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PUBLIC FINANCES, NATIONAL POLICIES AND COHESION

- The degree of decentralisation of both national public expenditure and Cohesion Policy programmes is generally lower in less developed countries, where there is scope for greater involvement of sub-national governments.

- Preliminary evidence shows that nationally funded investment for territorial cohesion in less developed countries represents in most cases only a small fraction of the funding provided under Cohesion Policy. There is therefore ample scope for increasing the efforts of the Member States concerned to strengthen cohesion as well as for improving the co-ordination with Cohesion Policy.

- Sub-national governments are responsible for carrying out a large share of public expenditure, though with significant differences across the EU.

- Sub-national governments are responsible for the majority of public investment in the EU. This is less the case in less developed countries, but the difference with more developed countries diminished significantly between 2004 and 2022 as public investment became more decentralised in the former. Since all governments decentralise certain public services and investment, a sound fiscal framework, as well as intergovernmental fiscal cooperation, is essential to improve the delivery of public services.

- Cohesion Policy multiannual programming has been a key driver of public investment integration in medium-term budgetary frameworks and public financial management structures. If managed well, decentralised investment, can improve the efficiency and effectiveness of public services to citizens and firms. Effective multilevel governance, in turn, relies on vertical and horizontal co-ordination across government's layers.

- Preliminary evidence from the OECD for several Member States shows considerable heterogeneity in the mix of funding sources at the regional and local levels. Transfers from other levels of government are the most important source of revenue. Countries where there is heavy reliance on one or only a few revenue sources are less resilient to shocks.

Chapter 8

Public finances, national policies and cohesion

1. Introduction

This chapter reviews national policies for territorial cohesion and sub-national public finances. It begins by examining preliminary evidence on the extent of nationally funded policies for territorial cohesion in a number of Member States using the data collected through ad hoc studies. It moves on to examine sub-national trends in public expenditure, revenue and investment over time and across Member States (Section 3). It then considers the composition of regional and municipal public expenditure and revenue in a number of EU Member States on the basis of data collected by the Organisation for Economic Co-operation and Development (OECD) with the support of the European Commission (Section 4).

In order to bring out broad differences, the chapter divides the EU Member States into two groups according to their gross national income (GNI) per head, which is taken as a proxy for their level of development. The 15 countries with GNI per head below 90 % of the EU average – the threshold for eligibility for the Cohesion Fund – are included in the less developed group (i.e. Bulgaria, Czechia, Estonia, Greece, Croatia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Portugal, Romania, Slovenia and Slovakia), the remaining 12 in the more developed group.

2. National policies addressing territorial disparities

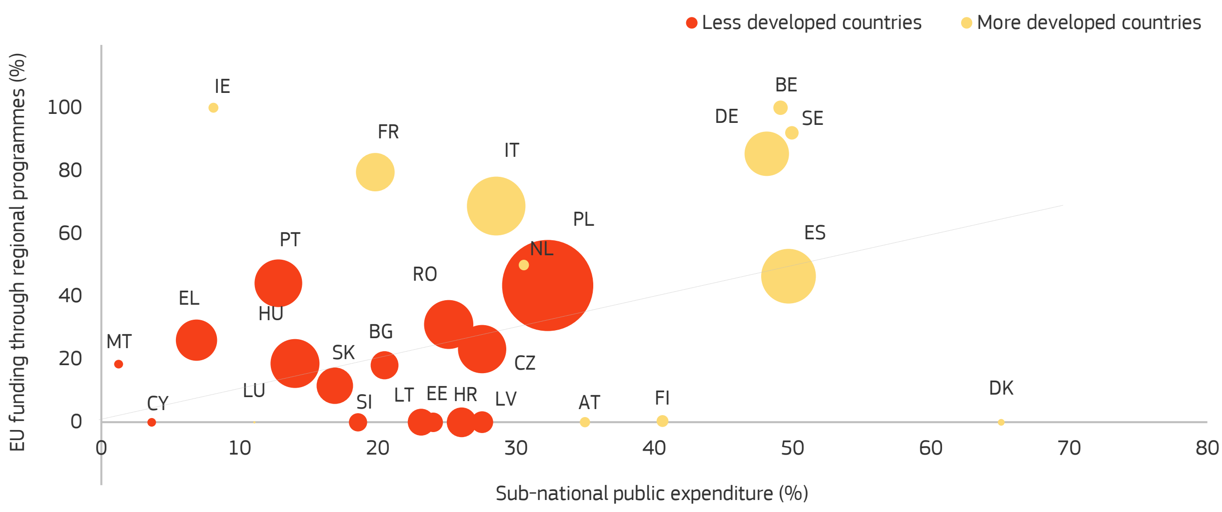
National policies to tackle regional disparities have a key role in strengthening territorial cohesion in the EU, especially contributing to reducing within-country disparities. Reducing internal territorial disparities is essential for optimising economic efficiency and improving competitiveness, and it needs to be a priority in Member States. By securing balanced development between regions, Member States can exploit the unique strengths and assets of each, contributing to a more diversified and resilient national economy. Improving the economic performance of all regions also increases the opportunities for co-operation and can create a dynamic environment in which innovation and knowledge are shared more widely, improving the competitiveness of the whole country.

These are compelling reasons why Member States should apply the 'do no harm to cohesion' principle to their national policies in all areas, meaning that national, regional and local authorities should be aware of the asymmetric territorial impact that any policy measure might have and take account of this in the policy-making process (the Treaty on the Functioning of the EU, it should be noted, explicitly calls on Member States to contribute to strengthening the economic, social and territorial cohesion of the EU through their economic policies (Articles 174 and 175)).

Where disparities exist within countries, these should be addressed in a complementary manner by national policies and EU funding. Where EU-funded interventions are planned and implemented, there may be a need for further support from national resources. This may be the case, for example, where the demand for a certain type of assistance exceeds the expectations of programmes or where unforeseen circumstances arise that require an immediate response. In areas not covered by EU funding, national policies represent the only level of support for sub-national governments to spend on policies aimed at strengthening socio-economic performance, recovering from immediate crises, addressing long-term deficiencies and building resilience to future shocks and a rapidly changing environment.

National policies and Cohesion Policy should be mutually reinforcing, leading to a more comprehensive and effective approach to regional development. By actively tackling regional disparities, Member States align their national strategies with overarching EU objectives.

Figure 8.1 Share of Cohesion Policy support implemented through regional programmes and share of sub-national public expenditure, 2014–2020



Source: DG REGIO calculations based on Eurostat gov_10a_main and Cohesion Open Data.

Figure 8.1 shows the share of EU Cohesion Policy support implemented through regional programmes in 2014–2020 (y-axis) in relation to sub-national public expenditure as a share of total government spending in the same period (x-axis), the size of the bubbles representing the amount of EU Cohesion Policy funding. There is a positive relationship between the two, implying that the degree of decentralisation of Cohesion Policy funding is positively correlated with that of national funding, or, in other words, that EU policy and national policy go broadly in the same direction. Figure 8.1 also shows that larger Member States and federal countries tend to be more regionalised in general (upper right-hand corner of the graph), while smaller Member States tend to be less regionalised in terms of general government expenditure and be dominated by national Cohesion Policy programmes. Remarkably, less developed countries are clustered in the lower left-hand corner of the graph; i.e. they are in general less regionalised, which gives ample scope for a greater involvement of sub-national governments in the design and implementation of both national public expenditure programmes and Cohesion Policy programmes (Box 8.1).

A more in-depth examination of the measures taken by countries to tackle territorial disparities is limited by the fact that available evidence on national policies is scarce and unsystematic, and, where it exists, is mainly limited to specific, time-limited case studies. To fill this knowledge gap, the European Commission has promoted a series of studies starting in 2019 to analyse policies for tackling territorial disparities that are fully funded by national resources.

One such study defined national policies for cohesion to encompass all policy initiatives and measures with the direct objective of reducing territorial disparities, together with those without such an objective but with a significant potential to achieve this. It covered 11 Member States[1]. All of these have national policies for cohesion, as defined, in place, with a range of policy instruments targeting different aspects of development, the most common being direct support for business development and innovation, transport infrastructure projects, and tax incentive schemes to support trade and improve the business environment.

1 European Commission (2019). The study was based on a combined analysis of statistical data, case studies, and stakeholder interviews. It covered 11 Member States, namely Bulgaria, Croatia, Czechia, Hungary, Italy, Poland, Portugal, Romania, Slovakia, Slovenia and Spain.

Box 8.1 Regional policies and multilevel institutional arrangements on the move

In recent years, regional policy has increasingly been confronted with competing objectives. First, the pursuit of its main objective of long-term structural change in less developed regions and the reduction of territorial disparities. Second, responding to short-term emergencies such as coping with the economic impact of the COVID-19 pandemic, facilitating recovery and dealing with the wide-ranging consequences of the Russian war of aggression against Ukraine, and, lately, the geopolitical instability in the Middle East. In addition, government policies are increasingly committed to meeting climate change targets, with potentially territorially asymmetric impacts on industrial production, energy generation and employment. Regional policies, as well as multilevel institutional arrangements and governance, are subject to multiple pressures that require them to evolve and adapt.

In its latest report, the World Observatory on Subnational Government Finance and Investment of the OECD (SNG-WOFI) and the United Cities and Local Governments (UCLG) provide the most comprehensive and systematic picture of territorial institutional structures and multilevel governance in 135 countries, of which almost half (61) have both a municipal and a regional level[1].

The picture that emerges from the report is one of decentralisation frameworks in continuous evolution around the world. It is interesting to note that there is a reform trend towards a clearer division of responsibilities between different levels of government and the allocation of the necessary resources to fulfil them, in an attempt to reduce the emergence of unfunded or underfunded mandates (i.e. the mismatch between responsibilities and available resources).

In addition, the decentralisation process is being accompanied by territorial reforms, such as municipal mergers or splits, in order to achieve greater efficiency. As an alternative to mergers, many countries are implementing inter-municipal co-operation, which can take various forms. In particular, countries are increasingly adopting asymmetric governance arrangements at the regional and metropolitan levels. In other words, more and more countries tend to allocate different political, administrative or fiscal powers to governments at the same sub-national level (regional/state, intermediate or municipal).

As far as Europe is concerned, a recent report by the European Regional Policy Research Consortium, based on a study of 30 countries, both EU Member States and non-EU countries, highlights five emerging trends in regional policy, each of which is actually reflected in the developments of EU Cohesion Policy between the current and previous programming period[2].

1 OECD/UCLG (2022).

2 Bachtler and Downes (2023).

Reducing territorial disparities is often pursued as part of growth and industrial policy, especially in Member States where all or most of the regions are less developed according to the EU Cohesion Policy classification. In these cases, territorial cohesion is often an integral part of a country's broader effort to reduce economic disparities with more developed parts of the EU.

Nationally funded policies complement EU Cohesion Policy in two main ways. Either they provide additional funding in national priority areas where Cohesion Policy funding is considered insufficient, or they support activities that are not eligible for EU funding. In practice, in budgetary terms, national policies for cohesion, as defined, appear to account for a very small fraction of EU Cohesion Policy funding. Of the Member States covered by the study, only Italy and Romania have a significant budget for territorial cohesion, of much the same size as Cohesion Policy in the case of Italy and just over a third of this in Romania. In the remaining countries, national funding ranges from just under 3 % of Cohesion Policy funding, here including national co-financing, in Croatia, to just under 9 % in Spain.

Regional policy is combining sustainability with competitiveness and innovation by reframing the growth objective in terms of sustainable growth. This is based on the recognition of the uneven territorial impact of climate change measures and the impact on already structurally weak regions.

The place-based approach to regional policy is now well established and widespread, often in the form of integrated development strategies tailored to the specific needs of places. It should be noted that the EU 'smart specialisation' approach has helped to disseminate and mainstream this approach among regional authorities in the EU and beyond. Closely linked to this are visible efforts to increase coherence between regional and sectoral policies, for example by giving a territorial dimension to sectoral policies. Again, smart specialisation is an early example of the regionalisation of an otherwise typical sectoral policy.

The study found an increasing focus on vulnerable or marginalised regions. In several cases, this reflects a renewed political concern with the economic and social difficulties faced by rural areas, often in remote parts of countries, where there is a perception of neglect in favour of a policy focus on cities. This focus is also linked to the objective of improving regional resilience, as a consequence of the territorial vulnerabilities revealed by the impact of the COVID-19 pandemic and the need for regions to be more resilient to shocks. This renewed focus is also part of a wider policy objective of using regional policy interventions to improve quality of life and access to public services where these are under pressure or linked to demographic decline.

Finally, governance and institutional reform and capacity-building at regional and local level remain high on the regional policy agenda across Europe. In some cases, this involves the redefinition of existing administrative boundaries or units, for example through mergers and rationalisation of municipalities or increased co-operation between regional and local authorities. Notably, and in line with the global trend observed in the OECD/UCLG report, the decentralisation process in some countries is asymmetric.

As regards the regions targeted, there is evidence of different approaches and mixed experience. According to the findings of the study, some countries (e.g. Czechia and Croatia) actively support the more prosperous regions, including capital city regions, considering them to be the driving centres of economic growth that can help reduce the country's development gap with the more advanced parts of the EU. Other Member States – Italy, Romania and Spain, especially, as indicated above – are more active in supporting less developed regions to reduce disparities. The first approach is more common in countries that devote very limited national resources to this type of policy, while the second approach, targeting less developed regions, is more common in countries that invest more.

The vast majority of national policy measures for cohesion in the countries covered are designed by central government (90 %), some are co-designed with the regions, while only 3 % of the initiatives examined are designed at regional level. Implementation is the responsibility of central government in 70 % of cases and only 16 % of measures are implemented by regional authorities, the rest being implemented by local authorities. Countries where sub-national authorities carry out only a small share of public expenditure tend to have a more centralised governance of national policies for cohesion (as in Bulgaria, Croatia, Hungary, Portugal, Romania and Slovenia).

Further evidence is obtained by restricting the scope of the analysis to investment programmes or initiatives fully financed from national resources in the fields of economic development (including e.g. investment in innovation, ICT, and SME competitiveness), transport (including all forms of mobility), energy, environment, health and education, thus excluding non-investment measures, and by focusing only on policies that either have a specific territorial/spatial focus or are explicitly aimed at reducing territorial disparities and strengthening territorial cohesion, thus excluding measures without direct cohesion objectives[2].

2 European Commission (forthcoming).

Preliminary results for seven Member States (Croatia, Czechia, Estonia, Lithuania, Poland, Romania and Slovenia) show that, for the period 2015–2021, 36 investment initiatives were planned with a budget of EUR 7.9 billion. This represents only 5.4 % of the combined European Regional Development Fund and Cohesion Fund allocations (including national co-financing), for these countries for the 2014–2020 programming period. There are, however, big differences between the countries, especially between Romania, where national investment for cohesion amounted to around 30 % of Cohesion Policy funding for investment, and the other six countries, where the figure ranged from 3.8 % in Slovenia and 1.7 % in Czechia to only 0.7 % in Poland and under 0.5 % in Croatia, Estonia and Lithuania.

The implemented budget of national investment policies for cohesion as of the end of 2023 is overall equal to 76 % of the planned budget for the seven countries surveyed, with a maximum in Czechia at 107 %, and a 100 % execution in Croatia, Estonia, and Lithuania, while Slovenia, Poland and Romania implemented 87 %, 84 % and 73 % respectively. If we compare the implemented budget with total public expenditure (taking into account the sum of central, state and local government) over the same period 2015–2021, we find that, in the seven countries surveyed, national policies for cohesion account for a total of 0.2 % of public expenditure, a tiny fraction. Again, there are huge differences between countries: in Romania, this figure is over 1 %, in Czechia it is almost 0.6 %, while in the other five countries it is less than 0.1 %.

While recognising that a national investment policy for cohesion may cover different policy areas, it can be seen that 50 % of the measures include the area ‘business & enterprise’, while areas such as ‘connectivity’, ‘human capital’ and ‘living standards’ are each included in around a third of the measures; 17 % of the measures include ‘climate change & environment’, while 6 % include ‘research & innovation’. In terms of policy instruments, the vast majority of the measures identified (94 %) mainly use grants and transfers, although some also offer interest rate subsidies (14 %), tax breaks (8 %) or loan guarantees (3 %), sometimes used in combination.

Evidence is available with a breakdown by categories of beneficiary of national investment policies for cohesion, where again a single measure may address more than one category of beneficiary. The policies identified cover a wide range of different beneficiaries. In particular, it can be noted that the majority of measures (67 %) are targeted at municipalities, followed by SMEs (39 %), public organisations (25 %), non-profit organisations (25 %), start-ups (22 %), scale-ups (11 %), large enterprises (17 %), industrial parks and other types of parks or innovation zones (11 %) and multinationals (8 %).

Some 86 % of the investment measures are designed by central government, 11 % by regional authorities and only 3 % by local authorities. The latter two, however, have more importance in the implementation of investment, being responsible for implementing 19 % and 25 % of measures, respectively. Overall, in these seven countries, therefore, national investment policies for cohesion appear to be predominantly centralised in terms of design, but both regional and local authorities have a significant role in implementation.

3. Sub-national public finances and investment

3.1 The national context: public finances on the way to a gradual improvement after the COVID-19 crisis and the energy crisis

In order to fully understand the situation and evolution of sub-national public finances in EU Member States, it is important to set out the macro-economic context in which they operate. Far from having a uniform impact across countries, macro-economic factors often have strong asymmetric effects that constrain the potential room for manoeuvre of sub-national finances. This is particularly true in the recent crises triggered by the COVID-19 pandemic and the Russian war of aggression against Ukraine. The section provides an overview of the markedly heterogeneous situation of national public finances across the EU in recent years.

The Eighth Cohesion Report described the significant improvement in the public finances of EU Member States in the years following the Great Recession of 2008–2009 and the sovereign debt crisis of 2011. While there was fiscal consolidation to reduce budget deficits in the period after 2011, which was supported by economic recovery from 2015 to 2019, trends were abruptly reversed in 2020 with the outbreak of the COVID-19 pandemic and the restrictive measures taken to contain it, along with the financial support provided to safeguard businesses and jobs. In 2021, the EU deficit started to decline, as a result of a reduction in expenditure on pandemic-related emergency measures, combined with a recovery of GDP from the collapse the year before. The decline continued in 2022, despite government spending on energy support measures in response to the energy crisis triggered by the war in Ukraine.

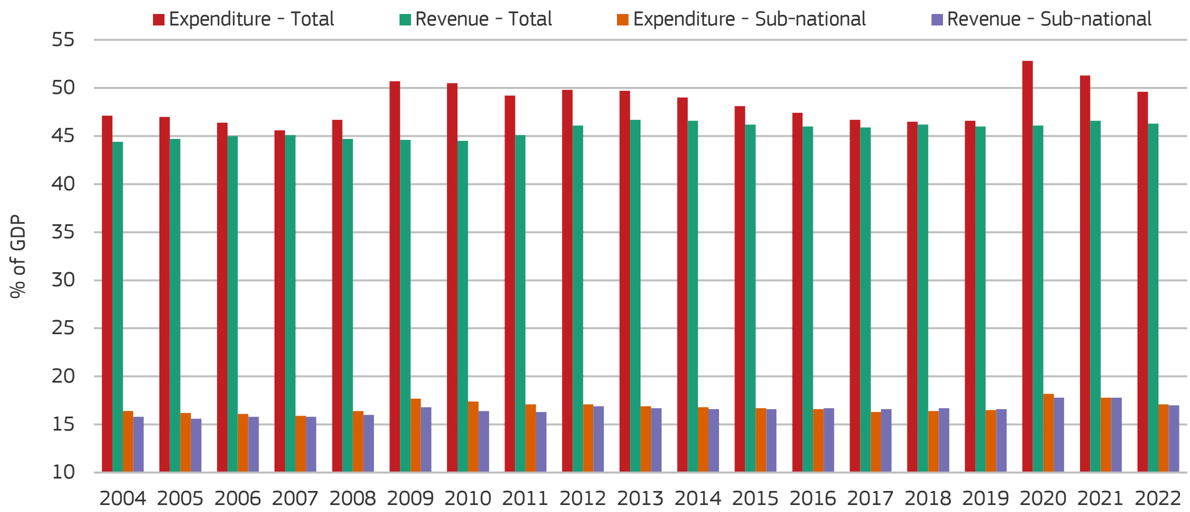
3.2 Sub-national governments carry out a large share of public expenditure, but with marked differences across the EU

This sub-section examines government expenditure and revenue at regional and local level and the changes that have occurred in recent years, including in response to the COVID-19 pandemic and the energy crisis of 2022. Around a third of total government expenditure in the EU-27 is carried out by regional and local authorities, highlighting their importance in the delivery of public services, and their fundamental role in the functioning of the public sector. However, there is substantial variation across Member States in the formal extent of decentralisation of government expenditure and revenue (Box 8.2).

It is important to note that the figures for government expenditure and investment carried out at the sub-national level and the revenues collected at this level indicate the amounts that are channelled through the authorities concerned. While these may be responsible for managing expenditure or collecting revenue, they may have limited autonomy over the underlying policy and the decisions on investment or taxes. Section 4 below sets out an exploratory examination of the composition of revenue and expenditure, which might shed some light on the actual decision-making powers of regional and municipal authorities.

In 2022, sub-national expenditure and revenue in the EU were both 17 % of GDP, or around a third of total government spending, and slightly more of revenue (Figure 8.2). The share of GDP has been very stable over time – in 2004, it was just over 16 %. In the same way as the total, sub-national government expenditure varies counter-cyclically with GDP, tending to increase as a

Figure 8.2 Total and sub-national government expenditure and revenue in the EU, 2004–2022



Source: Eurostat gov_10a_main.

share when GDP falls and to fall when it increases. The share increased sharply in 2020, jumping by 1.7 pp as a consequence of the pandemic and the measures taken in response to it, and falling back in the following two years as GDP recovered. In 2022, it was 1.1 pp lower than in 2020, though 0.6 pp higher than before the pandemic. Sub-national revenue also increased in 2020, by 1.2 pp to almost 18 % of GDP, and in 2022 it was still 0.4 pp higher than before the pandemic, partly because of increased transfers from central governments to combat the pandemic and to recover from the recession caused by the restrictive measures taken.

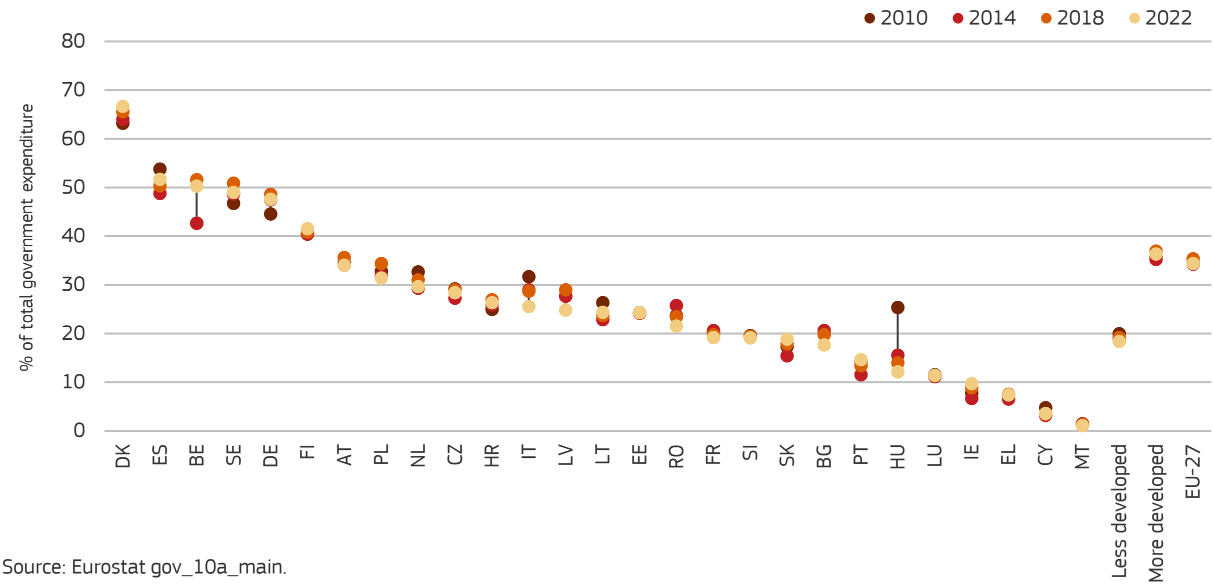
There are significant differences between Member States in the share of sub-national government expenditure in total government spending, reflecting in part differences in the institutional make-up (Figure 8.3). The share is largest in federal countries (Austria, Belgium and Germany) and in those where government is highly decentralised (Denmark, Spain, Sweden and Finland). In Denmark, around two thirds of public expenditure in 2022 was carried out by sub-national authorities; in Spain, Sweden, Germany and Belgium, around half; and in Finland, over 40 %. By contrast, in Cyprus and Malta, reflecting their size, sub-national authorities were responsible for under 5 % of public expenditure, and in Greece, Ireland and Luxembourg, only around 10 % or less.

Although the share of expenditure carried out by sub-national authorities in the EU has been stable over time, this is the result of differing developments across Member States. Between 2010 and 2022, the share increased in eight Member States and declined in 15. More specifically, it increased by around 8 pp in Belgium, by over 3 pp in Denmark and Germany, and by 2 pp in Sweden and Ireland, while it fell by over 1 pp in 11 countries, declining by 6 pp in Italy and 13 pp in Hungary.

Overall, government expenditure tends to be significantly less decentralised in less developed Member States than in more developed ones, with sub-national spending accounting for 18 % of expenditure in the former in 2022 and 36 % in the latter. Over the period 2010–2022, expenditure became less decentralised in less developed countries, with the sub-national share falling by 1.6 pp, while it increased by 0.5 pp in the more developed ones.

Sub-national government expenditure tends to be concentrated in certain policy areas (see Box 8.3 for a description of the breakdown by function).

Figure 8.3 Sub-national government expenditure in EU Member States, 2010, 2014, 2018 and 2022



Source: Eurostat gov_10a_main.

Box 8.2 Fiscal decentralisation and economic performance

The impact of fiscal decentralisation on economic growth has been intensively studied for decades. It is difficult to disentangle because fiscal decentralisation often evolves at different speeds along two axes, expenditure and revenue, which interact with economic performance in complex ways.

Public expenditure decentralisation can be seen as a means of increasing the efficiency of government service delivery at the local level, leading to better social conditions and, ultimately, higher economic growth[1]. However, the precise empirical relationship between fiscal decentralisation and growth is difficult to establish, as economic growth is affected by decentralisation, but decentralisation can also be affected by economic growth.

Using a variety of techniques, some recent studies find a positive effect of expenditure decentralisation on growth, i.e. increasing the share of sub-national expenditure in total general government expenditure increases GDP per capita growth[2]. However, there is still no firm and unanimous consensus in the literature on the existence and magnitude of a general positive effect of decentralisation on growth[3].

Several authors point to the crucial role of the institutional framework as a mediating factor in the relationship between fiscal decentralisation and growth. The efficiency argument, which is used to justify the decentralisation of public services and therefore of expenditure, finds its limits in the autonomy and accountability of sub-national authorities. The growth-enhancing effects of fiscal decentralisation are found to depend critically on the authority of sub-national governments. Fiscal decentralisation is more conducive to growth when sub-national revenues are mostly derived from autonomous sources (e.g. property taxes)[4]. And more generally, the quality of the institutional environment matters for the (positive) impact of fiscal decentralisation[5].

Finally, other studies point out that while greater autonomy for sub-national governments following greater control over locally generated revenues may encourage more efficient, accountable and business-friendly attitudes on the part of local administrators, it may also worsen these same incentives for central government administrators, making it difficult to predict the ultimate combined effect on economic performance[6].

The picture therefore appears to be indeed ambiguous, calling for investment in the production of better territorial data, including on the characteristics of the institutional environment and on the multilevel governance of public policies.

1 Oates (1999).

2 Aray and Pedauga (2024); Canavire-Bacarreza et al. (2020); Iimi (2005).

3 Anam and Plaček (2023).

4 Filippetti and Sacchi (2016).

5 Buser (2011).

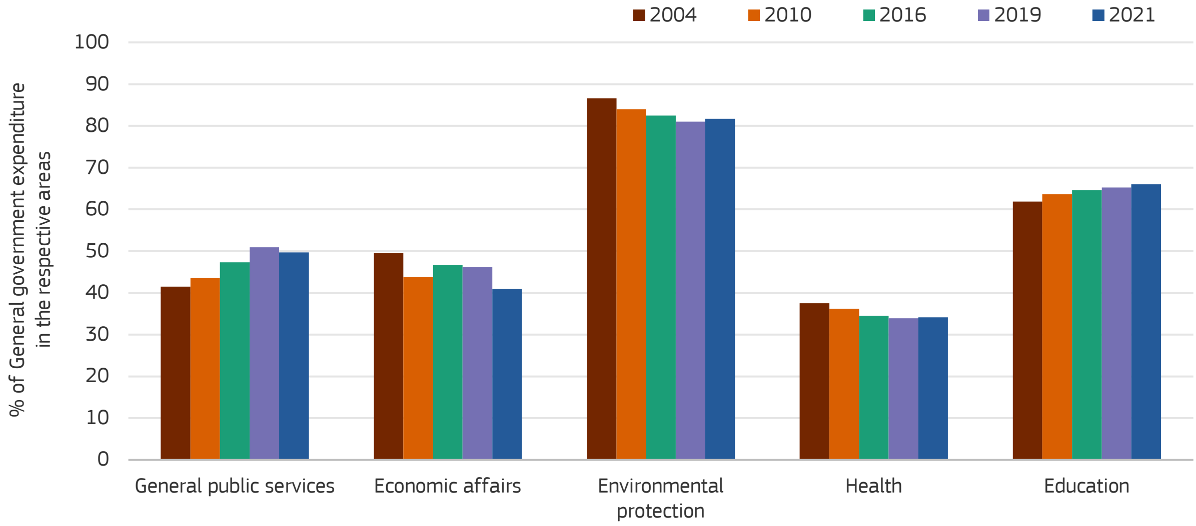
6 Treisman (2006).

In 2021, sub-national authorities were responsible for close to 82 % of public expenditure on environmental protection[3] and 66 % of education expenditure, as well as almost 50 % of spending on general public services, 41 % of spending on economic affairs[4], and over a third of that on health (Figure 8.4). Over the period 2004–2021, there was a marked and almost continuous increase in the decentralisation of spending on general public services (by 8.2 pp, equivalent to an increase of almost 20 %) and education (by 4.1 pp, or 7 %). Sub-national expenditure in other areas, on the other hand, fell, in economic affairs (by 8.5 pp, or 17 %), health (by 3.4 pp or 9 %) and environmental protection (by 4.9 pp, or 6 %).

3 The COFOG category ‘environmental protection’ includes waste and wastewater management activities.

4 The COFOG category ‘economic affairs’ includes transport and communication services, which represent a large share of expenditure.

Figure 8.4 Sub-national government expenditure in selected policy areas in the EU, 2004, 2010, 2016, 2019 and 2021

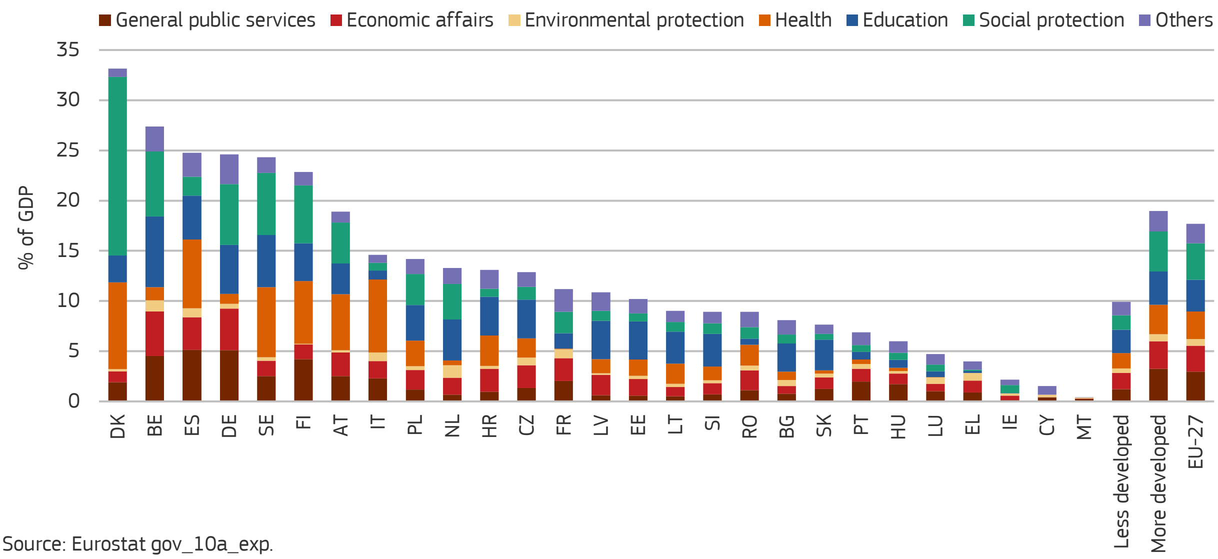


Source: Eurostat gov_10a_exp.

Social protection was the largest area of sub-national government expenditure in the EU in 2021, accounting for 3.6 % of GDP, followed by education at 3.2 %, general public services at 3 %, health at 2.7 % and economic affairs at 2.6 %, while expenditure on environmental protection was just 0.7 % of GDP (Figure 8.5).

Again, there is considerable variation between Member States. Overall, the expenditure carried out by sub-national authorities relative to GDP in less developed countries was only just over half of that in more developed ones (10 % as against 19 %). Spending in all areas was lower in the former, especially on social protection (2.5 pp lower), general public services (2.1 pp lower), health (1.4 pp lower), education and economic affairs (1 pp lower in both).

Figure 8.5 Sub-national government expenditure in selected policy areas, by EU Member States, 2021



Source: Eurostat gov_10a_exp.

Box 8.3 Classification of functions of government (COFOG)

The COFOG was developed by the OECD and is described in detail in the Eurostat guide[1].

There is a three-level classification with 10 'divisions' at the top level, each of which is further subdivided into six to nine groups, some of which are further subdivided into 'classes'. Here, the 10 top-level divisions are regrouped into the following seven categories: general public services (COFOG division 01), economic affairs – mainly transport (04), environmental protection (05), health (07), education (09), social protection (10) and other (comprising 02 'defence', 03 'public order and safety', 06 'housing and community amenities' and 08 'recreation, culture and religion').

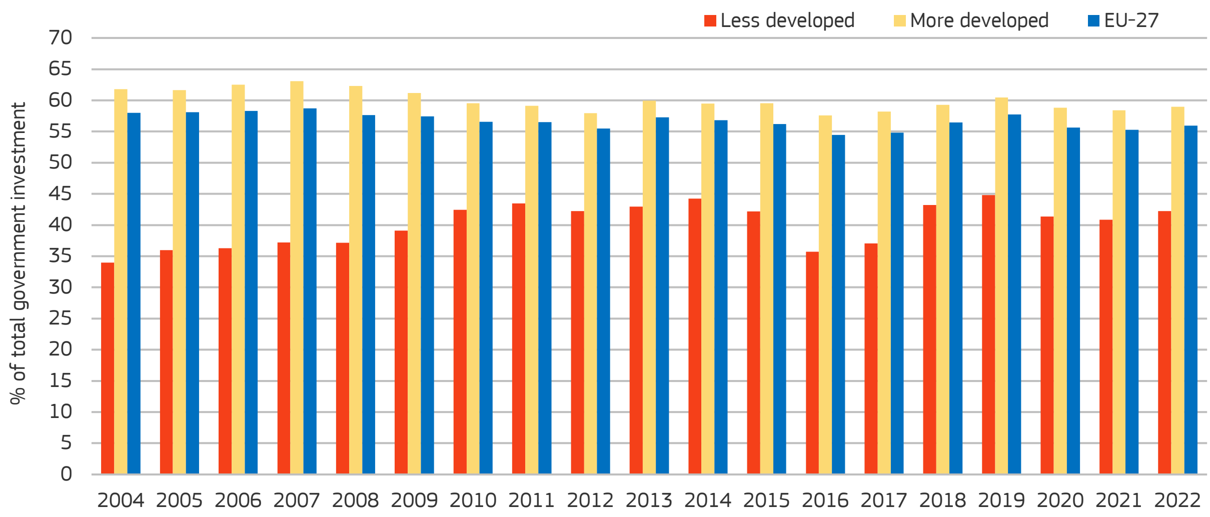
1 Eurostat (2019).

The differences between countries are even more marked. Sub-national expenditure on social protection was almost 18 % of GDP in Denmark, around 6 % or over in Belgium, Sweden, Germany and Finland, but only around 1 % or less in 17 Member States and zero in Malta and Cyprus. Expenditure on general public services at sub-national level was above 5 % of GDP in Spain and Germany, over 4 % in Belgium and Finland, but below 1 % in 11 Member States. Expenditure on education at this level was 7 % of GDP in Belgium, around 5 % in Sweden and Germany, and around 4 % in Spain, the Netherlands, Czechia, Croatia, Latvia, Finland and Estonia, but below 1 % in Italy, Hungary, Portugal, Luxembourg, Romania, Ireland and Greece, and again zero in Cyprus and Malta. Health expenditure was just under 9 % of GDP in Denmark, around 7 % in Italy, Sweden and Spain, and around 6 % in Finland and Austria, but well below 1 % in 11 countries.

3.3 Sub-national governments undertake the majority of public investment

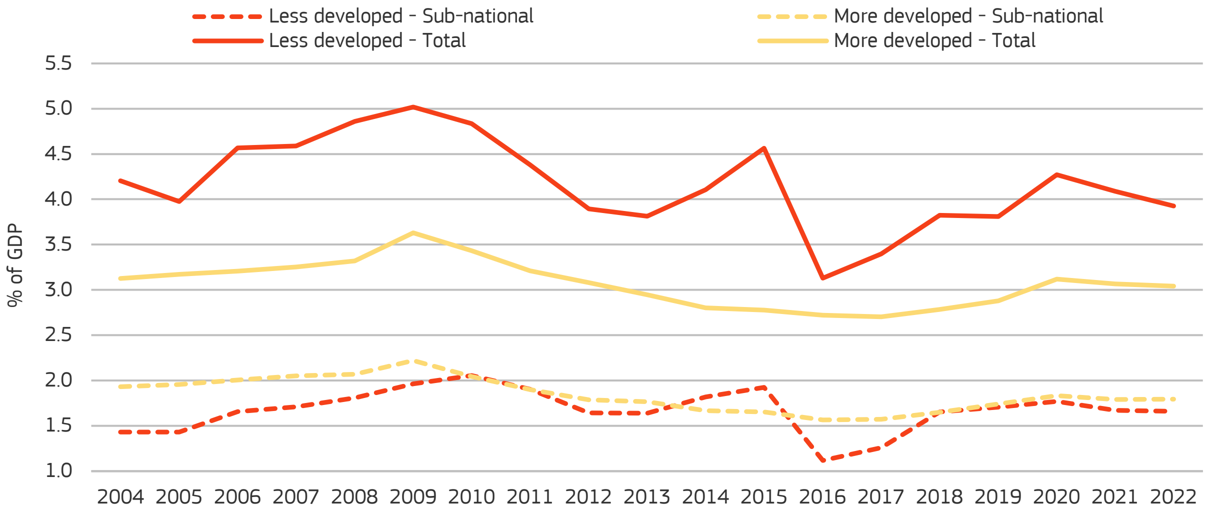
Sub-national authorities have a major responsibility for public investment, more than for public expenditure as a whole. Over half of public investment in the EU is carried out by sub-national governments – over the period 2004–2022, their expenditure on investment accounted for between 54 % and 58 % of the total carried out by government (Figure 8.6). Regional and local authorities, therefore, have a key role in providing the infrastructure to support development. At the same time, the sub-national share of public investment is smaller in less developed countries than more developed ones – 42 % of total investment in

Figure 8.6 Sub-national public investment in the EU and in more developed and less developed Member States, 2004–2022



Source: Eurostat gov_10a_main.

Figure 8.7 Sub-national and total public investment in more developed and less developed Member States, 2004–2022

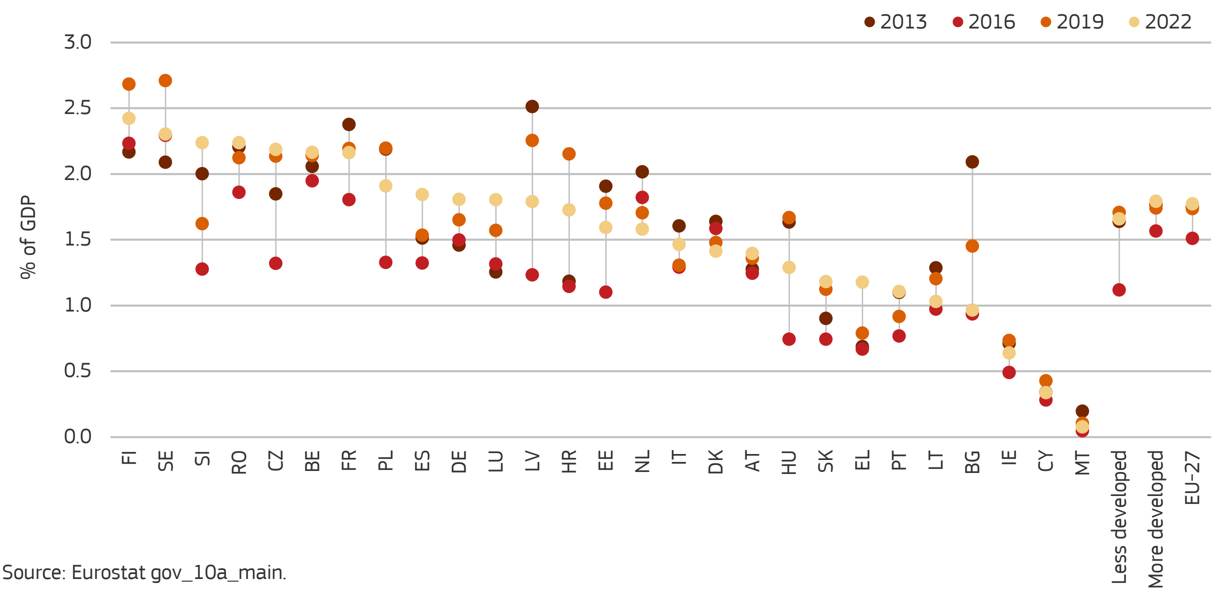


Source: Eurostat gov_10a_main.

2022 as against 59 % – although the difference declined by over 11 pp between 2004 and 2022.

As a share of GDP, total public investment in the less developed countries has been consistently higher than in the more developed ones over the last two decades (Figure 8.10), also due to the key role of Cohesion Policy support in the former. At the sub-national level, public investment as a share of GDP was of a similar magnitude in both more developed and less developed countries over the period 2004–2022, suggesting potential scope for further regionalisation in less developed countries. While, however, public investment as a share of GDP has tended to vary pro-cyclically in the two groups, declining dur- ing economic downturns and increasing during up- turns, the variation has been more pronounced in less developed countries than in more developed ones (Figure 8.10).

Figure 8.8 Sub-national public investment in EU Member States, 2013, 2016, 2019 and 2022



Source: Eurostat gov_10a_main.

Box 8.4 The challenge of producing comparable regional investment data – The experience of the Eurostat Task Force, 2019–2023

The production of systematic and reliable regional public investment statistics is a challenging task. To explore the feasibility of producing this type of statistics for the EU, Eurostat and several Member States formed a Task Force in 2019–2023, composed of experts in regional accounts and government accounts.

The main difference between regional and national government finance statistics is the type of statistical unit used to compile the accounts. While government finance statisticians work with institutional units, regional accountants use local kind-of-activity units.

The Task Force considered these and other methodological issues and made a number of recommendations on how to deal with them, depending on the nature of the assets and the information available.

The general government sector can be broken down into different sub-sectors. For the state and local government sub-sectors, the institutional unit consists of one or more local kind-of-activity units located in a single region. The importance of these two sub-sectors in total government investment at national level is on average close to 50 % for EU Member States. The Task Force recommended that the reporting of sub-sector data should start on a voluntary basis after 2024.

The Task Force focused mainly on the asset categories: other buildings and structures (representing on average three quarters of public investment), mobile equipment, and research and development. Four Member States participating in the Task Force produced test estimates based on new data sources and the recommended methodology. Of these four, Slovenia decided to publish the data[1], while the others considered that further work was needed, mainly to improve the data sources. Eurostat will continue to work with Member States to finalise the methodology for some specific goods (e.g. weapons systems and other military equipment), to establish new data sources and to encourage them to disseminate the results.

1 https://pxweb.stat.si/SiStatData/pxweb/en/Data/-/0309275S.px/.

In 2022, sub-national investment in the EU was 1.8 % of GDP. Public investment was of a similar size in relation to GDP over the period 2004–2022 in both the more developed and the less developed countries. While, however, it has tended to vary pro-cyclically in the two groups, declining during economic downturns and increasing during upturns, the variation has been more pronounced in less developed countries than in more developed ones (Figure 8.7).

In 2022, public investment carried out by sub-national governments was particularly high in relation to GDP in Finland and Sweden (2.3–2.4 %). It was also over 2 % in Slovenia, Romania, Czechia, Belgium and France, but below 1 % in Ireland, Cyprus and Malta. In general, countries with relatively low sub-national public investment also have low total public expenditure at sub-national level (Figure 8.8).

There has been no uniform pattern of change in sub-national public expenditure in relation to GDP over the past decade or so. In 14 Member States, it was higher in 2022 than in 2013, most notably in Luxembourg, Croatia and Greece (0.5 pp higher), while in 11 Member States it was lower, notably in Bulgaria and Latvia.

Cohesion policy multiannual programming has been a key driver of public investment integration in medium-term budgetary frameworks and public financial management structures. Integrated strategic planning and appraisal/selection models that effectively guide budget allocation and use asset registers as input are key for the delivery of public investment. A recent paper discusses a number of good practices across the public investment lifecycle, drawing on recent survey evidence from all EU Member States commissioned by DG ECFIN[5]. Overall, it finds that more sizeable

5 Belu Manesco (2022).

projects traditionally in the transportation sector are subject to a higher level of scrutiny. Similarly, EU financed investments tend to follow stricter rules throughout the project cycle than nationally financed ones. However, evidence also points to wide-ranging reforms of public investment management systems in several Member States, while room for improvement is evident across many Member States.

4. New evidence on regional and local finances

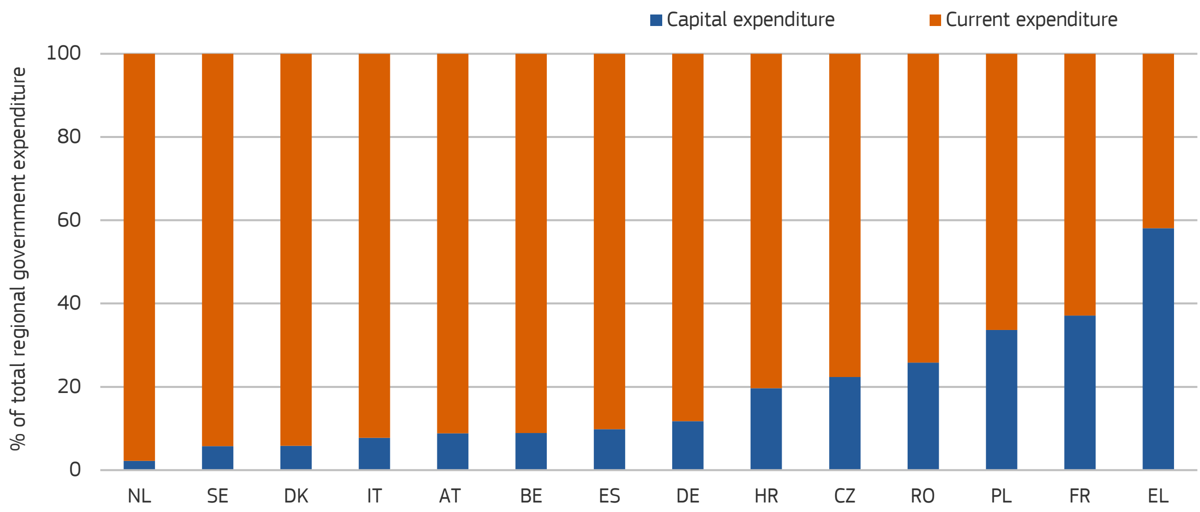
Sub-national public finances are examined in more detail below in order to better understand the role of sub-national governments in the institutional architecture of Member States, and ultimately to assess their degree of autonomy over decision-making. This is based on an initial, and still preliminary, dataset showing the relationship between current and capital expenditure and between different revenue sources for the regional and municipal levels of government in several EU Member States, developed by the OECD in collaboration with the Directorate-General for Regional and Urban Policy (DG REGIO)[6].

4.1 A comparative overview of current and capital expenditure

Figure 8.9 compares current and capital expenditure for 2020 of regional governments in the 14 EU Member States included in the regional government finance and investment database (REGOFI). It should be noted that regional capital expenditure includes the contribution from EU funding, which is particularly important in regions with more responsibility for investment programmes and for regional development more generally and less responsibility for service-provision (Box 8.4).

Current expenditure exceeded capital spending in the regions of almost all countries in 2020, implying that a major proportion of regional government revenue was spent on personnel costs and purchases of goods and services.

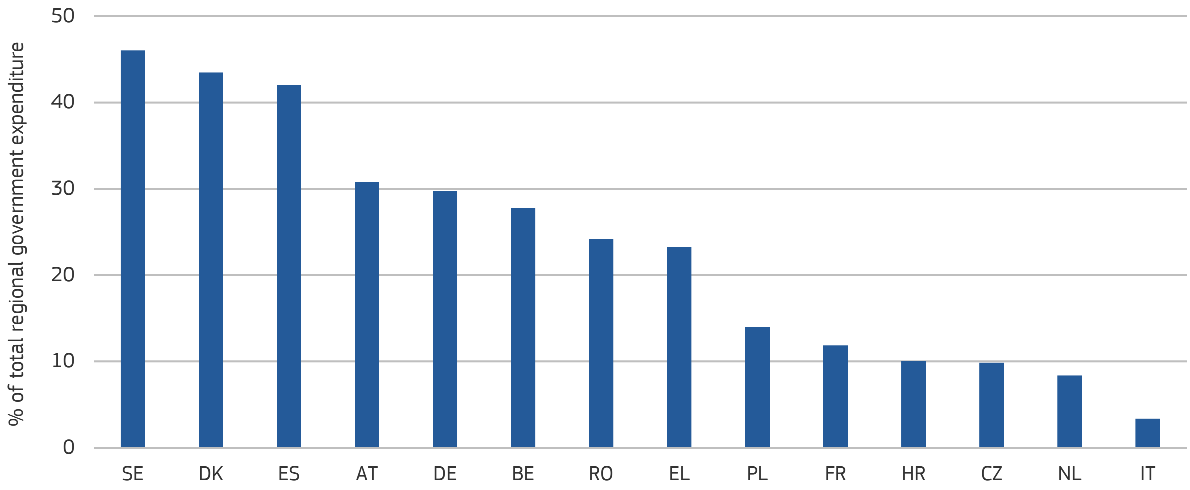
Figure 8.9 Breakdown of regional government expenditure in selected EU Member States, 2020



Source: OECD, MUNIFI and REGOFI Databases 2024.

6 The dataset consists of two databases, REGOFI and MUNIFI (municipal fiscal data), which currently cover 21 EU Member States at the municipal level and 14 at the regional level. They were built using a standardised methodology in collaboration with the national statistical institutes of most of the countries covered to facilitate in-depth comparison of the revenue, expenditure and investment profiles of regions and municipalities across countries. REGOFI covers regions defined at NUTS 2 level (nomenclature of territorial units for statistics) in all the EU Member States surveyed, except Belgium and Germany, where regions are defined at NUTS 1 level. The two databases cover only the regional and municipal levels and do not include other territorial units that fall between the two, such as Belgian provinces, French departments or Italian metropolitan cities, the public finances of which are included in Eurostat's sub-national government statistics. See: OECD (2024).

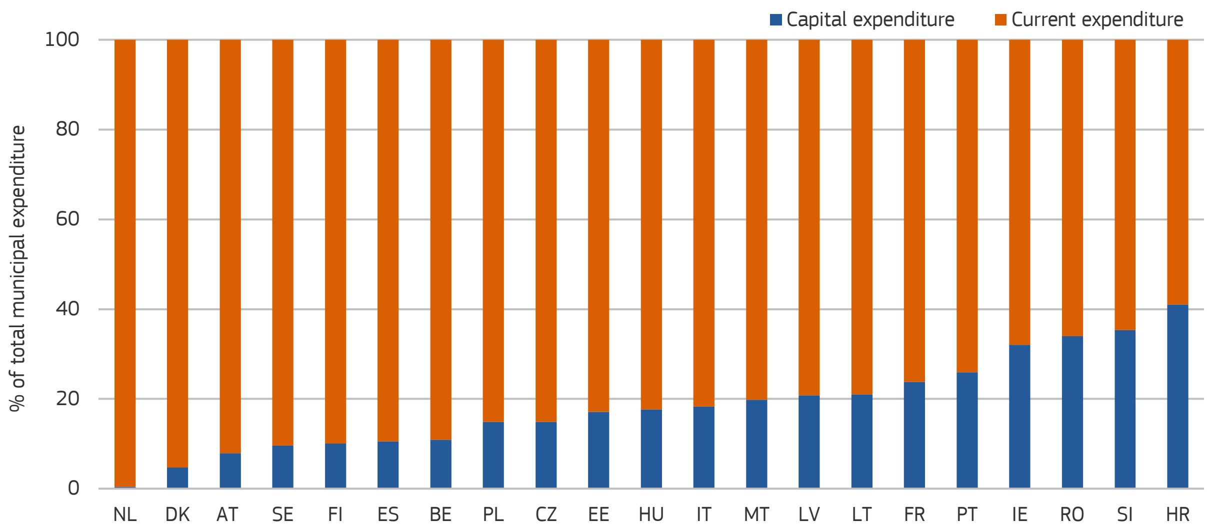
Figure 8.10 Regional personnel cost as a share of total regional expenditure in selected EU Member States, 2020



Source: OECD, MUNIFI and REGOFI Databases 2024.

Capital expenditure amounted to only just over 18 % of the total on average in the countries covered. This varied, however, from over 20 % in Czechia, Romania, Poland, France and Greece to under 10 % in the Netherlands, Sweden, Denmark, Italy, Austria, Belgium and Spain, with Germany and Croatia in between. The share of investment in total regional expenditure was largest in Greece, where regions are mainly responsible for regional planning and development, much of which is financed by funding under EU Cohesion Policy. Regions in Poland, which devoted around a third of their expenditure to investment, are also large recipients of Cohesion Policy funding and tend to play a relatively limited role in the provision of public services (for the 2014–2020 period, Cohesion Policy funding corresponded to around 13 % of public investment in the EU as a whole and to 51 % in the less developed Member States, see Chapter 9, Section 8). Similarly, in France, where the regions are responsible for their economic development, non-urban transport

Figure 8.11 Breakdown of municipal expenditure in selected EU Member States, 2020



Source: OECD, MUNIFI and REGOFI Databases 2024.

and spatial planning, capital expenditure accounted for 37 % of total regional public expenditure in 2020. When the share of capital expenditure is higher, the margins for adjusting the level and allocation of current expenditure in response to emerging exceptional circumstances may be limited, and public expenditure management should therefore be particularly careful.

On the other hand, the share of capital spending in total government expenditure at regional level was smallest in the Netherlands, Denmark and Sweden, where regional authorities have large responsibility for public services, such as healthcare, and administrative tasks. Regions in these countries also accounted for a smaller share of sub-national investment than local authorities.

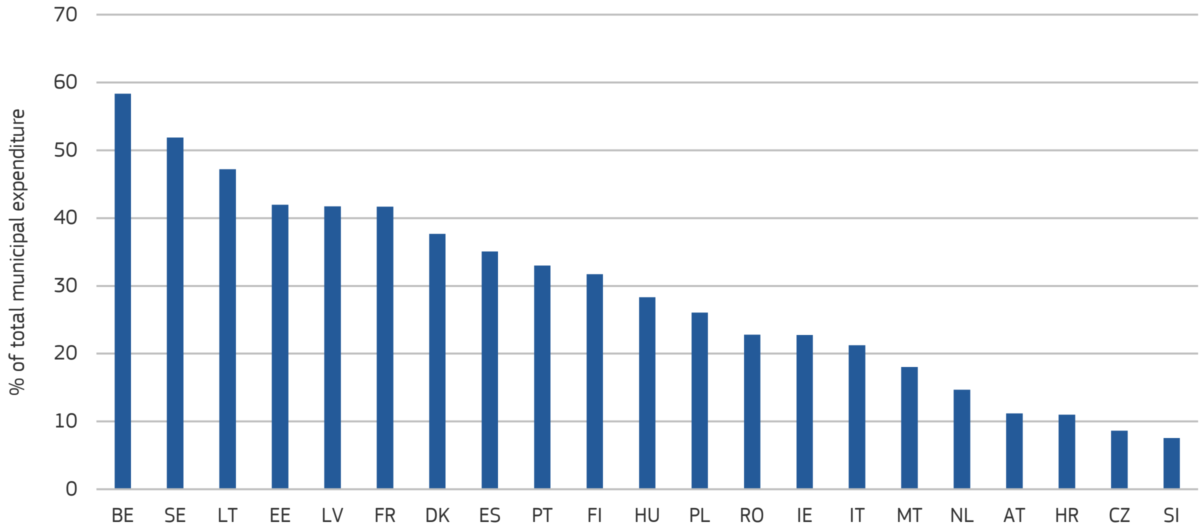
Figure 8.10 shows personnel costs as a share of total government expenditure at regional level for the 14 EU Member States covered. Personnel costs accounted for a particularly large share in Sweden, Denmark and Spain (over 40 %), but less than 10 % in the Netherlands, Czechia, Croatia and Italy (only 3 % in the last).

Figure 8.11 shows that, in all the 21 Member States for which municipal data are included in the database, current spending was the largest component of total government expenditure at this level in 2020. Capital expenditure accounted for just under 19 % of total municipal expenditure, on average, much the same as for regional government, although the set of countries covered is different and a comparison not meaningful.

Again, there is substantial variation between countries. Capital expenditure in municipalities was only around 10 % or less of total spending in the Netherlands, Denmark, Austria, Sweden and Finland, but over 20 % in Latvia, Lithuania, France and Portugal and over 30 % in Ireland, Romania, Slovenia and Croatia, in the last 41 %. In the last three countries, municipalities have the main responsibility for urban development, transport and housing. On the other hand, the small share of capital expenditure, and the correspondingly large share of current spending, in the first group of countries reflects their major role in the provision of education and social services (and social protection in Denmark).

Figure 8.12 shows personnel costs in 2020 as a share of total expenditure at municipal level for the Member States covered. These accounted for over 50 % of the total in Belgium and Sweden and over 40 % in Lithuania, Estonia, Latvia and France, while they accounted for under 20 % in Croatia, Austria, the Netherlands and Malta, and under 10 % in Slovenia and Czechia.

Figure 8.12 Personnel cost as a share of total municipal expenditure in selected EU Member States, 2020



Source: OECD, MUNIFI and REGOFI Databases 2024.

Box 8.5 Building resilience: the need for diversified revenue sources

In an era of unprecedented challenges and crises, the ability of sub-national governments to respond effectively depends on their capacity to adapt both the level and the composition of expenditure to changing circumstances. This requires access to financing, to taxation or borrowing. Where borrowing is constrained (usually by central government restrictions) – because, for example, of tight monetary conditions, as in the aftermath of the COVID-19 and energy crises – the key factor in ensuring financing at sub-national level is the diversity of revenue sources available.

Diversified revenue sources give sub-national governments operational flexibility, while overdependence on a main single source increases vulnerability, especially during crises. By diversifying revenue sources, sub-national governments can better withstand shocks. A balanced mix of sources, such as revenue from assets, user fees, grants, and taxes contributes to fiscal resilience, acting as a buffer and giving financial stability when one source is adversely affected.

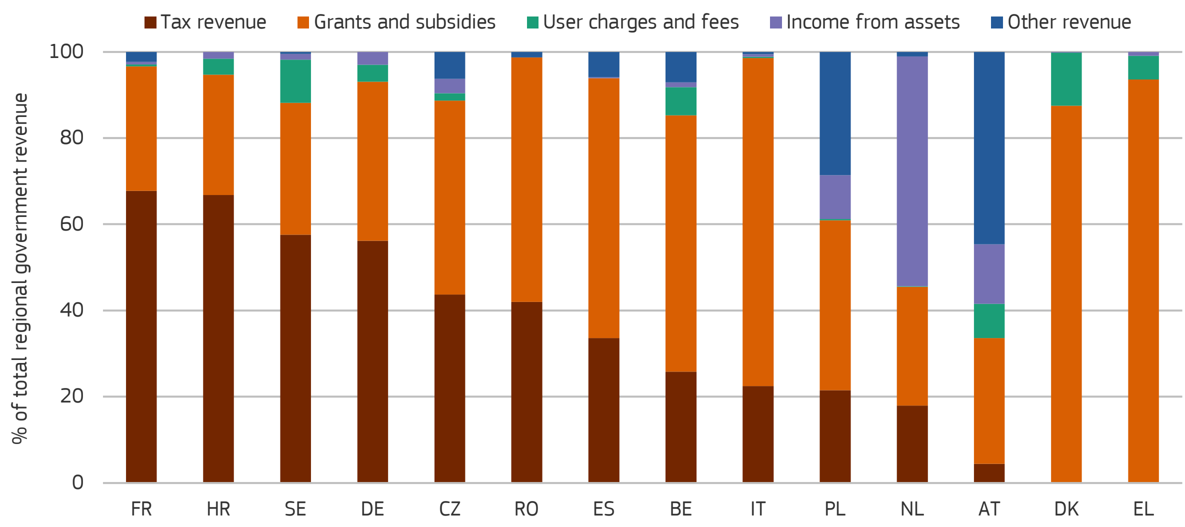
The importance of cultivating flexibility in revenue sources for sub-national governments cannot be overstated. The ability to weather crises, respond skilfully to unforeseen challenges and promote long-term sustainability depends on the diversification of revenue streams. By adopting a multi-faceted approach to revenue generation, sub-national governments can strengthen their fiscal resilience and ensure the well-being of their constituents in the face of an ever changing world.

4.2 Municipal and regional revenue sources

This section examines the revenue sources used to finance regional and municipal government expenditure. Relying on a single or only a few revenue sources as opposed to having a more diverse mix has important implications for the sustainability and resilience of public finances at sub-national level. Other things being equal, reliance on a few sources generally means less resilience to shocks and changing socio-economic conditions. Resilience can, therefore, be improved by diversification of revenue sources, but effective institutions and mechanisms need to be in place to achieve this (see Box 8.5).

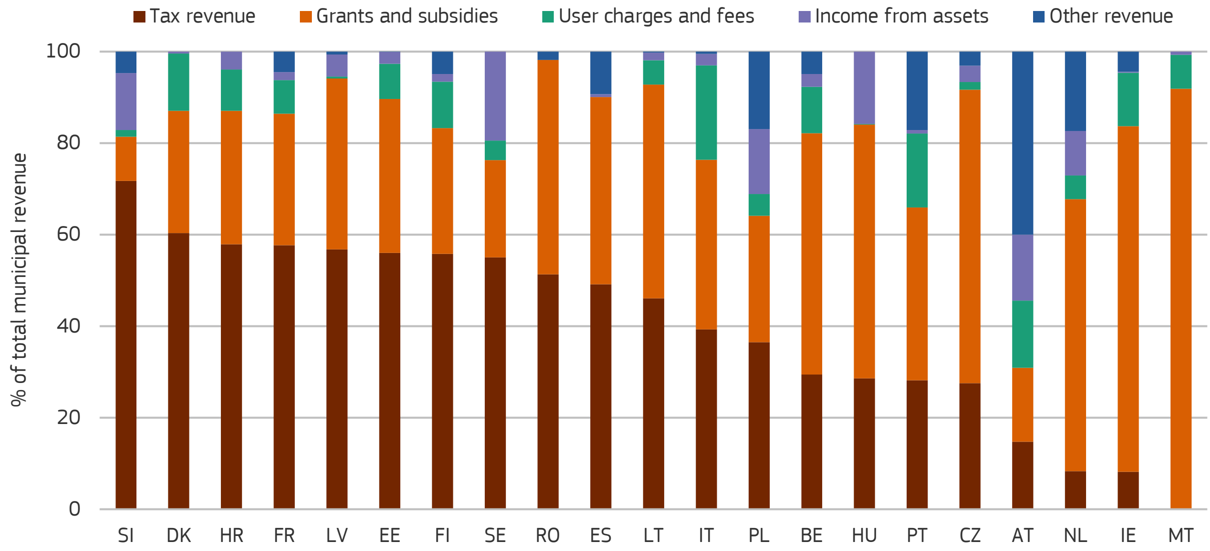
Figure 8.13 shows the breakdown of regional revenue sources for 14 EU Member States in 2020. It is important to note that a larger share of revenue

Figure 8.13 Breakdown of regional government revenue in selected EU Member States, 2020



Source: OECD, MUNIFI and REGOFI Databases 2024.

Figure 8.14 Breakdown of municipal revenue in selected EU Member States, 2020



Source: ECD, MUNIFI and REGOFI Databases 2024.

from taxes as compared with, for example, transfers from central government does not automatically mean a higher degree of autonomy for regions in deciding and managing their finances. Regional governments have different degrees of control over tax rates and provisions, especially with regard to shared taxation, i.e. national taxes where a specified proportion of the revenue raised is allocated to regional or other sub-national authorities[7].

In general, the main source of regional government revenue in 2020 was grants and subsidies, i.e. transfers from central government and the EU, accounting on average for half of the total revenue (see Box 8.6 on the challenges of managing transfers between different levels of government). This revenue source was the only one present in all 14 countries covered, ranging from 94 % in Greece, over 70 % in Denmark and Italy and over 50 % in Belgium, Spain and Romania to under 30 % in Austria, France, Croatia and the Netherlands.

The second major source of revenue at regional level is taxes, including both shared and own-imposed, which, on average, accounted for a third of total regional government revenue in 2020. It is notable that regions in both Denmark and Greece had no revenue from taxes, reflecting their lack of tax-raising power. Much the same was the case in Austria, where taxes accounted for under 5 % of revenue. By contrast, in Sweden and Germany over 55 % of regional government revenue came from taxes and over 65 % in France and Croatia.

User charges and fees and asset-based revenue made up a much smaller share of government revenue at regional level, averaging just under 4 % and just over 6 %, respectively. However, in Sweden and Denmark, user charges and fees accounted for over 10 % of revenue, and in the Netherlands, asset-based revenue for over half.

Funding sources at regional level are most diverse in Poland, the Netherlands, Austria and Sweden, while they are most concentrated in Greece, Denmark, Italy, France and Croatia.

Contrary to the situation at regional level, transfers and taxes were of a similar weight in funding municipal governments in 2020 (Figure 8.14), each accounting for around 40 %. However, differences between Member States are again considerable. The most diverse mixes of funding sources at this level were in Poland, Austria and Portugal, followed by Finland, Sweden, Italy, Belgium and Hungary, while they were most concentrated in Malta, Ireland, Czechia and Slovenia.

7 In Germany, for example, tax revenue is the main source of revenue for the Länder, but they have little influence over it, as most comes from shared taxation (from personal and corporate income tax and value added tax).

Box 8.6 The challenges of managing fiscal transfers between different levels of government

Inter-governmental financial transfers, often in the form of grants and subsidies, are an important source of revenue for sub-national governments and the main one in several EU Member States. The transfers can be used to finance the implementation of national policies as well as sub-national expenditure as such[1].

The governance of fiscal transfers depends on the political, economic and administrative system of the country, and so their design and effects can only be fully understood in the specific institutional context concerned. The governance of transfers is complex and practices vary widely across countries, with implications for the efficiency and effectiveness of delivery of the services that transfers support.

In general, multilevel governance poses the challenge of balancing the need for sub-national authorities to have some autonomy with the need to avoid policy incoherence and economic inefficiency. The former is important for policy accountability, while the latter cannot be taken for granted, as governments at different levels serve the interests of different constituencies, which may not coincide, especially in countries with significant territorial disparities. These challenges involve the design and management of transfers.

To address them, the design needs to make policy objectives clear, transparent and measurable with all levels of government being accountable. Imposing conditionality on transfers is a powerful means of striking a balance between the need to ensure alignment of policy objectives, and standards of delivery between national and sub-national governments, and the decision-making autonomy of the latter. This is a means through which the central government can influence the sub-national government by limiting its discretion through incentives and constraints.

Conditional grants are now widely used. An important aspect of their functioning is that they require both donor and recipient governments to establish effective means of monitoring, controlling and enforcing the conditions. This in turn requires reporting, robust evaluation methods, the capacity to analyse, and procedures for resolving disputes, all of which are costly. It requires skilled and committed personnel, diplomacy when co-operation is at stake, and institutional stability. All of these factors can create a significant administrative burden, particularly for sub-national governments and especially for small municipal authorities.

In some cases, sub-national authorities, especially in less developed EU Member States, lack the capacity and resources to set up effective systems for managing such fiscal transfers. The transfer of resources implies a transfer of responsibilities and the ability to perform the tasks and functions involved, which cannot be taken for granted. Specific reforms may be needed at the sub-national level to build stable structures capable of managing fiscal transfers effectively. The receptiveness of sub-national authorities to nationally determined reforms is also a prerequisite for the successful imposition of conditionality on transfers.

1 Bergvall et al. (2006), Lago et al. (2022) and Spahn (2012).

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