Reviving local public investments

Flexibility is needed in the existing rules of the Stability and Growth Pact

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INTRODUCTION

“Since several years most subnational governments have been under financial pressure. They face great challenges in implementing policies decided at European and national level with decreasing own-source tax revenues and government transfers, and less favourable borrowing conditions. Increased investments are necessary to prepare our cities, municipalities and regions to mitigate and adapt to climate change, to manage energy transition requirements and to handle the demographic change. At the same time, local and regional authorities realise that they are also affected by many of the EU's new financial rules, which have been introduced to handle the economic crisis.

With this position paper, the Council of European Municipalities and Regions would like to raise the awareness of the European institutions and the national governments, of the need to resolve the investment problems that local and regional authorities are experiencing, due to the rules of the Stability and Growth Pact (SGP) and the Treaty on Stability, Coordination and Governance (TSCG).

We believe that the flexibility in the Stability and Growth Pact, presented by the European Commission in its Communication earlier this year, should be extended to allow sustainable public investments within certain conditions. Public investments have fallen significantly in recent years and this increases the risk that disproportionate levels of investments will be necessary in the future. Thus, we will simply shift the financial burden to the next generations, which is neither sustainable nor equitable.

I hope that CEMR’s view will contribute to a constructive debate about how we can on the one hand, achieve the right balance between the necessary stability in our public finances, and the need to invest in growth, jobs and the future of our citizens, on the other.”

Philippe Laurent
CEMR spokesperson on local finances
Mayor of Sceaux (AFCCRE, France)

CEMR Key Messages

European rules and regulations adopted to manage the financial crisis have led to an alarming decline of public investments at local and regional level. This development risks setting back the revival of activity in the European Union and its return to growth. Therefore, CEMR on behalf of local governments and regions, calls on the EU institutions and national governments to take into account our views:

1. CEMR calls on the EU institutions to recognise the investment problems that local and regional authorities face due to the rules of the Stability and Growth Pact (SGP), the Treaty on Stability, Coordination and Governance (TSCG) and the European Accounting Standards (ESA 2010).
2. The European Commission's Communication on "making the best use of flexibility within the existing rules of the Stability and Growth Pact" is a good step into the right direction; it should be extended to allow necessary sustainable public investments.
3. The TSCG requests an annual balanced budget or a budget in surplus that is adjusted to take account of the economic cycle; however, we would like to stress that the situation of public investment at local and regional level naturally gives rise to structural deficits. We urge the EU decision makers to introduce necessary adjustments to allow borrowing for the purpose of public capital expenditures to be considered as a productive investment, which increases the value of local governments' assets in the medium and long-term.
4. Therefore, the "golden fiscal rule" should be introduced in the European Stability and Growth Pact and the Treaty on Stability, Coordination and Governance, which states that growth-conducive long-term public investments remain separate from current expenditure. Both, the SGP and the TSCG should allow flexibility for Economic and Monetary Union (EMU) deficits caused by local and regional public investments.
5. Local governments' investments should not systematically be taken into account at national level when calculating the national deficit, particularly in the negotiations with EU Institutions as they contribute to long-term growth.
6. Given the importance of subnational budgets in the EU's macro accounting figures, CEMR invites the European Commission to include a section on local government finances in its White Paper on the long-term plan for the European Monetary Union, to be published in spring 2017.
7. CEMR stresses that the relevant parts of the Action Plan for the Capital Markets Union should take into account their impact on local and regional finances.

1. Context: the EU's financial rules resulting from the economic crisis have strongly impacted on local finances

Most subnational governments are largely under financial pressure. On the one hand, they must implement many policies and confront on-going and new challenges, such as the arrival of huge numbers of refugees, climate change, energy efficiency, demographic change, etc. On the other hand, local governments suffer from the decrease in own-source tax revenues, heavily reduced tax and government transfers, and less favourable borrowing conditions. Local and regional authorities are also affected by many of the EU's new financial rules, which have been introduced or modified since the start of the financial crisis.

These initiatives, such as the Six Pack, Two Pack, the Treaty on Stability, Coordination and Governance, the international regulation of the banking sector (Basel III), the VAT legislation on public bodies, the European Public Sector Accounting Standards (EPSAS) and the entire European Semester process, have an impact on local finances. We still need to assess the extent to which the recently published Action Plan for a Capital Markets Union will affect local and regional finances.

The most recent problem has arisen from the interpretation of the Stability and Growth Pact (SGP), which has been modified by the Six Pack, the Treaty on Stability, Coordination and Governance (TSCG) and new Eurostat standards (ESA 2010). Local government finances are included in the SGP's and TSCG's deficit and debt criteria calculation (3% deficit ceiling and public debt below 60% of GDP) on the basis of different national rules for implementation. Each Member State is expected to achieve a sound budgetary position over the medium term (so-called Medium-Term Objective, MTO) on an annual balanced budget or a budget in surplus that is adjusted to take account of the economic cycle and corrected to exclude the impact of one-off measures.

These rules limit local authorities in undertaking the necessary investments for the provision of sound infrastructures and services to our citizens and enterprises and to prepare for a sustainable future of our next generations. This problem has already been addressed by the European Parliament[1] and the Committee of the Regions[2].

A concrete example to highlight this, is that local authorities need to finance actions to tackle the challenges of climate change. In December 2015, the COP21 (the Paris Climate Conference) will meet to achieve a legally binding and universal agreement to reduce CO_2 emissions. This new global commitment will need to be implemented and financed at all government levels. In that perspective, the European Structural and Investment Funds are crucial and remain the major European tool to support the implementation of local projects in the field of energy and climate change.

A more recent challenge is the humanitarian crisis caused by the influx of hundreds of thousands of refugees in Europe that has hit local governments directly. The emergency measures at local level, such as housing, healthcare, sanitation, and also the long-term measures to assure the integration of migrants, all contribute to help to cope with the human tragedy. The aid measures that local governments must provide in managing this crisis require substantial financial resources. Therefore, it is crucial that these expenditures and investments are exempted from the limitations of the SGP and TSCG rules.

[1] EP report on the review of the economic governance framework: stocktaking and challenges. A8-0190/2015, 17.06.2015

[2] CoR Opinion. Making the best use of the flexibility within the existing rules of the Stability and Growth Pact ECON-VI/002, 08.07.2015

These elements clearly demonstrate how important it is to modify and adapt the European rules in order to align them with the reality being experienced at the local level.

One of the core problems stems from the application of the rules of the Stability and Growth Pact, the Treaty on Stability, Coordination and Governance and the European System of Accounts, all of which require public investments to be calculated based on the annual total expenditure and revenue. This leads to a situation where there is no distinction between local authorities' debt for investment and debt for financing operations.

2. Local investments support growth, employment and efficiency

There is a paradox in the EU between the demand for reducing public deficits and increasing budgetary discipline, whilst at the same time the lack of growth and investment is highlighted as being a major problem.

Europe's economic crisis has proven the need for EU level monitoring and supervision of public finances. Strong and sustainable public finances can best be ensured by addressing unfavourable developments at the earliest stage possible. However, in a time of economic difficulties, it is important that local authorities maintain a sufficient level of investment, so as to keep the wheels of the economy turning.

It is worthwhile to finance at least some sound investments through debt financing. Public investment is needed, given its long-term horizon and leverage effect on private sector investment decisions, particularly in less attractive areas and sectors. Local authority investments support growth and would be in the wider interests of society. The European Commission seems to be aware of this paradox and therefore, clarified with the Juncker Investment Plan and proposing that these debt-financed investments are not counted in the calculation of Member States' debt.

In its Communication "*Making the best use of the flexibility within the existing rules of the stability and growth pact",* the European Commission clarifies that the European Fund for Strategic Investments (EFSI), which was created in partnership between the Commission and the European Investment Bank (EIB), will provide credit enhancements to eligible projects, and that "the use of this EU guarantee and of EIB funds has no impact on the deficit of debt levels of Member States." [3] Hence the Commission recognises the importance of public investments, even in cases where they are financed with debt funding. Furthermore, the Commission is willing to consider the contribution to the EFSI to be a "relevant factor" and therefore, will not launch an Excessive Deficit Procedure (EDP) "if the non-respect is due to the contribution and if the excess over the reference value is small and is expected to be temporary."[4]

Whilst it can be said that local authorities are keen to invest in key areas such as infrastructure development and education, usually EIB grants to public authorities are at minimum 50 million Euros, and therefore EFSI financing will mostly benefit national and regional actors – unless mechanisms are established, such as platforms to bring local projects together.

[3] Making the best use of the flexibility within the existing rules of the stability and growth pact; COM(2015) 12 final/2, 10.2.2015, page 5: The new European Fund for Strategic Investments

[4] Same, page 7

- ⇨ *CEMR welcomes this first step of the European Commission to acknowledge the need to exempt certain investments from the application of the EDP, and we support the European Parliament's statement that further investment programmes should be accommodated.*

Pressure on public investment means underinvestment in the long run, which can have a devastating impact on the sustainable development of municipalities and regions. Capital expenditures in infrastructure and services (public transport, energy, climate change adaptation, social and health care, housing, waste management, etc.) have a positive impact on economic growth and social cohesion. This will not only increase productivity and jobs in the long term, but also foster confidence in the overall investment climate and contribute to an inclusive society.

Infrastructure spending is considered as a government investment, because it will usually save money in the long run, and thereby reduce the net present value of government liabilities. The ripple effect therefore would tend to boost private investment, further enhance the attractiveness of territories, foster employment and improve local business conditions. A serious limitation of public expenditures may also threaten other long-term European investment policies, such as cohesion policy, where national, regional and / or local co-financing is needed.

- ⇨ *CEMR calls for the "golden fiscal rule" to be introduced in the European Stability and Growth Pact and the Treaty on Stability, Coordination and Governance, which states that debt financing of local and regional public investment remains separate from debt financing of current expenditure. Local and regional public investment should be entitled to a certain amount of flexibility as regards deficits, so as to prevent under-investment to the detriment of future generations.*

- ⇨ *Public investments cannot be treated as a variable of adjustment in fiscal policy. The drop in local and regional investment is a major socio-economic error for Europe. Especially in times of economic downturn, we must preserve the capacity of local and regional governments to invest in their infrastructures, to support their local economy and to maintain employment in their territories, while ensuring the long-term economic development of Europe.*

3. Operational expenditures and investments must be distinguished

The EU's criteria for assessing public finances do not take into account the differences between the public finance of the national government and the public finances of the local and regional governments. This leads to the situation where the European rules do not properly assess the financial situation of local and regional authorities.

The main problem is that the fiscal rules do not make a distinction between debt-financed current operational expenditures and debt-financed regional and local public investments. The situation has not improved with the new European System of National and Regional Accounts (ESA 2010), which is in force since September 2014.

This means in practice, in the case where a school is built, construction costs must be accounted over the period of the construction duration, which may last 1-2 years. However, according to general book- keeping rules, this expenditure is considered a long-term investment and therefore, depreciated over a longer time horizon e.g. 15-20 years. Furthermore, accounting and statistical systems in the Member States are different and produce information which needs a better country-specific analysis so that it can be applied in a sensible way. We therefore fully support the CoR's request to the Commission to assess the impact of the ESA 2010 rules on public investment capacity.

Another problem is that assets of local and regional authorities are not included in any way in the debt criteria. Some local authorities have significant assets, e.g. stocks or properties. Obviously local authorities with significant assets can bear a higher amount of debt than those without any assets.

- ⇨ *CEMR demands that the calculation of public investments in the SGP's deficit and debt criteria is changed in a way that long-term public investments are accounted by being spread out over time, not just during the first year in which the expenditure is made.*

- ⇨ *CEMR requests a recognition that borrowing for local governments' capital expenditures purpose is a productive investment which increases the value of local governments' assets in the medium and long-term.*

4. National rules should not introduce more difficulties for local governments

When implementing the rules of the Stability and Growth Pact (3% deficit ceiling and public debt below 60% of GDP) and the Treaty on Stability, Coordination and Governance, Member States include local and regional authorities' finances in their national calculations. As a consequence, central governments generally apply the rules in a way that forces local and regional government to reduce their expenditures by the same proportions as their own.

Instead of being strictly applied to each level of government and individually for each municipality, balanced budget rules should be applied at a more macroeconomic level. An option for instance would be to not consider a municipality on a single basis but rather all municipalities together as a group: their investments may compensate among themselves from year to year. It would ensure that local public investments are not discouraged.

Moreover, when the share of central government's investment in national spending is lower than that of the share of local governments, central governments should allow for a proportionate reduction in the contribution made by local governments' budgets, towards the objective of not exceeding the 3% national deficit ceiling.

However, the issue is not only that local debt levels are, in general, lower than national debt levels. The lion's share of local debt has, as its main purpose, the objective of financing productive investment and is governed by strict prudential domestic rules. In 2011, the average local debt was 5.9% of GDP and 7.1% of the public debt while "in the 27 Member States of the European Union, their share is about two-thirds of public investment".[5]

- ⇨ *Local governments' investments should not systematically be taken into account at the national level when calculating the national deficit, particularly in the negotiations with EU Institutions as they contribute to long-term growth.*

[5] Subnational public finance in the European Union. Study done by CEMR and Dexia, 2012

5. Further action from the EU institutions is needed

The European Commission's Communication "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact" describes quite well the problems relevant for local and regional authorities and the need for some flexibility in the rules. The report of the European Parliament and the opinion of the Committee of the Regions both mention the problems being posed by SGP to local investments and highlight the necessity of more flexibility.

The Communication concludes that the Commission will be in contact with the stakeholders at all levels in order to define further action ensuring a closer coordination of economic policies and progress in deepening the Economic and Monetary Union. As a representative for European local and regional authorities and thereby a major share of public investors, CEMR welcomes the Commission's initiative to make contact with stakeholders at all levels. CEMR is keen to work in close cooperation with the Commission and the other EU institutions in order define further actions.

Unfortunately, the report of 22 June 2015, prepared by five Presidents[6] on a long-term plan for Europe's Economic and Monetary Union[7] fails to mention the problems of local government investments.

The Council of the European Union is expected to deliver its interpretation of how to apply the flexibility clauses included in the Stability and Growth Pact by December 2015. For instance, Member States are expected to clarify how cyclical conditions, structural reforms and public investment should be taken into account when assessing national budgets under EU rules.

CEMR wishes to refer to the Recommendation on *Effective Public Investment Across Levels of Government,* adopted by the OECD Council in March 2014[8]. In this document, the ministers agree on principles for public spending on investments in order to help governments at all levels assess the strengths and weaknesses of their public investment capacity. We invite the EU Institutions to take this document as reference and to also consider the quality criteria of public spending (how public spending is undertaken) and not only the quantity.

CEMR encourages the EU institutions to take action to resolve the public investment problems that local and regional authorities face due to the rules of the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance.

A section covering local and regional government finances should be included in the Commission White Paper on the long-term plan for the European Monetary Union, to be published in April 2017. A similar section should also be included in the Treaty on Stability, Coordination and Governance into the EU Treaty, which is foreseen for January 1st 2018, at the latest. They should also be taken into account in the relevant parts of the Action Plan for the Capital Markets Union.

[6] European Commission President **Jean-Claude Juncker**, President of the Euro Summit **Donald Tusk**, President of the Eurogroup **Jeroen Dijsselbloem**, President of the European Central Bank **Mario Draghi** and President of the European Parliament **Martin Schulz**: http://europa.eu/rapid/press-release_IP-15-5240_en.htm

[7] http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf

[8] http://www.oecd.org/gov/regional-policy/Principles-Public-Investment.pdf

⇨ *CEMR invites the European institutions and Member States to consider the impact of the SGP's rules on public investments and to provide further clarification on how they can be better taken into account when assessing national budgets.*

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About CEMR

The Council of European Municipalities and Regions (CEMR) is the broadest organisation of local and regional authorities in Europe. Its members are over 50 national associations of municipalities and regions from 41 European countries. Together these associations represent some 150 000 local and regional authorities.

CEMR's objectives are twofold: to influence European legislation on behalf of local and regional authorities and to provide a platform for exchange between its member associations and their elected officials and experts.

Moreover, CEMR is the European section of United Cities and Local Governments (UCLG), the worldwide organisation of local government.