Council of European Municipalities and Regions
European Section of United Cities and Local Governments

The Secretary General

Mr Valdis Dombrovskis
European Commission Executive Vice-President

Mr Paolo Gentiloni
European Commissioner for Economy

Brussels, 2 February 2023

Re: Impact of the Reform of EU economic governance on municipalities and regions

Dear Executive Vice-President, dear Mr Dombrovskis,
Dear Commissioner, dear Mr Gentiloni,

On behalf of the Council of European Municipalities and Regions (CEMR), I would like to draw your attention to the potential impact of the upcoming reform of the EU economic governance framework and of the Stability and Growth Pact on local governments.

The CEMR welcomes the Communication on the orientations for a reform of the EU economic governance framework, that was published in November last year. Nevertheless, we consider it is our responsibility to share our concerns on the impact that such reform may have on municipalities and regions and ultimately on the quality of the public services provided to European citizens, unless we work together on effective solutions to preserve and reinforce investment capacity at local level, such as the **exclusion of the expenditures of the local government sector from the definition of the net expenditure ceilings.**

You may appreciate that the EU economic governance framework has become overly complex over the years, creating unnecessary burdens and operational challenges for local and regional governments. In addition, our institutions have been hit hard by the financial and economic crises and the consequent austerity measures. This has led to a drop in local public investments in several European Member States, hampering the local contribution to the EU policy agenda. Local public investments have not fully recovered since, and the recent crises (COVID-19, war in Ukraine) are also expected to undermine the investment capacity of local and regional governments in the long term.

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In this context, **the exclusion of the expenditures of the local government sector from the definition of net expenditure ceilings will help our local institutions to progressively recover and allow to relaunch concretely our local and European ambitions.** Indeed, the local government sector uses debt financing exclusively for investment in capital assets with multi-year utility. Moreover, the level of debt of the local government sector is prudent in all member states of the European Union, while at the same time local governments are responsible for a substantial part of public investments made in the EU. This proposal is especially important since local governments are not represented in the European semester framework.

Please find attached a short paper further elaborating and justifying our proposal. We would welcome the opportunity to present these ideas to you and contribute in the most constructive way to the work you and your team are currently doing on the legislative proposal that will be published later this year. Please do not hesitate to contact the CEMR Secretariat, and in particular Ms Marine Gaudron (marine.gaudron@ccre-cemr.org ; +32 2 213 86 93) to organise such a meeting.

Yours sincerely,

Fabrizio Rossi

Explanatory note: Exclude local government-sector from definition net expenditure revised SGP

The European Commission announced in the communication on November 9th of 2022 the revision of the rules of the Stability and Growth Pact (SGP). With the revision, the 60% GDP (gross) national debt limit and the 3% GDP budget deficit limit of the Treaty on the Functioning of the European Union (TFEU) remain unchanged. The communication proposes abandoning the next three rules from the current underlying regulations of the SGP:

1. The 1/20th debt reduction benchmark if debt exceeds 60% of GDP;
2. The expenditure rule that sets a limit for annual expenditure growth;
3. The cyclically-adjusted limit for the structural expenditure deficit for the medium-term objective (MTO) of fiscal policy.

The Commission wants to replace them with a coordination mechanism between the Commission and the member state that sets net expenditure ceilings, which in the case of an excessive debt leads to a reduction in that debt.

Abandoning the MTO restores room for local public investments

Of the three limits that the Commission wants to abandon, the cyclically adjusted structural EMU deficit limit (MTO) has exerted a negative impact on the expenditure on investments of the local government sector through two channels. Because capital expenditures of local governments normally are exceeding the depreciation costs of the investments, there are annual positive net capital expenditures. To finance these net investment-expenditures the local government sector needs a room for a fixed annual deficit.

The first channel of the negative impact of the MTO on the local government sector expenditure is through the room for an EMU deficit itself. That room for a deficit must be distributed domestically between the central government, regional government and local government sectors. Especially in member states that were in the preventive arm, the room for an EMU deficit for the local government sector was cut. As a result, local governments could not borrow sufficiently for the necessary public investments and a significant share of its public investments was postponed and cut.

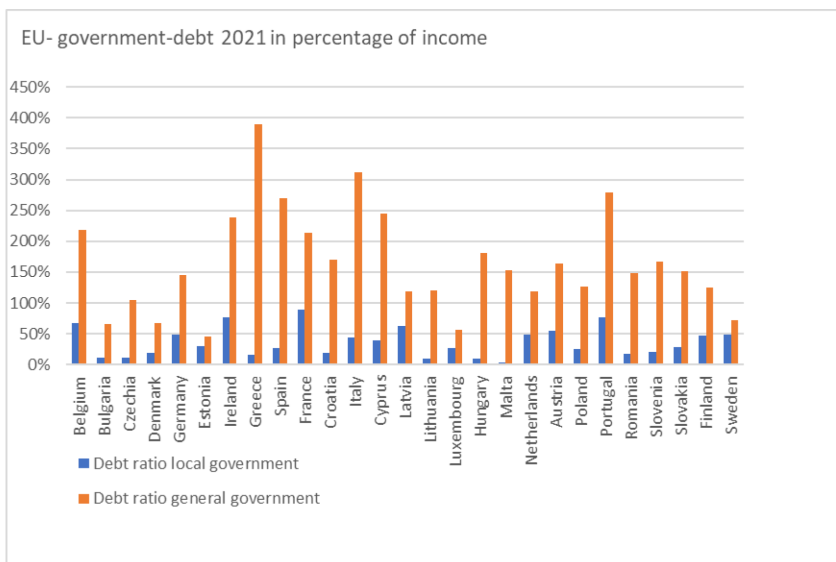
The second channel of the negative impact of the MTO is through the direct financial transfers from the central government (and regional governments) to the local government sector. In several member states that were in the preventive arm for long or short periods of time, the MTO imposed a heavy austerity burden on member states in a short period of time. This caused disproportionate cuts in transfers to the local government sector. Local governments generally operate cost-benefits accounting (using the method of double-entry bookkeeping or using a capital and current account). The declining transfers were met in part by not investing or investing much less, thereby reducing the depreciation costs and the maintenance and operation costs of investments.

The share of public investment by the local government sector, although it has thus declined, varies in the Member States between 20% and 60% of the total public investment of the Member States (excluding Malta and Cyprus). For the whole European Union the share is 49% of the total public investments. These investments are indispensable for the European Union to achieve its ambitions and goals in areas such as climate, energy and the digital agenda. The low level of public investment in recent years has also caused negative consequences for Europe's economic growth potential. This is, for example, due to poorly maintained infrastructure. We therefore see abandoning the MTO as a good step forward.

All local government-sector-debts in the EU are prudent

Within the 3% limit for the EMU deficit of the TFEU there is again room to grant the local government sector a fixed EMU deficit margin of sufficient size. So far, the 3% EMU deficit limit and quarterly reporting requirements on the development of the financial wealth of local governments (indirectly) to the EU institutions have worked well in controlling the debt evolution of the local government sector. Here we note that member states generally have internal rules to control the borrowing behaviour of the local government sector. In general local governments only borrow money to finance investment-expenditure and there is no discussion about the definition of investments. Only capital-expenditures are seen as investment-expenditures. Therefore, the level of debt of the local government sector is prudent in all member states of the European Union.

By expressing debt as a percentage of revenue, the debt ratios of the local government sector can be properly compared with the debt ratio of the central government or the general government as a whole. Of the local government sector in the European Union France's has the highest debt ratio at 89% followed by Ireland's local government sector at 77% and Portugal's at 76%. For the general government as a whole, these debts as a percentage of revenue are many times higher. Only five member states have a public debt lower than that of France's local government sector. For example, the public debt of the Netherlands is 119% of revenues and is thus higher. This public debt of the Netherlands as a whole is well below the 60% GDP debt standard of the TFEU. The European 60% GDP debt limit translates into a debt at 140% of revenues.



A net expenditure ceiling for the local government sector will also hamper investments

The envisaged revision of the Stability and Growth Pact (SGP) extends the range of instruments to include monitoring of exceeding the net expenditure ceilings for member state governments. This underlying debt targeting methodology is based onto the finances of central governments. This indirectly controls the evolution of the public debt. However, the control of local government finances differs significantly from this methodology of debt targeting through net expenditure ceilings. The definition for net expenditures of the proposed revision does not exclude local government sector expenditures. The differences create unnecessary problems for the local government sector when net expenditure ceilings are applied.

Firstly, it could lead to substantially higher administrative burdens. After all, the development of the net expenditure of the local government sector must be estimated and monitored four years in advance. This in fact leads to additional administrative burdens, because local governments do not use the net expenditure concept. It is therefore difficult to monitor. In addition, due to a different political cycle, the policy mandate does not coincide with that of the central government, which further complicates estimating the net expenditure. Some member state (especially the larger ones) have many local governments, which aggravates the situation.

Secondly, the problem of cuts in the level of local public investment also arises when using net expenditure ceilings for the local government sector. Again, less room for (net) expenditure for the local government sector means more room under the ceiling for expenditure by central and regional governments. Despite the local government sector's prudent financing performance, this tendency will be strong among central governments in member states. In that case, the easiest way for local governments to adjust to this excessively tight room for net expenditure is to postpone or cut local public investments. This has no direct impact on operational costs and is therefore an easier sell for local politicians. The problems of the current MTO for local governments, which fortunately is abandoned, will return with the new instrument.

Solution, exclude expenditure of local governments from definition net expenditure
In itself, we see the switch to use net expenditure ceilings as a good step if at least the net expenditure of the local government sector is excluded from its definition. This in itself isn't different from excluding, for example, the cyclical part of unemployment spending as has now been proposed in the communication. We therefore ask the European Commission, when revising the legislation for the SGP, to exclude the net expenditure of the local government sector from the definition of net expenditure of the new rules.