist those small municipalities which 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 pre-financing of EC projects has had to be increased and member states should enhance the part financed by the Community and bring forward the implementation of major investment projects, *simplify* the treatment of advances paid to the beneficiaries¹². *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.

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

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.

Table 4. Actions to improve the access to EU Funds

1.	Federation of BiH	IPA, Taiex, Twinning programs: awareness raising, capacity development, decrease co-financing, 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 non-profit organization to assist the municipalities in preparing proposals for EU structural funds offer. Preparation of 4 years action plans for the municipalities with population 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 co-financing 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* towards 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 funds¹³.

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 expansion¹⁴. 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 crisis¹⁵. 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 co-financing and pre-financing 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 grew by 1.4%, only. *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 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, Poland issue bonds more actively, because no public procurement 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.

¹³ Desilets, P. (2009): PPPs Projects and Financial Crisis: Short-Term Impacts and Medium-Term Trends Institute for Public-Private Partnerships, Inc.

¹⁴ In the case of China the East Asian crisis was partly managed by lifting the constraints on sub-national 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

¹⁵ Like Kommunalcredit (Austria), Kommunalkredit (Norway) or Dexia. See CEMR survey in March, 2009

Table 5. Changes in local government borrowing

1.	BiH/Republika Srpska	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	66%
		Q2 of 2009/2008	280%
9.	Romania	Loans: Q1 of 2009/2008	125%
		Q2 of 2009/2008	700%
10.	Serbia	Debt service Q1 of 2009/2008	126%
11.	Slovakia	Loans and credits Q1 of 2009/2008	96%
		Q2 of 2009/2008	540%

3.3.5. Improved project preparation and management

The EU fund allocation mechanisms through the *Operational Programs* 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 have, not only general urban and regional development plans, but 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)¹⁶. 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.

¹⁶ <http://www.misp-serbia.rs/en/slap.php>

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 which 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 local level. These measures are partially justified by the high share of local capital investments in the public sector and by the multiplier affect 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, shared and own source revenues.

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 the (i) 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, (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 the 1980 three basic strategies have been crystallized: a) increase in 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 argumentation 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 sector¹⁷. The desire for a “new deal” between different tiers of governments should be also 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, the institutions and procedures developed under the slowly evolving decentralization framework.

¹⁷ Kaufmann, www.thekaufmannpost.net

CHAPTER IV: 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.

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.

Justified as they may be, these are temporary or one-off savings which 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

This is the subject of "value for money" approaches and performance audit systems developed over the last three decades under the umbrella of New Public Management. Three examples can be quoted:

- "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 Institute 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 performance of 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 LGI 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 was so far weak. In particular:

- 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 well 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 which would like to cut costs are frequently debarred by national regulation prescribing inputs rather than outcomes. This applies particularly in countries which 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:

"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 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 micro-manage 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 LGI commissioned reports on local government audit in twelve eastern European countries. The countries covered were Armenia, Azerbaijan, Bosnia 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:

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

In Bosnia Herzegovina, 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 which possess or aspire to EU membership and the arrangement arises from recent reforms designed to conform with *l'acquis communautaire*. 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 non-earmarked 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:

- Armenia: an average of 24 local governments audited annually out of 926;
- Bosnia 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 7455;
- Serbia: the State Audit Institution has not yet been constituted by Parliament.

A rotating national audit is covering approximately one third of local government units p.a. in Croatia and "the former Yugoslav Republic of Macedonia", and one half in Republika Srpska. In Georgia the reorganised municipalities have 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 €100,000 pa), 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 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 falls short of the legal requirement. For example:

- By 2006 only 35% of Romanian authorities obliged to establish internal audit units had done so, and 85% of these had appointed only one member of staff to them;
- In Serbia few municipalities (mainly in Belgrade and Vojvodina) have as yet 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 non-availability 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, in 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 which approves the budget under scrutiny. It is less likely to pay attention to reports which 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 which 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 inter-personal 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.

CHAPTER V: 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 of both Western and Central-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 (experts 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 sub-national 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 is a plentiful of 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 LGI (see Houlberg 2009, in print)¹⁸.

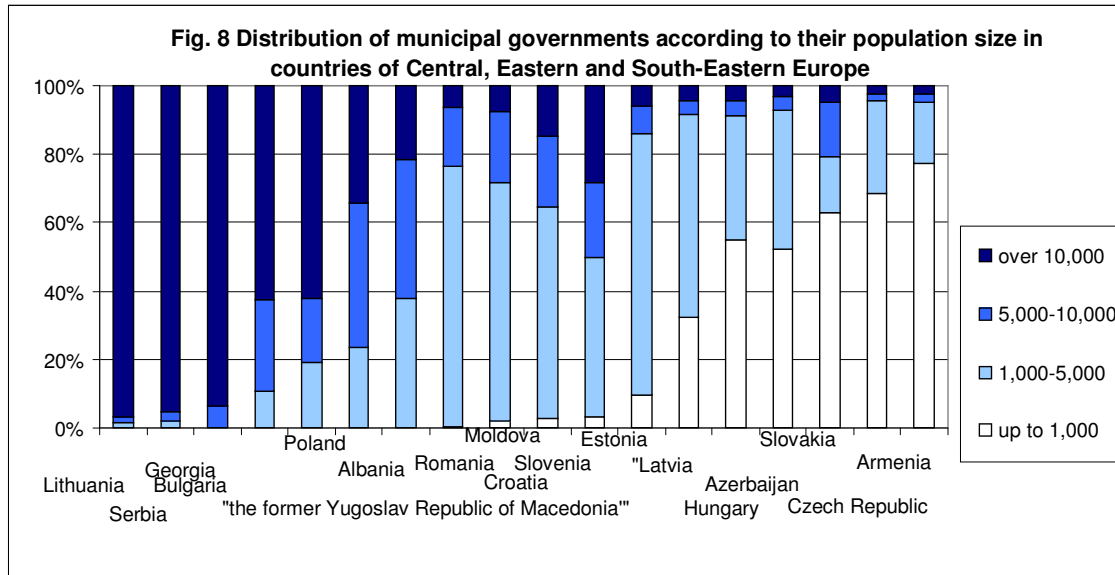
Leaving aside other services, on which arguments are more complex, there is no doubt that size is negatively correlated with spending on administration. As the 2002 study showed (Swianiewicz 2002), in several small Slovak, Hungarian or Czech municipalities, administration consumes close to half of the operating budget, leaving not much for other functions. Houlberg (2009) demonstrates economy of scale effect in administrative spending in Norway, which strongly affects municipalities 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 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 322 PLN, while the median for rural local governments over 10,000 citizens was 210 PLN. A recent careful analysis of one Polish rural government which 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 (leave aside other economic costs, more difficult to measure).

¹⁸ 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 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 bigger 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 believed¹⁹.

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 an 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 1. 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 Kosovo²⁰ is presented in the figure).



¹⁹ Although we should note that Mouritzen was comparing „mid size” with larger local governments. His analysis did not involve very tiny (below 2-3,000 population) municipalities.

²⁰ “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.”

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

1. The most obvious is boundary reform through territorial consolidation (amalgamation);
2. A frequently suggested alternative is developing voluntary or semi-voluntary inter-municipal co-operation;
3. Less obvious and more indirect solutions may include 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 countries of Northern Europe. Reorganisations introduced in Norway, Finland, Sweden, Denmark, Netherlands and 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. 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 sub-national government – *powiat* and *województwo* – was discussed; likewise in Bulgaria, Montenegro or Poland, bottom-up pressure to split existing larger municipalities has occasionally pushed towards 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 post-communist environment one can only point to examples of territorial reforms in Georgia, "the former Yugoslav Republic of Macedonia" and Lithuania – and even in each of these examples there are elements which 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 be now 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 case²¹.

There are a few countries in which territorial reforms are still discussed (for example Armenia, 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 **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 Orange Revolution (including the radical and never implemented Bessmertnyj proposals). Also here, in spite of political chaos in Kiev, the crisis has been used by some pro-reformers as an occasion to exert more pressure for change. On April 24, 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, ie. 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 has submitted in May 2009 a draft law in which provides for transforming current inter-municipal 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 “for ever”), 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.

²¹ My analysis is based on national reports from following countries: Armenia, Bosnia, 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”).

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. Inter-municipal co-operation (IMC)

Some politicians and experts claim that voluntary inter-municipal co-operation may be an 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 saving 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 to 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 inter-communal 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 towards local citizens and the transparency of the decision making process more problematic.

Nevertheless one might expect promotion of inter-municipal 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 or Finland, and in 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.

5.4. Conclusions

The reactions of both central and local governments to the crisis have so far been schematic rather than innovative. Looking for saving through cutting some expenditures, enlarging budget deficits or increasing tax 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 which might undermine their chances to win 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.

CHAPTER VI: 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 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 the 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.

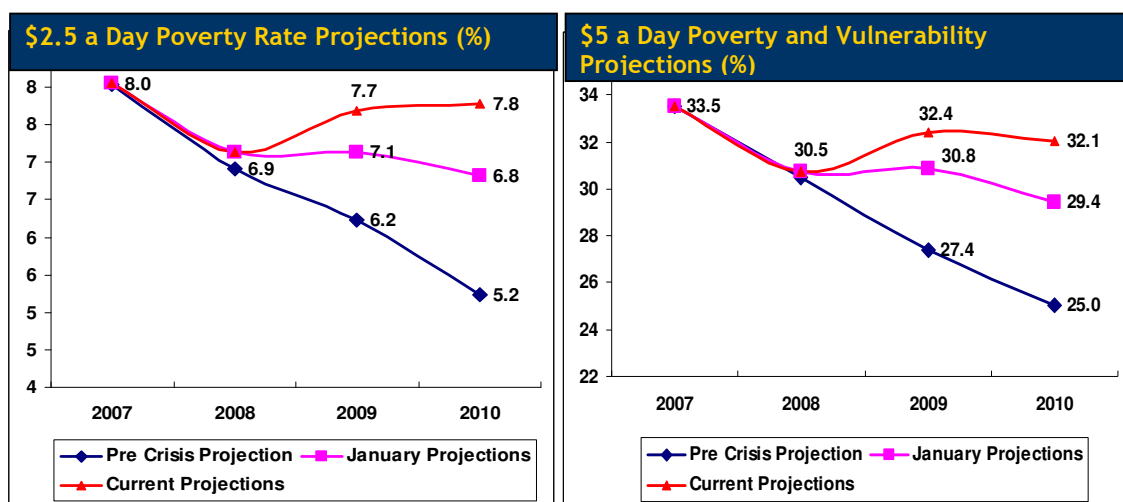
A PowerPoint presentation of the World Bank to a conference in spring 2009 contained the following:

Social policy actions are a priority:

- 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 countries were vulnerable, but there are also large differences across countries in the region – with 7 months of the crisis, the region has started to lose poverty gains made over the last 10 years²²

Fig. 9. Poverty rate projections



Source: World Bank staff estimates

²² ECA Economic Briefing. Office of the Chief Economist Europe and Central Asia World Bank Spring Meetings 2009

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.

Table 6. Seasonally adjusted unemployment rates ²³

Geo \ time	Sep 2008	Sep 2009
EU27	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	:
EU27	7.7	9.2
Belgium	7.3	7.9
Bulgaria	5.2	7.6

: Not available

Source: Eurostat

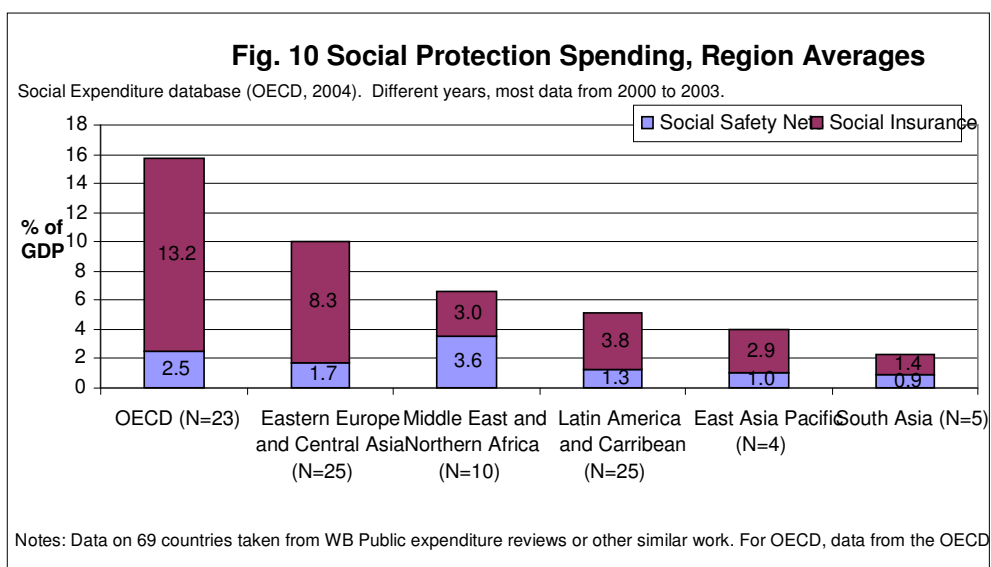
Last Update: 12.08.2009

²³ Puglia, Antonella (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 aging.



“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.²⁴ 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.

²⁴ ECA Economic Briefing, Office of the Chief Economist Europe and Central Asia World Bank Spring Meetings 2009

Table 7. Expenditure on social protection (as % of GDP²⁵)

	2000	2001	2002	2003	2004	2005	2006
EU 27	:	:	:	:	:	27.1	26.9
EU 25	26.5	26.7	27	27.3	27.2	27.3	27
EU 15	26.8	27	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
BE	26.5	27.3	28	29.1	29.3	29.7	30.1
BG	:	:	:	:	:	16	15
CZ	19.5	19.4	20.2	20.2	19.3	19.1	18.7
DK	28.9	29.2	29.7	30.9	30.7	30.2	29.1
DE	29.3	29.4	30.1	30.4	29.8	29.7	28.7
EE	14	13.1	12.7	12.6	13	12.7	12.4
IE	13.9	14.9	17.5	17.9	18.2	18.2	18.2
EL	23.5	24.3	24	23.6	23.5	24.3	24.2
ES	20.3	20	20.4	20.6	20.7	21.1	20.9
FR	29.5	29.6	30.4	30.9	31.3	31.4	31.1
IT	24.7	24.9	25.3	25.8	26	26.3	26.6
CY	14.8	14.9	16.3	18.4	18.1	18.4	18.4
LV	15.3	14.3	13.9	13.8	12.9	12.4	12.2
LT	15.8	14.7	14	13.5	13.3	13.1	13.2
LU	19.6	20.9	21.6	22.1	22.2	21.7	20.4
HU	19.3	19.3	20.4	21.1	20.8	21.9	22.3
MT	16.9	17.8	17.8	18.2	18.6	18.4	18.1
NL	26.4	26.5	27.6	28.3	28.3	27.9	29.3
AT	28.4	28.8	29.2	29.7	29.3	28.8	28.5
PL	19.7	21	21.1	21	20.1	19.7	19.2
PT	21.7	22.7	23.7	24.1	24.7	25.4	25.4
RO	13.2	13.2	13.4	12.6	15.1	14.2	14
SI	24.2	24.5	24.4	23.7	23.4	23	22.8
SK	19.4	19	19.1	18.2	17.2	16.7	15.9
FI	25.1	24.9	25.6	26.5	26.6	26.7	26.2
SE	30.1	30.8	31.6	32.5	32	31.5	30.7
UK	26.4	26.8	25.7	25.7	25.9	26.3	26.4
IS	19.2	19.4	21.2	23	22.7	21.7	21.2
NO	24.4	25.4	26	27.2	25.9	23.8	22.6
CH	26.9	27.6	28.5	29.1	29.3	29.3	28.4

Expenditure on social protection as a percentage of GDP was 26.9 percent 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 percent 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.

²⁵ Puglia, Antonella (2009) Population and social conditions. Statistics in focus 40/2009 p.4.

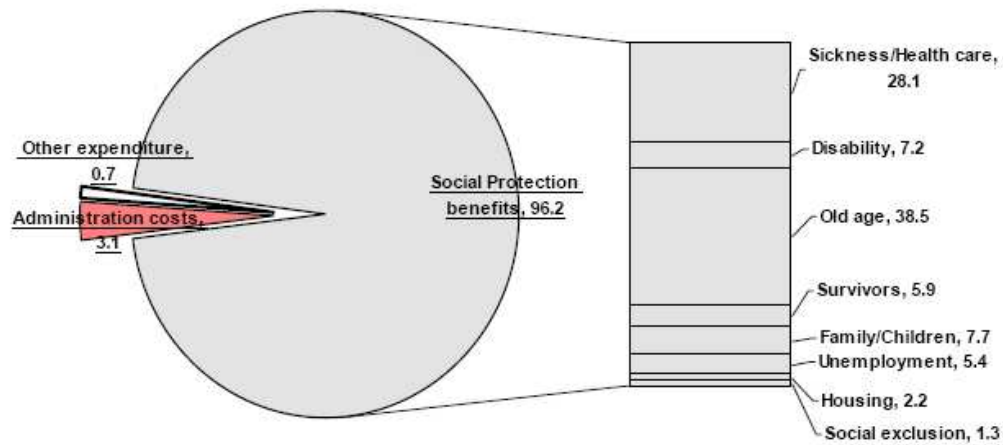
Table 8. Social protection receipts by type (as % of total receipts)²⁶

	General government contributions		Social contributions						Other receipts	
			Total		Employers		Protected persons (1)			
	2000	2006	2000	2006	2000	2006	2000	2006	2000	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	34.2	64.3	62.4	41.4	39.8	22.9	22.6	3.9	3.4
BE	25.3	27.7	72.1	70.8	49.9	49.3	22.3	21.4	2.5	1.5
BG	:	39.5	:	58.0	:	38.3	:	19.7	:	2.5
CZ	25.0	18.8	73.8	80.3	49.8	53.9	24.0	26.4	1.2	0.9
DK	63.9	62.8	29.4	30.8	9.1	11.0	20.3	19.8	6.7	6.4
DE	31.9	35.3	66.0	63.1	38.4	35.3	27.6	27.8	2.1	1.6
EE	20.6	19.5	79.2	80.4	79.2	80.1	:	0.3	0.2	0.1
IE	58.6	53.2	41.0	41.8	25.6	26.2	15.4	15.5	0.4	5.0
EL	29.2	31.4	60.8	57.7	38.2	35.1	22.6	22.6	10.0	10.9
ES	29.4	33.9	68.0	63.9	51.8	48.5	16.2	15.4	2.6	2.2
FR	30.3	30.6	65.9	65.2	46.0	44.3	19.9	20.9	3.8	4.2
IT	40.6	41.9	57.7	56.4	42.8	41.3	14.9	15.1	1.6	1.6
CY	39.9	48.1	43.0	39.1	26.6	24.0	16.4	15.1	17.1	12.8
LV	34.6	35.5	65.4	63.9	49.4	47.1	16.0	16.8	0.0	0.6
LT	38.9	38.5	59.6	61.0	53.7	54.9	5.9	6.1	1.5	0.5
LU	46.9	45.6	48.6	50.5	24.7	26.5	23.8	24.0	4.6	3.9
HU	31.6	40.6	59.7	53.8	47.0	38.6	12.8	15.2	8.7	5.7
MT	29.8	35.2	67.6	62.0	46.6	43.3	21.0	18.7	2.6	2.8
NL	14.4	20.1	67.5	69.5	29.4	31.8	38.1	37.7	18.1	10.4
AT	32.3	33.3	66.3	65.3	39.2	37.8	27.1	27.4	1.3	1.4
PL	32.5	33.3	55.3	48.0	30.5	25.9	24.8	22.0	12.2	18.8
PT	39.1	44.1	53.0	45.3	35.6	30.8	17.4	14.5	7.9	10.6
RO	:	19.6	:	69.5	:	56.3	:	13.2	:	10.8
SI	31.5	30.7	66.3	67.9	27.0	27.1	39.3	40.8	2.2	1.4
SK	31.0	25.5	66.8	65.6	48.3	44.2	18.5	21.4	2.2	8.9
FI	42.9	43.3	50.0	50.6	38.0	38.8	12.0	11.8	7.0	6.0
SE	45.9	48.9	49.9	48.7	40.4	39.9	9.4	8.9	4.3	2.4
UK	46.4	50.4	52.4	47.9	29.9	34.2	22.5	13.7	1.2	1.7
IS	51.4	31.6	48.6	30.6	39.5	24.8	9.1	5.8	:	37.9
NO	60.5	52.9	38.4	47.0	24.4	32.0	14.0	15.0	1.1	0.1
CH	21.0	22.3	60.4	62.2	29.3	28.7	31.1	33.6	18.6	15.4

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 UK 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."²⁷

²⁶ Antonella (2009) Population and social conditions. Statistics in focus 40/2009 p.10.

²⁷ Puglia, Antonella (2009) Population and social conditions: Statistics in focus 40/2009. p.10.

Fig. 11. Structure of social protection expenditure in EU27, 2006²⁸

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 percent to a high of 15.5 percent (IT) and a low of 5.5 percent (EE). In health care the average is 7.5 percent, and ranges from a high of 8.7 percent (FR, NL) and a low of 3.5 percent (LV).

Table 9. Changes in social benefits between 2000 and 2006

Number of benefits affected by the changes	Country
1 significant increase	EL, CZ, DK, NL, BE, IT, MT, PT, DE, SI
2 significant increases	EE, LV
3 significant increases	LT, ES
4 significant increases	CY, HU, LU
5 significant increases	IE, RO
1 decrease	BE, NL, AT, MT, RO, SI, UK, EE, LT
2 decreases	PL, DK, SE
3 or more decreases	DE, SK

While expenditure for social protection grew overall among the European Union members between 2000 and 2006 (2.6 percent in the EU-25, there were differences between countries. In Romania (11.0 percent) and IE (10.3 percent) the growth in welfare 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 IE and RO increased their expenditure significantly more than average in all aspects of social benefits, DE and SK introduced significant cuts in all areas except pensions. Some countries increased certain benefits while others cut them.

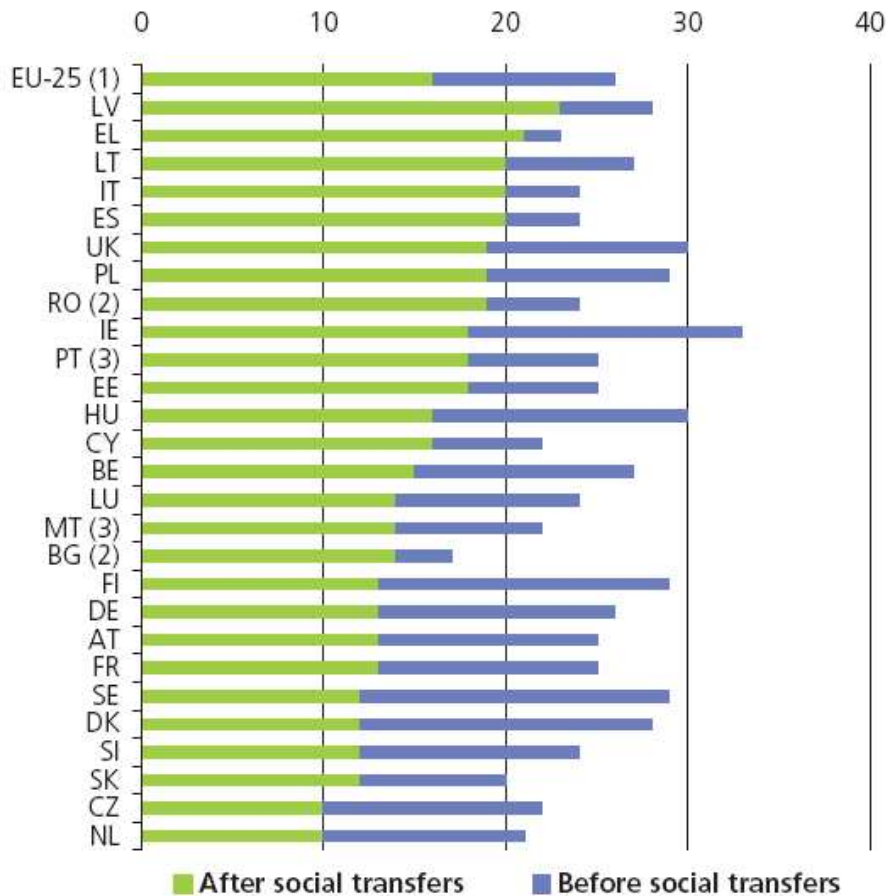
²⁸ Antonella (2009) Population and social conditions. Statistics in focus 40/2009 p. 5.

Table 10. Changes in social benefits from 2000 to 2006

	Old-age and survivors	Sickness/health care	Disability	Family/children	Unemployment	Housing and social exclusion
Particularly high growth	EE, EL, CY, HU, IE, RO	IE, HU, LV, RO	CZ, DK, EE, IE, CY, LT, LU, HU, RO	EE, IE, ES, CY, LT, LU, HU, NL, RO	BE, IE, ES, IT, CY, LV, LT, LU, MT, PT	DE, ES, LU, RO, SI
Reduction		DE, SK	BE, DE, NL, AT, PL	DE, MT, SK	DK, DE, PL, RO, SI, SK, SE, UK	DK, EE, LT, SK, SE

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 percent), 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.

Fig. 12 Persons at-risk-of-poverty, 2006 (% of total population)²⁹

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

Source: Eurostat (tsisc020 and tsisc030)

There was a sharp decline in poverty in 2006 in IE, HU, FI, BE, DE, AT, FR, SE, DK, SI, CZ, and NL, while the social assistance provision system was expressly poor in effectiveness in LV, EL, LT, IT, ES, RO, CY, and BG. 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.

²⁹ Key figures on Europe. 2009 edition. Eurostat Pocketbook p.90.

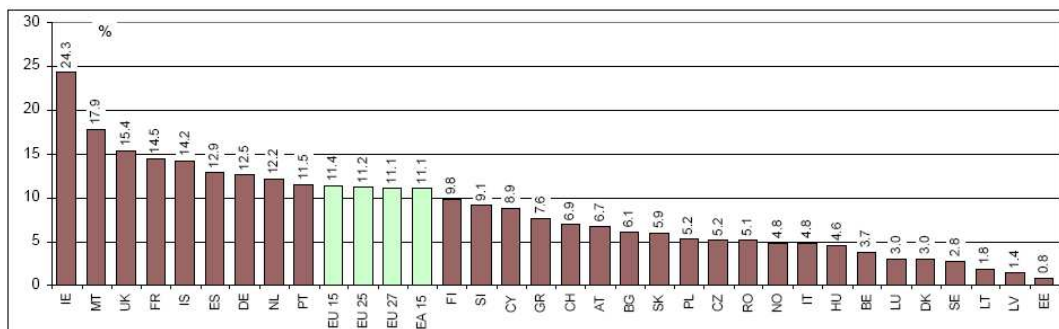
6.2. Social assistance systems and responses to the crisis

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-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 (as 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, 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 big 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.

Fig. 13 Means tested social benefits, 2006 (as % of total social benefits)³⁰



Note: the percentages in this graph are calculated out of data expressed in Euros

Source: Eurostat

Many people see the way to overcome negative effects in expanding the circle of means-tested benefits. In all EU members 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.

³⁰ Puglia, Antonella (2009) Population and social conditions: Statistics in focus 40/2009. p. 9.

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 enrolment to keep programs within budget allocations."³¹ Lack of information, high transaction costs (such as the stigma attached to applying for assistance) leads 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 percent for social assistance and housing programs."³²

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 Regions³³ 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.

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.

Measures being taken or proposed to local governments for reducing the costs of social expenditures by modifying the system of social benefits or services

³¹ Grosh, Margaret- Ninno, Carlo del - Tesliuc, Emil and Ouerghi Azedine (2008) For protection and promotion: The design and implementation of effective safety nets. The World Bank p. 90.

³² 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.

³³ 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>

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)
CZ, EE, FR, PL, RO, SK, Armenia, “the former Yugoslav Republic of Macedonia”	BG, HU, Russia	FI, Ireland, Russia, HU, 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 anti-recessionary 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 percent.

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, FL, FR, PL, RO, Russia, SK
In services only, new/expanded	EE
In both – increase	-
Negative reaction: fewer resources for aid	-
Negative reaction: fewer resources for services	Armenia, HU
No change	BG, Bosnia-Herzegovina, LU

Some countries (Estonia, Bosnia-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 prioritizing 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
EE, Ireland,	FI, FR, LU, PL	Bosnia-Herzegovina, RO, Serbia, Ukraine	EE, Bosnia, FI, RO, Russia, Ukraine, Serbia

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-Herzegovina, Romania and Ukraine. The main problem of the Russian 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-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 percent), 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-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."³⁴

³⁴ Kildal, Nanna: Workfare Tendencies in Scandinavian Welfare Policies International Labour Office, Geneva February, 2001. p.2. <http://www.ilo.org/public/english/protection/ses/download/docs/workfare.pdf>

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*³⁵ ('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 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."³⁶

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
CZ, FR, LU, Ireland, GE, Iceland, Slovenia	DK, FI, HU, SK

³⁵ US terminology uses the word "welfare" as a synonym for social assistance.

³⁶ Kildal, Nanna: *Workfare Tendencies in Scandinavian Welfare Policies* International Labour Office, Geneva February, 2001. p.2. <http://www.ilo.org/public/english/protection/ses/download/docs/workfare.pdf> p.1.

As already mentioned, the activation measures can include training and retraining, provision of work experience, or participation in 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 the working-age social assistance recipient.

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 to 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 Needy Families (TAN F) 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.”³⁷

Methods like this, which limit personal and family autonomy, are non-traditional 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).”³⁸

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
BG, Estonia, HU	DK, Sweden	Fr, Ireland, HU, GE, UK, Cyprus, Latvia, Malta

³⁷ Fiszbein, Ariel and Schady, Norbert *with* Ferreira, H.G. Francisco, Grosh, Margaret, Kelleher Nial, Olinto, Pedro and Skoufias, Emmanuel (2009) Conditional Cash Transfers, Reducing Present and Future Poverty, The World Bank p.33

³⁸ MISSOC database. Mutual Information System on Social Protection
http://ec.europa.eu/employment_social/spsi/missoc_en.htm

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.

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, too. 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 the 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 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 the USAID. The USAID supported the elaboration of a special Manual for Evaluation of local Service Performance was created (Markov & 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 Initiative and Borislav Tafradjiiski from Club Ekonomika 2000. The project was carried out in 6 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 15 Bulgarian municipalities. It was organized by the Resource Centre for Decentralization and Municipal Development³⁹ to determine and compare the unit costs for 4 local municipal services – garbage collection, street cleaning, planting, and street lightening and 2 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 pre-determined efficiency and effectiveness factors allows the tracking of different processes taking place at 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, Koprivshitsa and Tryavna. The survey included 4 local option services (financed by the municipalities own revenues) – garbage collection and transportation, street cleaning, landscaping and street lighting and 2 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 municipal 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 towards 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.

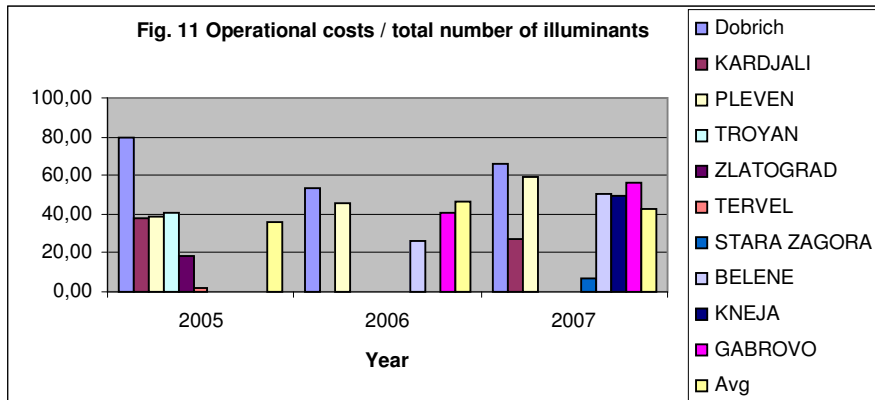
The main indicators for each service were listed and defined and a data collection form with a manual of explanatory notes was made. The main focus of the project was on the presentation of the data and the dissemination of good practice.

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

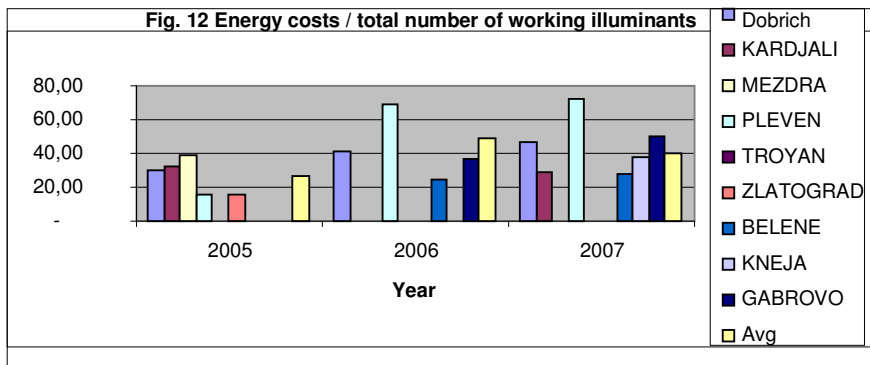
³⁹ The Resource Centre for Decentralization and Municipal Development is an organization comprising the Open Society Institute – Sofia and Partners for Effective Solutions Ltd.

Street lighting

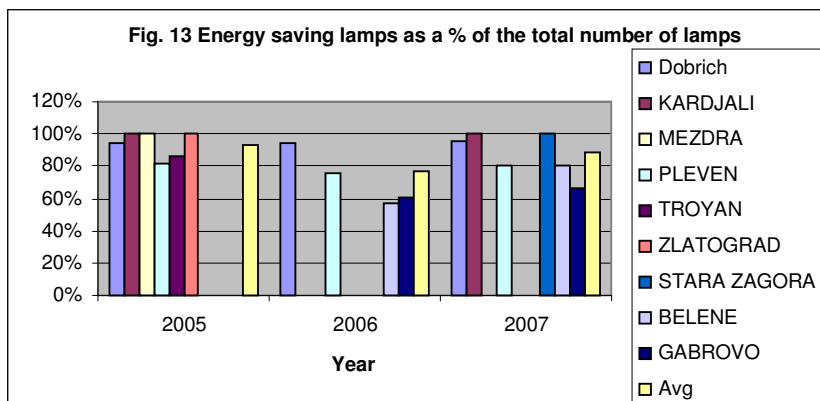
Indicators of effectiveness



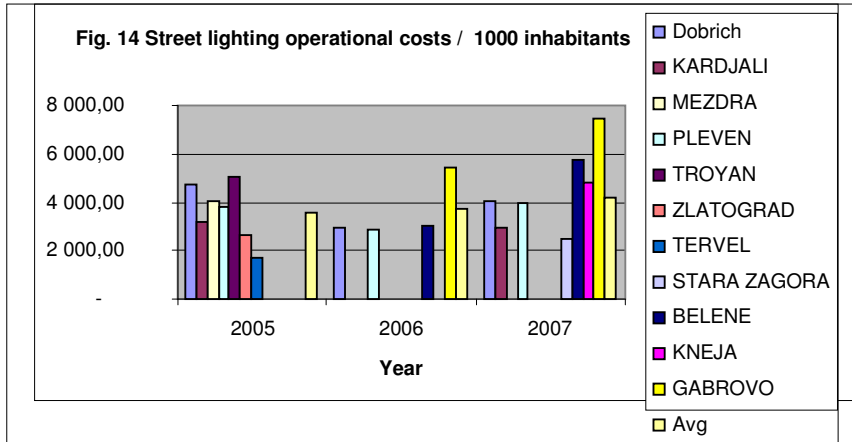
This indicator shows how much an illuminant costs to the local government. This is a typical unit costs indicator, which shows how cost efficient is the provision of street lighting in general.



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.

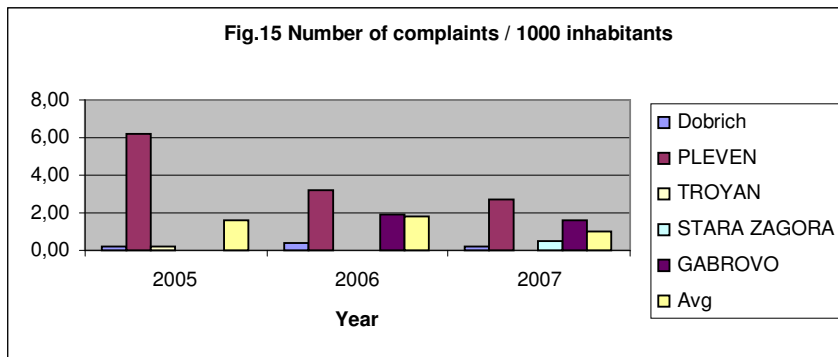


This indicator shows to what extent the local authority provides the service in a more technologically advanced way and to what extent it has invested in technological improvement.

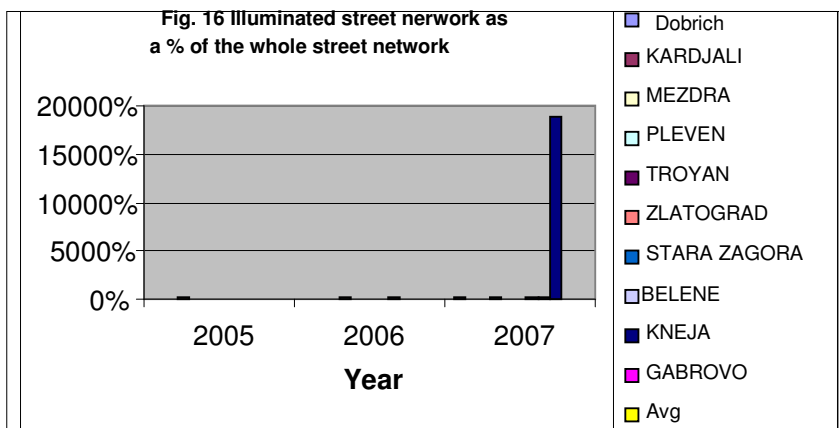


This is a unit cost indicator, which shows how efficient the local government is in providing the service to each inhabitant. But the indicator doesn't tell about the quality of the service.

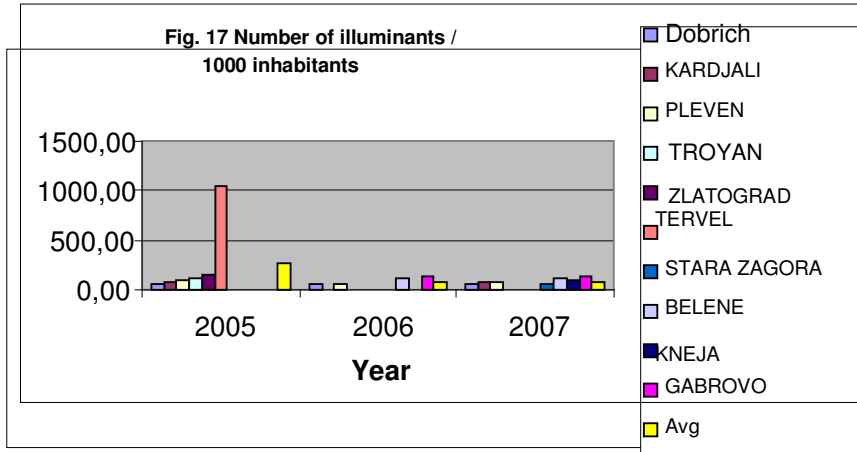
Efficiency and quality indicators



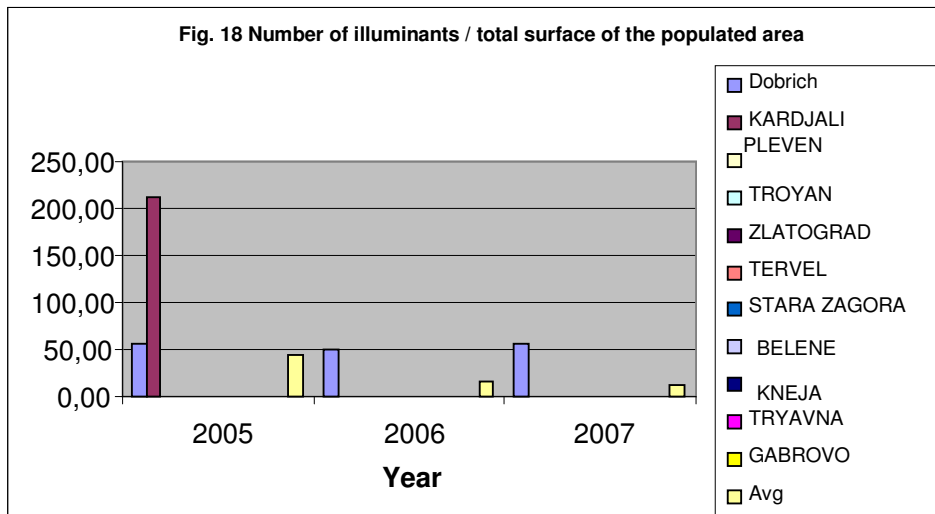
This is a typical consumer satisfaction indicator, which should demonstrate how dissatisfaction of the population drops.



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.



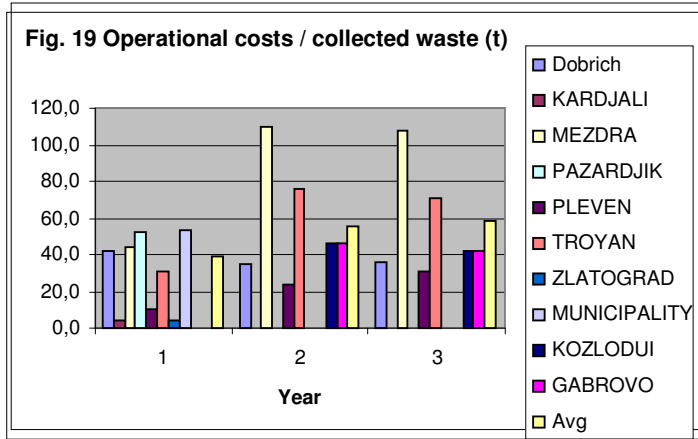
This indicator like the previous one measures the quality of the service. It has to be used together with the unit cost indicators. It can be used with almost any local service.



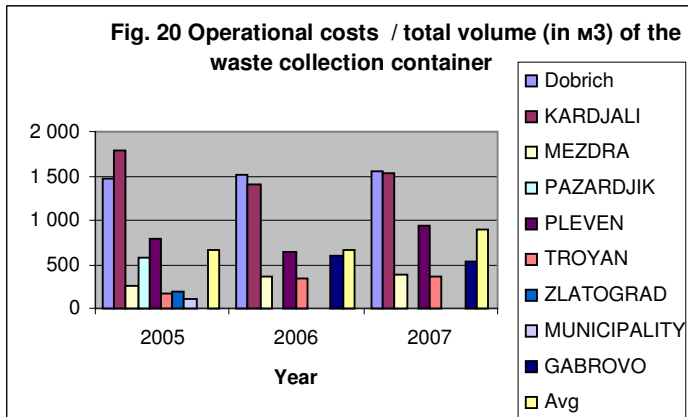
This is an indicator of technical efficiency, which shows how efficiently the lighting of a territory is organized. But it doesn't tell if this is a result of good design or just of poor quality of the service – too few street lamps. So this indicator has to be used together with some quality indicators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

Garbage collection

Indicators of effectiveness

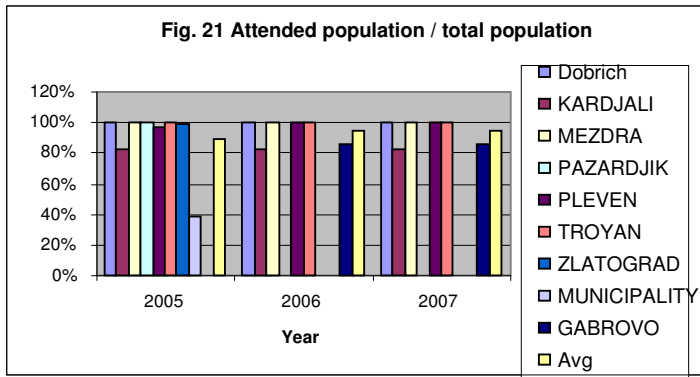


This is typical unit cost indicator, which indicates the overall cost efficiency of garbage collection so it should be used in conjunction with previous indicator.

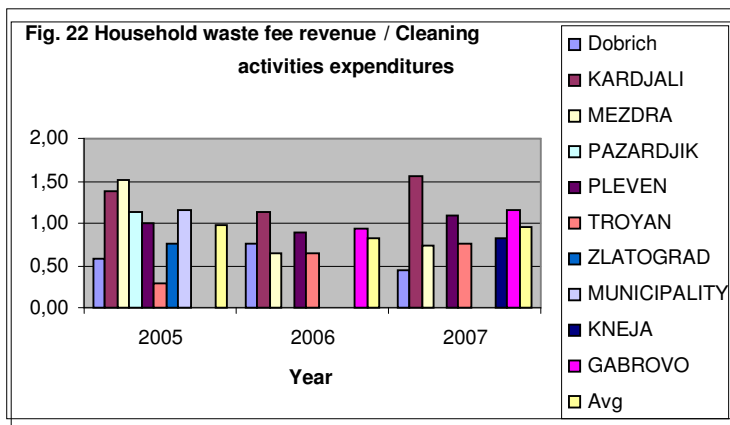


This is again a unit cost indicator, which indicates the cost efficiency in the management of available assets. But it does not tell if these assets are too big or too small.

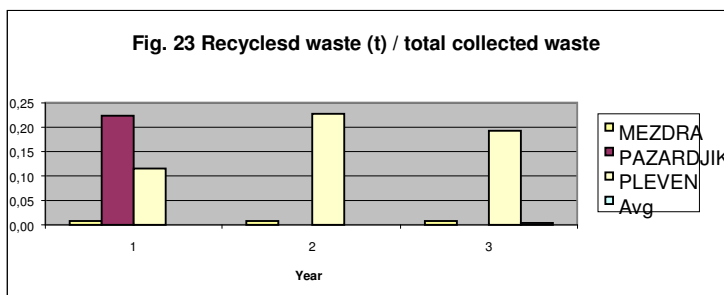
Efficiency and quality indicators



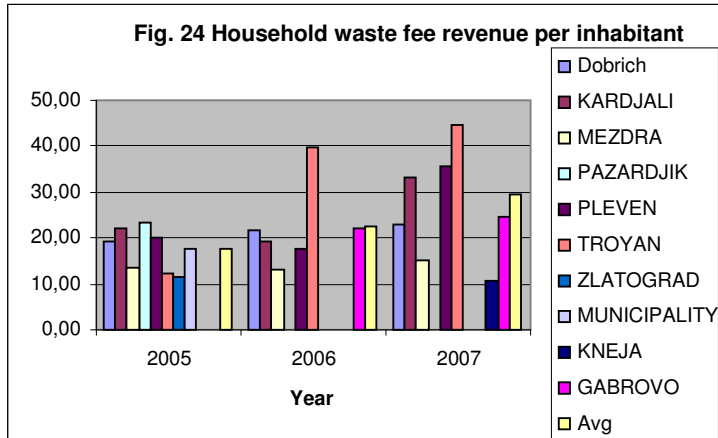
This is an output indicator which shows the scope and coverage of the service and its accessibility.



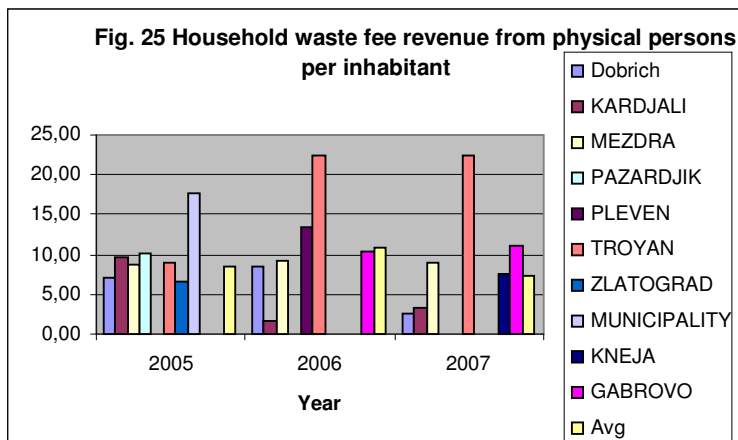
This indicator shows if the service is financially sustainable. If revenue is much lower than the expenditures this may be due to a high rate of subsidizing the service or to very low cost efficiency. This indicator can be misleading if used as a stand alone but quite revealing in a package with other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



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



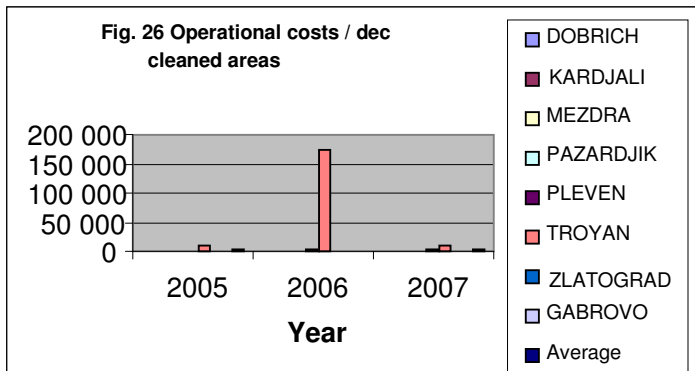
This indicator shows how “expensive” the service is to the inhabitants. It is a unit price indicator (or a proxy for a unit cost indicator), which has to be used together with quality indicators.



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

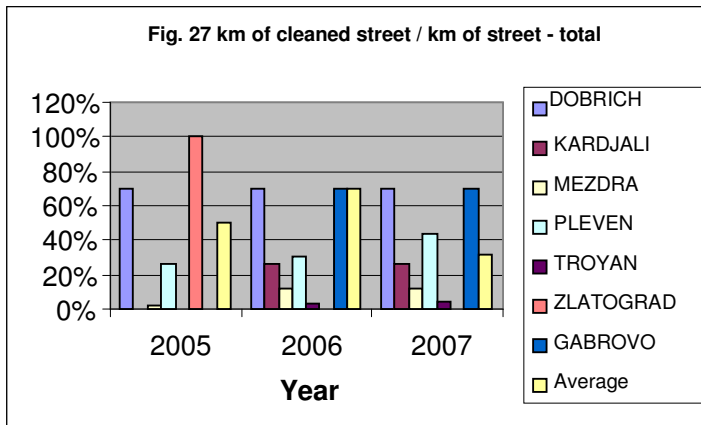
Street cleaning

Indicators of effectiveness

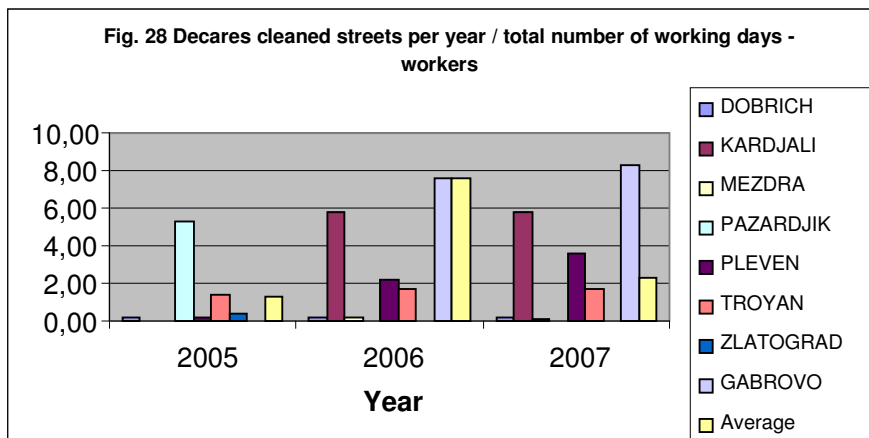


A typical unit cost indicator using natural units. It shows the overall cost efficiency of the service production.

Efficiency and quality indicators



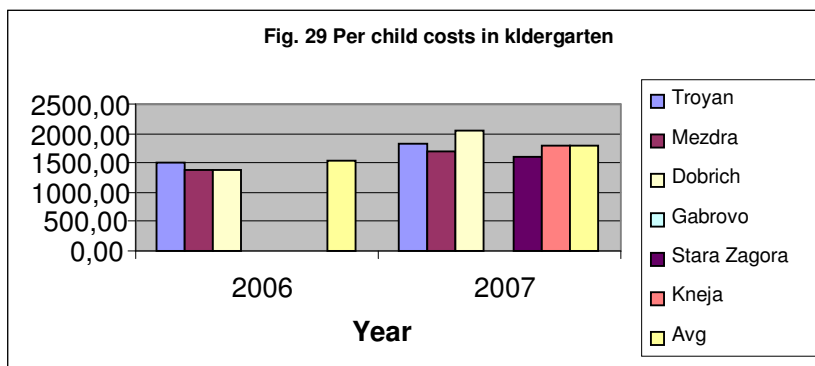
This indicator shows the quality of the service. More cleaned streets mean larger scope of the service and can be even regarded as a better quality if we take the cleaning of the city to be an integral task. So it is important to use this indicator in conjunction with the unit cost indicators to guarantee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



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

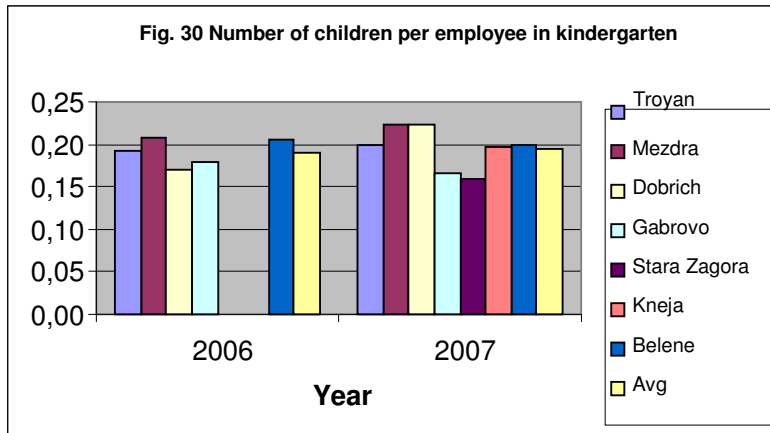
Expenditures



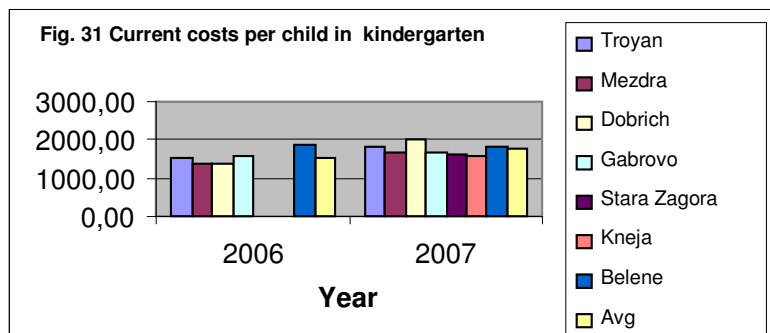
Maintenance costs of the kindergarten per child

- 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

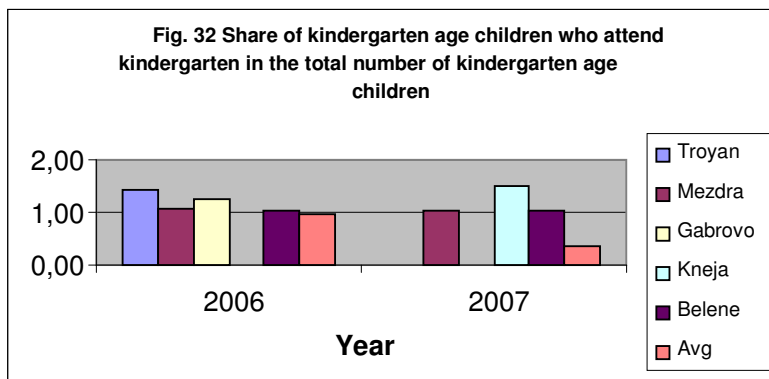


This is an indicator of technical efficiency. Like all similar indicators it should be used together with quality assessment indicators to guarantee this high technical efficiency does not come at the expense of overcrowded classes and poor teaching. In the above case not just the pedagogical but the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



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

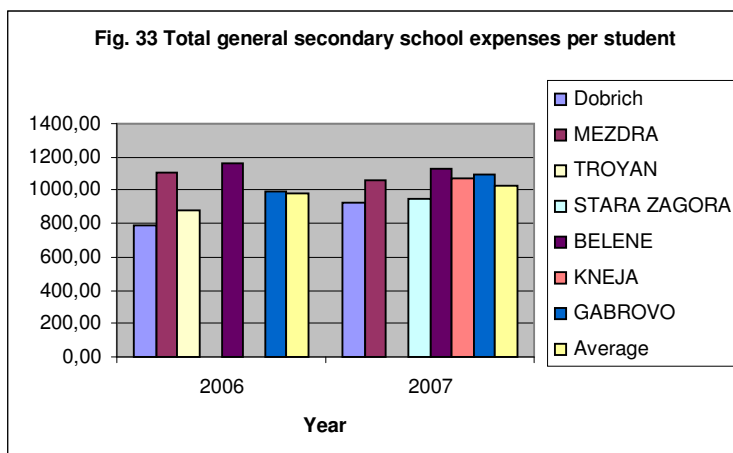
Efficiency and quality indicators



Enrolment 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.

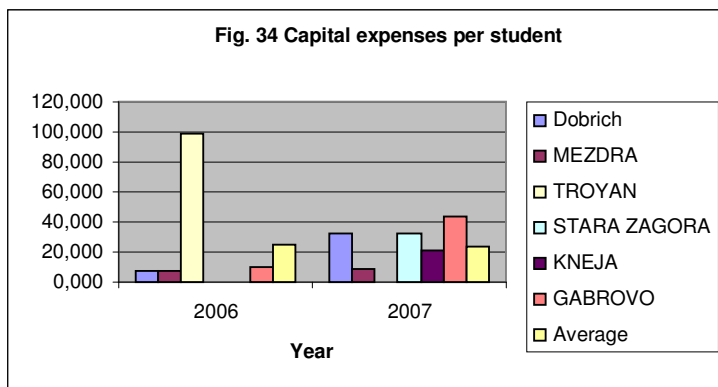
Schools

Expenditures



This is the classical cost efficiency indicator in education.

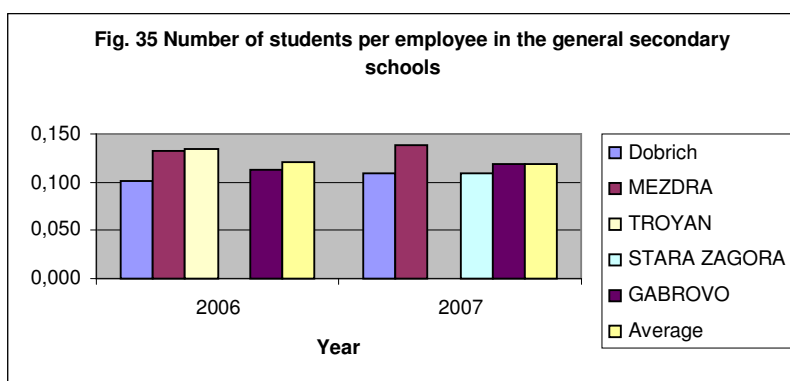
- Share of the labour expenses of the general secondary schools per student
- Share of the labour expenses of the general secondary schools in the total current expenses
- Share of the expenses for additional pedagogical services (incl. free choice subject) in the general secondary schools in the total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

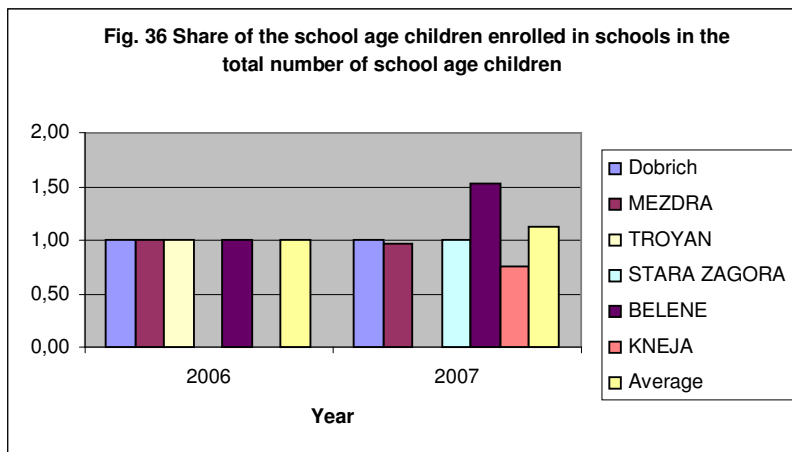
As in the case with kindergarten these indicators should be used together with quality assessment indicators and interpreted with care. For example a high share of the labour costs and low share of maintenance and capital costs may indicate that there are too many teachers per child or that the service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

Indicators of effectiveness



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. 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



Enrolment 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 enrolment 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 enrolment rates.

The results from the survey were discussed on a round table with the participating municipalities to have their feedback on the interpretation of results. Then the final document 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 big 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 big cities – the capital city 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 shore. The analysis demonstrated that the revenues of these biggest 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.

Fig. 37 Consolidated budget revenues of the municipality of Sofia 2003-2008

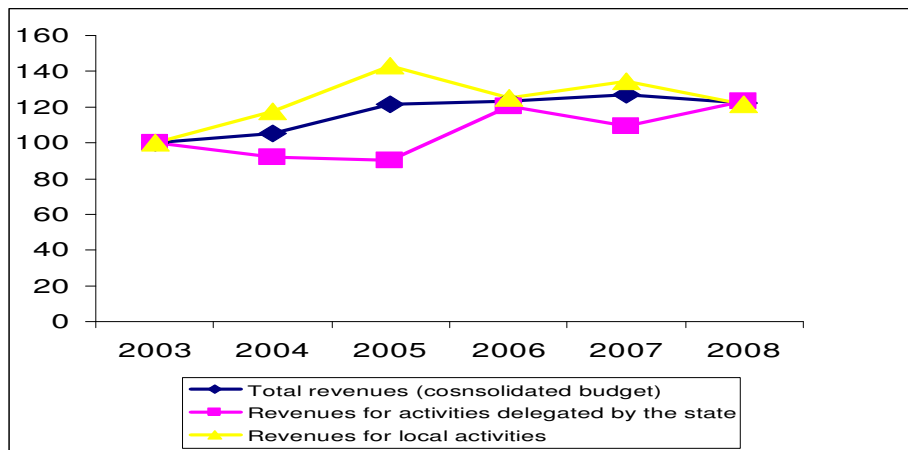
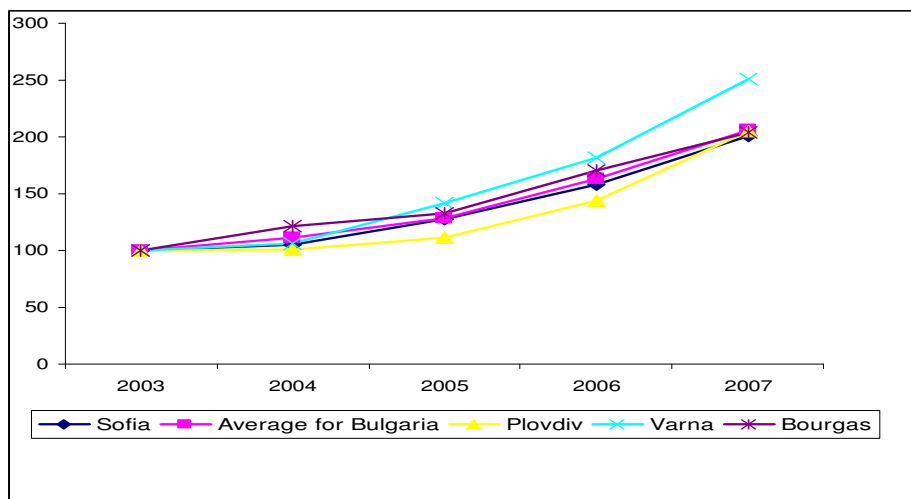


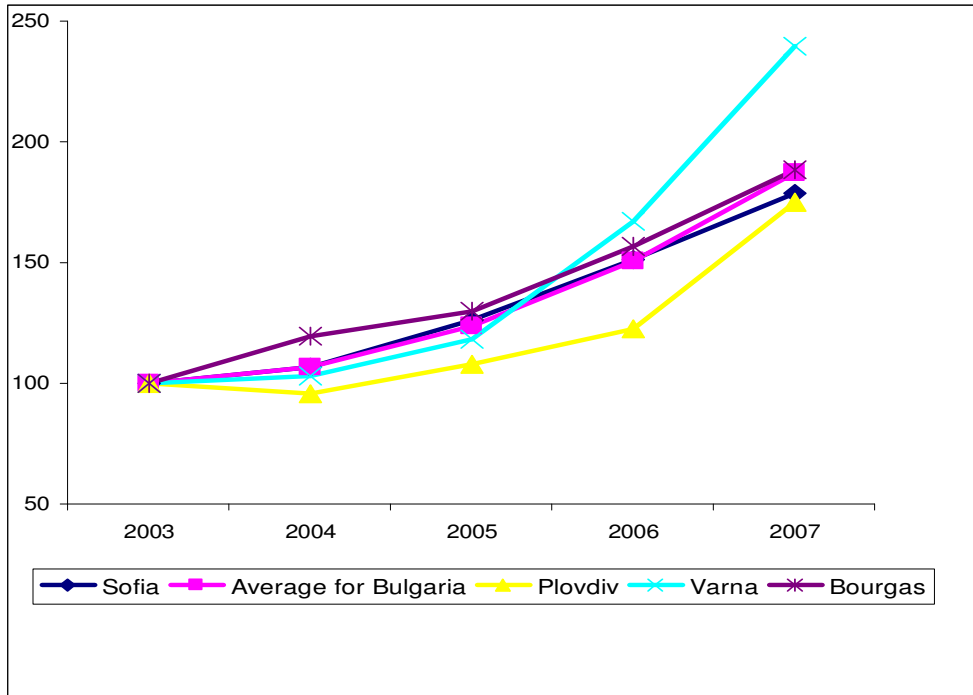
Fig. 38. Consolidated budget revenues 2003-2007 (four cities and average for Bulgaria)



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.

Fig. 39. 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 generalized input and output. Both the input and the output side can of course be broken into lower order items.

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

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 mostly bother about inputs or about 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 the 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 local level will now become how to keep costs from rising or 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 consider doing during a crisis. But still if a countercyclical intervention can be combined with efficiency gains on the long run and thus 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 IBNET benchmarking 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 to get 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 of them already 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 m³ of water annually, while sales at the biggest one exceed 150 million m³/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 terrains. 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 other 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 6 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 4 or 5 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 the Corvinus University of 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. Each year, the questionnaire is to be reviewed and updated 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 minutes of meetings.

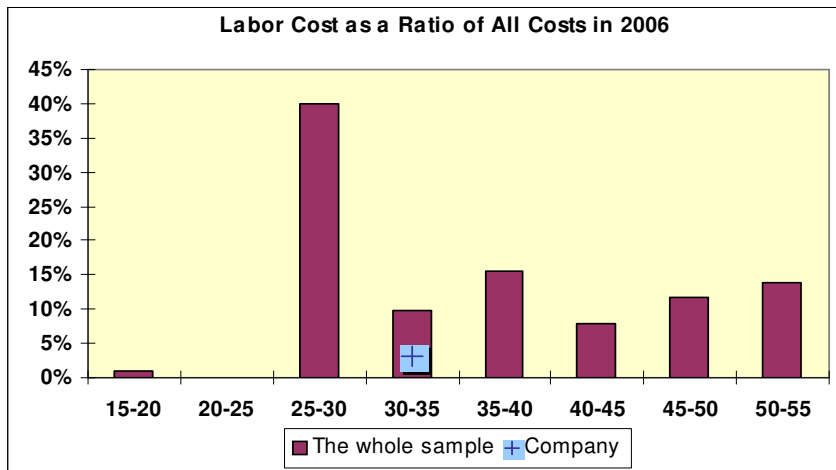
Annual results

At the end of the annual benchmarking survey, member companies of the Club receive a company specific document with over two hundred 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 0. 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 indicators values of all the other companies – in line with the data confidentiality rules of the Club.

Figure 40. The Position of the company compared to the distribution of the indicator values of the sample



By mid-2008 for many of the indicators already three years of data will be available (2005-2007), 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 groups

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 0 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 through 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 are willing to disclose their identity. Since companies are not “ashamed” by their good performance, they usually agree 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;
- Pipe breaks and other technical problems on 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 calls 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, especially other Central European utilities will also be computed and used as part of the benchmarking exercise. The necessary data will be 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, is to recruit additional members. This goal is 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 will also contribute to wider application of prevailing good practices among Hungarian water and wastewater utilities.