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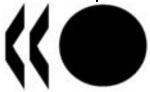

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The Austere Fiscal Environment and its Lasting Impact on Regions

Main Issues for Discussion

23rd Session of the Territorial Development Policy Committee (TDPC)

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This document is submitted to delegates of the TDPC for DISCUSSION.

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THE AUSTERE FISCAL ENVIRONMENT AND ITS LASTING IMPACT ON REGIONS:

MAIN ISSUES FOR DISCUSSION

An austere fiscal environment in OECD countries…

1. Fiscal consolidation is becoming the main challenge in many OECD countries. On average, OECD budget deficits are projected to rise to over 8% of GDP in 2010. The average debt level in OECD countries is expected to peak at 100% by 2010 (about 30 percentage points higher than before the crisis). Record debt levels have already impacted the borrowing costs of several countries, such as Spain where credit rating was recently downgraded by Fitch. Fiscal consolidation will therefore be a priority in most OECD countries in the coming years in order to reduce the debt burden before long-term pressures (notably related to population ageing and health care expenditures) fully materialise.

…is having a strong impact for regional and local public finances

2. Consolidating budgets is not only a priority for central governments. Sub-national governments (SNGs) have been strongly hit by the global financial crisis and have seen their fiscal situation deteriorate significantly. The crisis has had a large negative impact on most SNGs' finances due to a "scissors" effect: expenditure has increased (especially for SNGs with large responsibilities for the provision of welfare services, as in Denmark, Sweden or Canada), while revenues have fallen (especially for SNGs largely depending on taxes linked to the level of activity, such as business taxes or sales taxes, or, in some cases, to housing markets where the number of transactions and the prices fell significantly).

3. The critical role played by sub-national governments on public finances has been increasing over the past 20 years. On average, they represent 31% of public spending in OECD countries (equivalent to 15% of GDP), 22% of public revenues and are responsible for about 66% of public investment in the OECD (2.4% of GDP on average). The role of SNGs has been reinforced by the crisis since many stimulus plans contained large earmarked grants for sub-national governments for capital investment. Their contribution in restoring long-term growth and fiscal sustainability is thus essential.

The impact of the crisis will persist over the long-term in regions with structural problems

4. The impact of the crisis has not been uniform within countries, with some region more severely hit than others. Notably, the rise of unemployment has been larger in more vulnerable regions and/or those specialised in vulnerable sectors (*e.g.*, the automotive sector). In general, industrial regions have been the most severely affected. A recent survey in France has shown that 63% of employment losses during the crisis were located in the industrial sector, mostly concentrated in regions like Franche-Comté, Champagne-Ardenne, Picardie, or Auvergne.[1] In the United States, job losses have been most severe in areas that had experienced a big boom in housing, those that largely depend on manufacturing and those that already had the highest unemployment rates before the crisis[2].

[1] INSEE, May 2010

[2] *Financial Times*, May 2010

5. While the impact of the crisis is not uniform, it does not depend on the type of regions. Preliminary results for five OECD countries show that all types of regions – rural, intermediate and urban – have been affected, in different manners depending on their industrial-mix. For example, the impact was larger in urban regions in Canada and the United States. However, in Sweden and Spain, while urban regions suffered the largest absolute impact on job losses, the relative impact appears much larger in intermediate and rural regions close to cities (Sweden) and in intermediate remote regions (Spain). In the US and Spain, the more vulnerable regions (*e.g.* regions with the highest initial unemployment rates) experienced a larger increase of unemployment during the crisis, whereas it has been less the case in Canada and Sweden[3].

6. While the cyclical component of unemployment may abate during economic recovery, structural unemployment will continue to be concentrated in certain geographic areas. Out-migration of more mobile labour – usually high-skilled – will tend to reduce the quality of the labour pool, making depressed regions or cities progressively lesser and lesser competitive. The long-term impact of the crisis will therefore persist over time in regions with structural problems and this will intensify the fiscal challenges that these regions will have to meet. Consequently, long-run recovery and fiscal consolidation strategies will require national and regional answers tailored to local needs, rather than 'one-size fits all' policies.

Consolidating budgets will be particularly challenging due to the lagged effect of the crisis

7. Given the large impact of the present crisis on unemployment, social protection and welfare expenses are increasing. The lagged effect of the crisis will make budget consolidating particularly challenging for sub-national governments. Indeed, SNGs revenues have fallen sharply as a consequence of the recession, but as SNGs' revenues are often based on previous years' activity (*e.g.* shared taxes, equalisation transfers, etc.), most SNGs are expecting the situation to actually worsen in 2010-11. In addition, as people who lost their jobs first benefit from unemployment insurance, which is a central government responsibility, before moving to social welfare programmes, which often involve SNGs. Thus, the rise in SNGs' expenditures will take some time to materialise. As an order of magnitude, welfare transfers currently represent about 16% of SNGs' expenditure in the OECD, ranging from less than 5% in Portugal to over 25% in Norway and the United Kingdom, with a record at more than 50% in Denmark.

8. In most OECD countries, the financial situation of sub-national governments has already worsened significantly. In Germany, gross public debt of the *Länder* increased by 8.5% in 2009 reaching EUR 526 billion. In the United States, State-level tax collections have declined for four consecutive quarters beginning in the third quarter of 2009 (the last three declines reached 10.9, 16.4 and 11.6%, respectively) and are expected to keep deteriorating. Given their balanced budget rules and these revenue declines, the US States cut expenditures by USD 31.3 billion in 2009 and 55.7 billion in 2010. General fund spending decreased by 3.4% in 2009 and 5.4% in 2010 (with public State employment falling by 18 000 jobs in January 2010). On an historical perspective, the only other annual decline in State spending occurred in 1983, but was only at 0.7%. Despite these general trends, some expenditure continue to rise, such as Medicaid that increased by 7.8% in 2009 (with 3.3 million new people covered by the system, the largest one-year increase since its creation) and is expected to increase further in 2010, as enrolment increased by 5.4% in 2009 and is expected to grow by 6.6% in 2010. States foresee the 2011 fiscal year (starting on 1st July, 2010 for most States) to be the most difficult in modern times, with few improvements expected for 2012.

[3] In Canada and Sweden, an 'equalisation effect' becomes visible, meaning regions with lower initial unemployment rates experienced larger increases (in percentage points) than regions with higher initial unemployment rates.

9. Exit strategies will also have a major impact on regional economies. In countries with a high level of public debt, the regions have received a reduced fiscal support from the central governments. Several OECD – particularly European countries – have recently announced austerity packages (see Table 1 below), including Greece, Ireland, Portugal, Spain, Italy and the United Kingdom, which will have a strong incidence on sub-national finances. Italy just approved EUR 24 billion emergency cuts, with a particular focus on sub-national governments (with EUR 13 billion cuts for regional and local governments.[4]. In many countries, the challenges for sub-national governments to continue financing basic public services, including health care, and keep investment priorities for long-term growth will intensify.

10. Structural long-term challenges linked to population ageing will even worsen this picture. As well, the rising costs of health care and, most importantly, elderly care, the largest single component of municipal expenditures in some countries, such as Sweden, will create additional pressures. In parallel, income and corporate tax bases may decrease, as well as property tax receipts, because declining demand for real estate and buildings will cause weak housing and building markets. In countries where sub-central governments are allowed to borrow, SNGs' debt levels are therefore likely to remain high.

Consolidating sub-national budgets will require increasing the effectiveness of spending,…

11. Consolidating budgets in this context of falling revenues and increased welfare expenditure, without compromising the quantity and quality of public services requires more effective spending ("to do more, with less"). In this context, this crisis has triggered a reflexion on the need to reform relations across levels of government (for example by reforming territorial organisation or the fiscal incentives of SNGs). Innovative regional public governance is also required to mobilise social and human resources outside of conventional government sectors. Public private partnerships, outsourcing of public service delivery to civil society, and many other innovative governance methods could be pursued. In broad terms, all possible synergies and complementarities should be used to enhance the return of each individual policy.

…. better prioritising investment needs…

12. Countries and regions have a narrow path to long-term growth. Better prioritising public investment and accommodating appropriate budget cuts will be the policy-mix to be found in all regions. To restore growth and build resilient regions, encourage innovation and share economic gains as broadly as possible, it will be essential to invest in what unlocks each region's greatest potential. Given that the margin of *manœuvre* for additional investment spending will be limited in the coming years, it is also crucial to make the most of investment recovery packages launched in the recession context, as in many countries and regions they have not yet been fully implemented.

…and enhancing coordination across levels of government.

13. Fiscal consolidation requires coordinated efforts from all levels of government to avoid simply shifting the problem from the centre to the regions. The economic response to the crisis has been mainly addressed through macroeconomic policy packages. Had a regional development framework been implemented more widely, the fiscal stimulus could have been applied with a better sense of development priorities. What is important in periods of expenditure expansion is even more relevant in times of budget cuts: any successful deficit reduction plans require strong involvement of sub-national governments. Proper coordination across levels of government is critical to define and implement appropriate and coherent exit strategies. Overall, the crisis represents a major window of opportunity to rethink and improve relations across levels of government in order to make the most of public expenditures, both in times of crisis and for long-term rebuilding of the economy.

[4] http://www.ft.com/cms/s/0/47e41d50-67fa-11df-af6c-00144feab49a.html

In this context, TDPC delegates may consider the following issues for discussion:

- *In your country, to what extent do the fiscal consolidation and exit strategies include specific actions from sub-national governments (i.e. reduction of transfers and/or compulsory cuts, etc.)?*
- *To what extent does the exit strategy from the crisis has a territorial dimension (e.g. helping lagging regions or regions strongly hit by the crisis)?*
- *Where does your country stand for the implementation of the recovery strategy launched in the crisis/recession context? What have been the major implementation obstacles?*
- *What are the reforms currently discussed in your country linked to territorial organisation, fiscal and institutional relations across levels of government, to address fiscal consolidation and long-term growth challenges?*
- *How to design a balanced regional policy-mix and innovative regional governance, addressing both short term fiscal consolidation constraints and long-term investment needs?*

TABLE 1: FISCAL AUSTERITY MEASURES IN OECD COUNTRIES

Overview of some recent fiscal austerity measures announced in May 2010* and new fiscal rules

Country	Total amount of budget cuts	Main measures adopted at the national level	Main measures adopted at the sub-national level
France	Not specified	The government has committed to reducing its deficit as a percentage of Gross Domestic Product to 6% in 2011 and 4.6% in 2012. By 2013, the government targets a deficit no higher than the 3% stipulated by the European Union. Main measure: Three-year freeze on public spending Next steps: Discussion around a possible constitutional reform to oblige every elected government to commit to a five-year plan for the deficit and to a date by which public finances would be balanced.	
Germany		The German government adopted a new fiscal rule in May 2009 that will limit the cyclically adjusted budget deficit of the federal government to a maximum of 0.35 percent of GDP and require balanced cyclically adjusted budgets for the *Länder*[5]. It will become binding for the central government in 2016 and for the *Länder* in 2020. A longer transitional period has been agreed for the *Länder* since some are experiencing serious consolidation problems.[6] No borrowing limits have been specified for municipalities and social security funds.[7] To comply with the new fiscal rule, the German government has announced to cut public expenditure by EUR 10 Billion each year until 2016.[8]	
Greece	EUR 30 billion (10% GDP)	Two to three percentage points increase in value-added tax Three-year public sector pay freeze; recruitment frozen Abolition of '13th and 14th monthly salary' for public sector workers; 5% cut in allowances No renewals for short-term public sector contracts Closure of more than 800 out-dated state entities Overhaul of pension system: rising average retirement age to 67 for men and women; cutting state corporation pensions. Privatisation: sales of state corporations; flotating on Athens stock exchange; sales and leasing of state-owned properties	The government is planning a freeze pay for all public sector workers, at all levels of government.

[5] In Germany, gross public debt of the Länder increased by 8.5 percent in 2009 reaching 526 Billion Euros.

[6] Particularly in Bremen and the Saarland.

[7] OECD Economic Surveys, *Germany,* March 2010.

[8] Financial Times, *German cuts to be example to eurozone,* 24 May 2010.

Ireland	EUR 3.2 billion	Reduction in wages of public sector workers (police, nurses, and teachers) Hiring freeze in the civil service sector Cuts in social welfare benefits	
Italy	EUR 24 billion	Reduce the budget deficit to 3% of GDP by 2012. Main measures include: Cuts for sub-national governments (see right column) Wage freezes and cuts for public-sector workers (EUR 6 billion). Salaries for government ministers and parliamentarians will be reduced by 10% and the government will slow its hiring Only one in every five government positions that come open between 2011 and 2013 will be filled The vast majority of the above measures will take effect in 2011. A few will be brought forward to 2010.	EUR 13 billion cuts for sub-national governments in 2011-12 (i.e. 54% of the total budget cuts) Few details were released after the cabinet meeting and precise data on the savings to be achieved from the individual measures has not been issued Abolition of provincial governments with less than 220 000 inhabitants
Portugal	EUR 11 billion over the next four years (8% GDP)	Portugal has lowered its 2010 fiscal deficit target to 7.3 % of GDP and 4.6% in 2011. Objective: meet the 3% EU target by 2013. Main measures: - Tax increases: 2.5 % increase in corporate tax to 27.5% on annual profits which exceed EUR 2 million, a 1 % increase in value added tax to 21% and increases of up to 1.5 percentage points in the income tax - Spending cuts: general 5% pay cut for the public sector including ministers and reduction in transfer payments from central to local government.Privatisation of public holdings in 17 different enterprises.	EUR 100 million reductions in transfer payments from central to local government.
Spain	EUR 15 billion	The austerity package should lower Spain's deficit to 6% of GDP in 2011, from 11.2% in 2009. Main measures announced: - Cut civil service salaries by 5% in June, then freeze in 2011 - Ministers will take a 15% pay cut - EUR 6 billion cut in public sector investment - EUR 1.2 billion € cuts in local & regional governments	EUR 1.2 billion cuts in local & regional governments EUR 6 billion cut in public sector investment

		- Freeze on pension payments - Abolition in 2011 of EUR 2 500 childbirth allowance - EUR 600 million reduction in foreign aid	
UK	GBP 6.25 billion of public spending cuts	Details of these and possible further cuts will be revealed in an emergency budget on June 22.	

** The information gathered in this table information was gathered in the international press in the week of May 25*