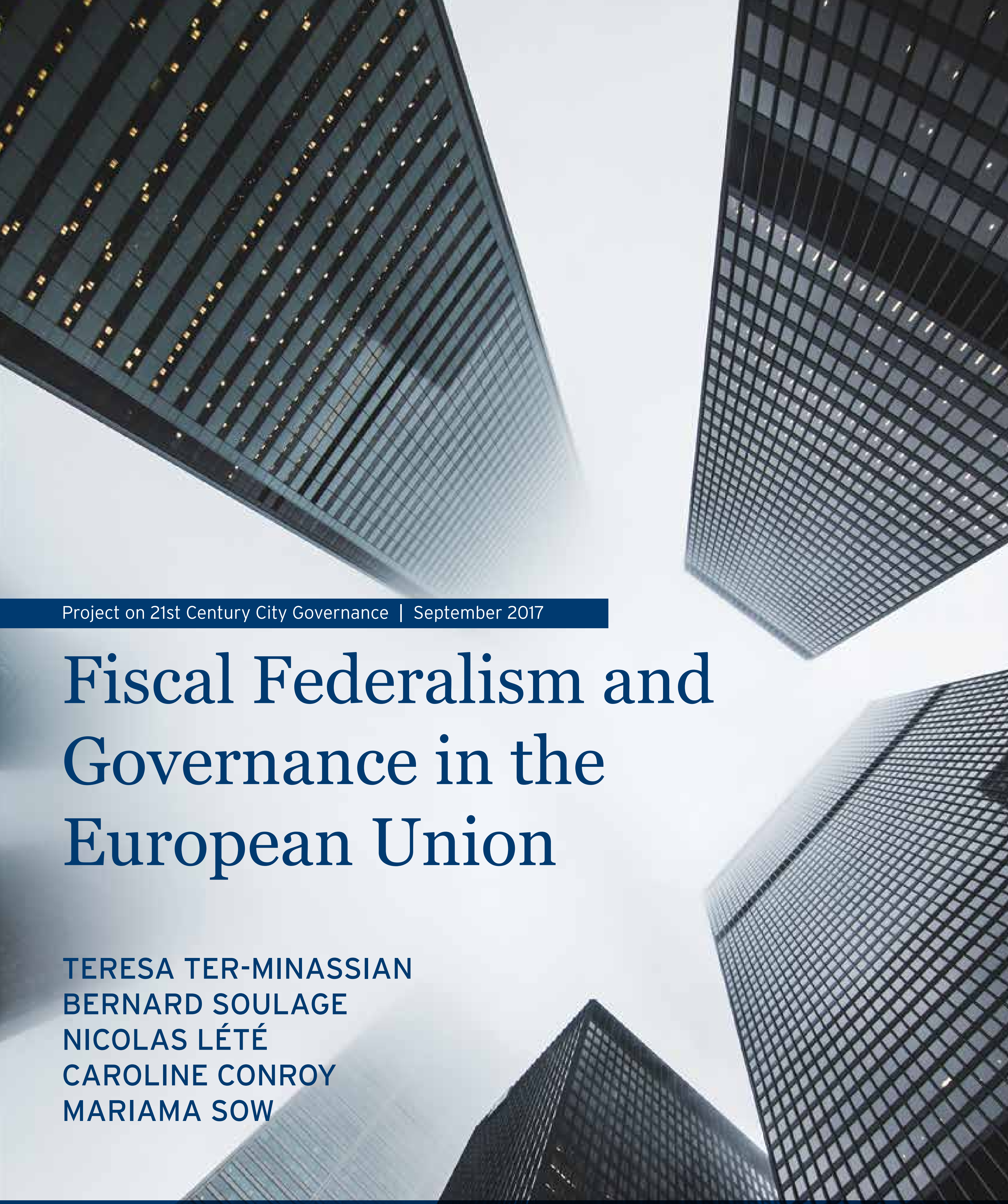

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Fiscal Federalism and Governance in the European Union

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CONTENTS

Local finances in Italy[1]

TERESA TER-MINASSIAN

INTRODUCTION

Italy has a complex system of intergovernmental relations. It has three basic levels of government: a national one (the Central Government, or CG); a regional one, composed of 15 "ordinary statute" regions and five "special statute" ones;[2] and a local one, comprising 100 provinces, 10 metropolitan cities, and 8,100 municipalities. Broadly speaking, the national and regional levels share normative and policy functions, as well as the delivery of public goods and services in their respective areas of responsibility, while the local level is primarily responsible for the delivery of local services.

The system of fiscal relations among the three levels of government has been in a state of flux for decades. After a phase during the 1990s of enthusiasm for fiscal decentralization, a constitutional amendment was enacted in 2001 calling for an expanded role in spending and increased revenue autonomy of the subnational governments (SNGs). However, the necessary implementing legislation was delayed until the end of the decade, and subsequent reforms, being largely influenced by the aftermath of the global and subsequent European financial crises, reflected a shift toward recentralization.

This paper, which has been prepared for the Brookings Project on 21st Century City Governance, begins in Section II with a brief overview of the ebbs and flows of the decentralization process in Italy in recent decades, highlighting the main institutional changes affecting all the subnational levels of government and relating them to the evolving political, economic, and fiscal trends of the period.

The subsequent sections focus especially on the local level of government, analyzing the current state of affairs regarding:

- Governance arrangements and spending responsibilities (Section III).
- Own sources of revenues, in particular the central government-induced travails of the local property tax and their cost for the municipal finances (Section IV).

[1] The author wishes to acknowledge gratefully the useful comments received from Kemal Derviş, Giorgio Brosio, Bernard Soulage, Alaina Harkness, and Caroline Conroy.

[2] The regions with special statutes (Aosta Valley, Trentino-South Tyrol, Friuli-Venezia Giulia, Sicily, and Sardinia) were created in the aftermath of World War II with the new Republican Constitution, to recognize ethnic, linguistic, or other historical distinguishing characteristics of these regions. These regions have traditionally received larger CG transfers than the ordinary ones, although the gap has been shrinking in recent years.

- The system of intergovernmental transfers, in particular the innovative system of equalization transfers introduced in recent years (Section V).

- The constraints imposed on the local finances by the past Internal Stability Pacts and the national legislation implementing the EU Fiscal Compact of 2012, and their implications for local investments (Section VI). This section also discusses the problems of hidden debts and arrears of municipalities, past bailouts, and municipal bankruptcy procedures; and the main existing mechanisms for vertical and horizontal intergovernmental cooperation.

- Entrepreneurial activities of local governments, including through municipal enterprises and public-private partnerships (PPPs) (Section VII).

The paper concludes in Section VIII with a discussion, in the light of the analysis of the previous sections, of priorities for further reform of the local finances in Italy.

A BRIEF HISTORICAL REVIEW OF THE DECENTRALIZATION PROCESS IN ITALY[3]

The decentralization process in Italy over the last few decades has been all but linear. The 1970s and 1980s witnessed various waves of spending decentralization, with the devolution of important expenditure responsibilities to the newly created *Regioni a Statuto Ordinario,* as well as to the local authorities (provinces and municipalities). The spending decentralization was not accompanied, however, by a devolution of revenue-raising responsibilities. As a result, the SNGs financed their expenditures mainly through transfers from the CG. This contributed, along with inadequate controls and poor information on subnational accounts, to significant local deficits and accumulation of arrears, and to repeated bailouts by the CG.

Against a background of national focus on fiscal consolidation as precondition for Italy joining the euro during the 1990s, concern grew over these trends, as did political pressures for greater fiscal autonomy, especially by the richer northern regions. That led to the assignment to the SNGs of significant own sources of revenues, specifically health contributions, a motor vehicles tax, and a tax on the value added of enterprises (*IRAP*) to the regions; surcharges on the personal income tax to both regions and municipalities; and a new property tax to the municipalities.

This decentralization phase culminated in the passage in 2001 of a constitutional amendment, which, among other things, substantially reduced the areas of exclusive competency of the CG and affirmed the principle that SNGs should be financed mainly through own revenues and non-earmarked, equalization-oriented intergovernmental transfers. Specifically, Article 117 of the new Constitution substantially expanded the legislative power of the regions in key areas, such as health, education, energy, transport, environment, and regulation of markets.

However, most of these functions were defined as areas of concurrent responsibility between the CG and the regions, leaving to subsequent national legislation a precise determination of respective competencies in each area. Since such implementing legislation was substantially delayed by political wrangling, ample scope arose for jurisdictional conflicts around the extensive areas of overlap in spending responsibilities, which often were escalated up to the Constitutional Court.

When a framework law on fiscal decentralization (Law 42/2009[4]) was finally enacted, it still left most of the reform specifics to subsequent government decrees, which were to focus on: the enhancement of regional and local revenue autonomy; the redesign of the system of intergovernmental transfers, to base them on standardized measures of fiscal capacity and spending needs; the harmonization of accounting standards across levels of government; and the improvement of intergovernmental coordination mechanisms.

However, by 2010, in the aftermath of the global financial crisis that took a serious toll on the public finances, and with the onset of the euro crisis, policy imperatives shifted to fiscal adjustment, and the subnational finances were required to make a large (some believe disproportionate)[5] contribution to the adjustment. The latter included substantial cuts in CG's transfers to the SNGs and a tightening of constraints under the so-called Internal Stability Pacts[6] (see Section VI). The toll was especially

[3] For a more detailed account of the history of decentralization in Italy in recent decades, see Piperno, 2013, and Ambrosanio and others, 2016.
[4] The law *Delega al Governo in materia di federalismo fiscale, in attuazione dell'articolo 119 della Costituzione,* available at www.parlamento.it/parlam/leggi/09042l.htm.
[5] The total cuts in non-interest spending of the CG (including the social security system) over the period 2008-2012 amounted to 5.3 percent of such spending; those in subnational spending to 12 percent (Piperno, 2016). Cuts are defined in relation to projected spending on unchanged legislation.
[6] The Internal Stability Pacts are agreements between CGs and SNGs setting limits on the latter's deficits or spending. They have been used by a number of EU countries (including Italy), with varying degrees of success, to promote compliance with the EU's fiscal rules. A review of experiences with these pacts can be found in Ter-Minassian, 2016.

pronounced on subnational investments, which fell by 34 percent in nominal terms between their peak in 2009 and 2014.

In such a "fiscal emergency" context, structural reforms of the intergovernmental relations system took a back seat to the fiscal consolidation imperative, and progress in the implementation of the framework law remained uneven. Indeed, the delegation by Parliament to the government to legislate the pending reforms by decree was allowed to expire before the completion of the agenda set by Law 42. The main steps forward related to the local level of government and included: a revamping of the system of transfers to the municipalities (see Section V); a new 2014 law (Law 56/2014, the so-called *legge Delrio*), which significantly reduced the role of the provinces and created metropolitan cities (see Section III for details); and legislation to standardize accounting norms for all levels of government. In contrast, little progress was made in increasing subnational fiscal autonomy, and, as explained in more detail in Section IV, some recent changes in property taxation can be viewed as a step backward in this area.

In the meantime, the government proposed a constitutional reform to modify the bicameral parliamentary system and transform the Senate into a sort of regional Chamber, with a much reduced number of members chosen by the regional councils and with jurisdiction limited to very few issues, including major reforms of the intergovernmental relations system.[7] The reform—which was approved by both ouses of Parliament in April 2016 with a less than two-thirds majority and was therefore subject to ratification by a popular referendum—aimed to strengthen the CG's powers vis-à-vis the regions, in particular through the abolition of concurrent responsibilities and a significant expansion of the functions assigned to the CG, including regulation of the production and distribution of energy, strategic infrastructures and transport networks, labor protection, and disaster preparedness, among others.

Moreover, the reform provided that, in case of conflict between central and regional legislations, even in areas assigned to the regions, the former should prevail if "the national interest is at stake" (the so-called supremacy clause). The reform also proposed to eliminate any reference to the provinces in the Constitution, thereby paving the way for their eventual abolition.

Voters, however, rejected the reform in a December 2016 referendum, leaving the status quo described in the following sections unchanged for the time being. It is too soon to say, at the time of this writing, whether new legislative initiatives will be taken by this or future CGs to reduce the scope of concurrent functions, or at least to better delineate respective responsibilities of the different levels of government in those functions.

[7] See Bilancia and Scuto, 2015, for a detailed discussion of the implications of the proposed reform for the intergovernmental relations system.

GOVERNANCE AND EXPENDITURES OF LOCAL GOVERNMENTS

The changing structure and functions of local governments

As mentioned above, the local level of government in Italy encompasses three types of jurisdictions: municipalities (*comuni)*, provinces, and metropolitan cities.

Municipalities are very diverse, ranging widely in size and population. About 70 percent of them have fewer than 5,000 inhabitants. They are responsible for a range of local public services, including management of the territory, social assistance, local transport, water and sanitation, pre-primary education, building and maintenance of local schools, and the promotion of local economic development.

The provinces cover larger geographical areas, encompassing a number of municipalities. They also vary significantly in size and population. Their main functions have traditionally been regulatory, in areas such as environmental protection, territorial planning, and labor markets. Their responsibilities have also included the construction and management of secondary schools and provincial roads.

Metropolitan cities are a recent creation, whose functions and governance are discussed further below.

Clearly, the local government level is quite fragmented, compared with many other advanced countries, a fact that has long historical roots. Moreover, the number of local governments has been increasing over the years, driven by the quest for transfers from the CG and by pressures to create well-remunerated positions for local politicians.[8]

Such proliferation of local governments has a number of significant costs, including a bloating of local public employment; a superimposition of different levels of spending authority, often with conflicting interests, and consequent delays in the approval of public investment projects; lack of economies of scale in the provision of essential public services; and increased risk of adverse spillovers from uncoordinated actions of small municipalities on their neighbors.

An approach that has been increasingly used to reduce the costs of the excessive fragmentation of the municipal level has been the creation since the early 1990s of consortia of small municipalities (*unioni di comuni*) to provide jointly one or more public services. Both the CG and the regions have promoted the formation of such unions, including through financial incentives. As of 2014, 2,090 municipalities had joined permanent unions, which numbered over 400.[9] In addition, many municipalities and unions have stipulated limited-term cooperation agreements (*convenzioni*) for the delivery of specific services. There is, however, little analytical evidence so far on the effectiveness and efficiency gains from these forms of association in the delivery of local public services.

There has been less success in promoting the merger of small municipalities. Initial attempts to require the transformation of unions into larger municipalities (Law 142/1990) were abandoned in 1999. The *Delrio* law of 2014 included steps to consolidate the municipal level, by requiring the association of small municipalities into unions and by fostering mergers through the maintenance for the new larger municipality of the same financial incentives provided to the merged municipalities or to their unions. However, since 2014, only 57 small municipalities have merged into 24 larger ones.

The *Delrio* law also introduced important changes in the governance and role of the provinces. Such changes had been called for by many experts of

[8] It is interesting that, while only 17 percent of the Italian population lives in municipalities with fewer than 5,000 inhabitants, mayors and council members of these towns account for 55 percent of local elected officials (Ambrosanio and others, 2016).

[9] Arachi, Di Liddo, and Giuranno, 2015, provides a detailed analysis of municipal consortia in Italy.

intergovernmental fiscal relations in Italy for years, but had been blocked by affected interests and by the political weakness of previous national governments.

Specifically, the law abolished the direct popular election of the provincial presidents and councils, who are now chosen by the mayors and councilors of the constituent municipalities among themselves.[10] More importantly, it significantly curtailed the functions of provincial governments, which now maintain only some basic responsibilities (*funzioni fondamentali*), including territorial planning and the building and maintenance of provincial roads and schools.

The *Delrio* law left the distribution of the remaining functions among regions, metropolitan cities, and other municipalities to subsequent national and regional legislation, in the respective areas of responsibility. According to the law, this distribution should aim to increase efficiency in the delivery of the corresponding services through better exploitation of economies of scale. An intergovernmental conference set out some basic principles, subsequently incorporated in a CG decree, to guide the redistribution.

So far, only six regions have enacted legislation to define the allocation of the different functions. In the other regions, legislation has been proposed by the respective executives but not yet approved by the regional parliaments. These actual or proposed legislations show significant differences. Some regions, in particular, Lazio, Liguria, Lombardy, Marches, Puglia, Tuscany, and Umbria, have taken over many functions of the provinces (albeit delegating some of them to the metropolitan cities in their respective territories); others have maintained some of the functions with the provinces, or shifted them to metropolitan cities or to unions of municipalities.[11] The transfer of functions is to be accompanied by reallocation of the corresponding human and budgetary resources, a task that is still in process.

A further important innovation enacted by the *Delrio* law was the creation of metropolitan cities. Although legislation since 1990 and the 2001 constitutional reform had already envisaged the creation of such institutions, no concrete steps had been taken in this direction until 2012, when an attempt by the government to define the procedures to set them up through a decree was invalidated by the Constitutional Court, which judged the decree to be an inadequate legal basis for such an important institutional change.

The *Delrio* law established nine metropolitan cities (plus the Capital City of Rome) to replace the corresponding provinces. It also allowed regions with a special statute to set up additional metropolitan cities in their own territory, if they considered it appropriate. To date, the regions of Sicily and Sardinia have done so, bringing to 14 the total. Table 1 provides an overview of some salient characteristics of these cities.

The law also expanded the responsibilities of metropolitan cities compared with those of the provinces they replaced. These responsibilities now include territorial planning, the organization of area wide network for such public services as transport, utilities, and telecommunications, and the promotion of the metropolitan area's economic development. Moreover, regions can delegate additional functions to metropolitan cities, upon mutual agreement.

The law requires the mayor of the metropolitan city to be that of the main municipality in the province replaced (*capoluogo della provincia*). Its governing council is chosen among the mayors and councilors of the constituent municipalities. There is also a metropolitan assembly (*conferenza metropolitana*)

[10] Provincial presidents and councilors (as well as the presidents and councilors of the new metropolitan cities) receive no additional compensation for the exercise of these functions.

[11] For a more detailed discussion of the differences in the regional legislations, see Legautonomie, 2016. For an analysis of the case of the Lombardy region, see Nordi and Rizzo, 2016.

Table 1. City characteristics

Metropolitan city	Region	Number of municipalities included	Population (millions)	Population density (Pop./km^2)	Date of inception
Rome	Lazio	121	4.34	811	1/1/2015
Milan	Lombardy	134	3.20	2030	1/1/2015
Naples	Campania	92	3.12	2663	1/1/2015
Turin	Piedmont	316	2.29	336	1/1/2015
Palermo	Sicily	82	1.28	255	1/4/2016
Bari	Puglia	41	1.27	331	1/1/2015
Catania	Sicily	58	1.12	312	1/4/2016
Florence	Tuscany	42	1.01	288	1/1/2015
Bologna	Emilia-Romagna	56	1.00	271	1/1/2015
Genoa	Liguria	67	0.86	469	1/1/2015
Venice	Veneto	44	0.86	349	8/31/2015
Messina	Sicily	108	0.65	198	1/4/2016
Reggio Calabria	Calabria	97	0.56	175	8/7/2016
Cagliari	Sardinia	17	0.43	345	4/11/2016

Source: Author research

composed of all mayors and councilors of the constituent municipalities, with consultative powers only. These provisions aim to prevent the creation of a new bureaucratic structure superimposed on the municipal ones, with attendant fiscal costs.

The creation of metropolitan areas has the potential to promote a more efficient delivery of local services through coordination and economies of scale, but is also seen by many as part of the overall strategy to reduce the role of the regional level of government mentioned in Section II. The metropolitan cities started operating in 2015, and the experience with their functioning is therefore still too limited to draw firm conclusions about their benefits.

The structure of local spending

Unfortunately, the latest available consolidated data on expenditure and revenues of local governments[12] refer to 2014 and therefore do not reflect the impact of the changes introduced by the *Delrio* law. Nevertheless, they provide useful insights into the level and structure of the local governments' budgets, and are therefore briefly reviewed here. Table 2 presents some summary indicators of the spending performance of provinces and municipalities in 2013-2014. Charts 1 and 2 depict the functional composition in 2014 of municipal and provincial spending, respectively.

The table shows that, even before the *Delrio* reforms, expenditures of municipalities far exceeded those of the provinces, not only in absolute but also in per capita terms, reflecting their broader set of responsibilities. The table also points to a composition largely skewed in favor of current spending.

Within each level of government, there were substantial differences across the national territo-

[12] These data were published by the National Institute of Statistics (ISTAT) in July 2016 and are available at http://www.istat.it/it/archivio/188871.

ry. For example, the ratio of personnel spending to current revenues (an indicator of the weight of these expenditures in the local governments' budgets, as well as of the rigidity of these budgets) showed a wide regional variance around the municipal and provincial national averages. Similar ranges of regional variation could be found around the national means as regards the shares of expenditures on various functions (e.g., general administration, environmental protection, transport, education, and social assistance), reflecting differences in local preferences as well as in demographic and geographic characteristics.

Data not reported in the table also showed a U-shaped pattern in per capita spending, which tended to be higher in the smallest and largest municipalities, reflecting at one end of the distribution the lack of economies of scale, and at the other end both larger spending needs[13] and revenue-raising capacities.

The charts indicate that the average composition of expenditures was fairly similar between provinces and municipalities. For both levels of government, the two largest components were general administration and the management of the territory and the environment, followed by spending on roads and transport, and on education. Municipalities had a larger role than provinces in social assistance, while the reverse was true for spending on promoting local development.[15]

Table 2: Italy: Selected indicators of level and structure of local expenditures, 2013-2014

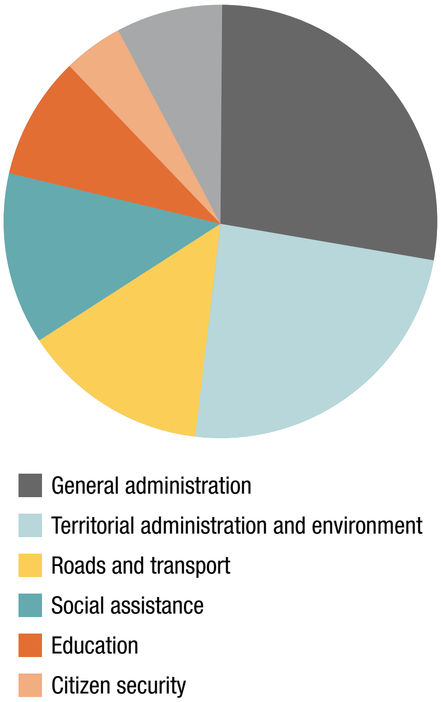
	2013	2014
Expenditures of provinces/expenditures of municipalities (%)	13.5	12.5
Average current expenditure per capita (in euros)		
Provinces	126	120
Municipalities	962	911
Current expenditures/capital expenditures (%)		
Provinces	370	520
Municipalities	430	430
Personnel expenditures/current revenues (%)		
Provinces		
National average	24.3	25.6
Regional maximum	44.8	47.1
Regional minimum	18.4	18.3
Municipalities		
National average	23.8	23.6
Regional maximum	32.9	32.3
Regional minimum	20.4	20.7

Source: ISTAT, 2016. Data are on commitment basis

[13] From the observation that many public goods—such as zoos—are indivisible, Oates and Schwab (1988) put forward the idea that the range of public goods should increase with localities' size; this is called the zoo effect. For an empirical investigation of this effect for French municipalities, see Frere and others, 2011.

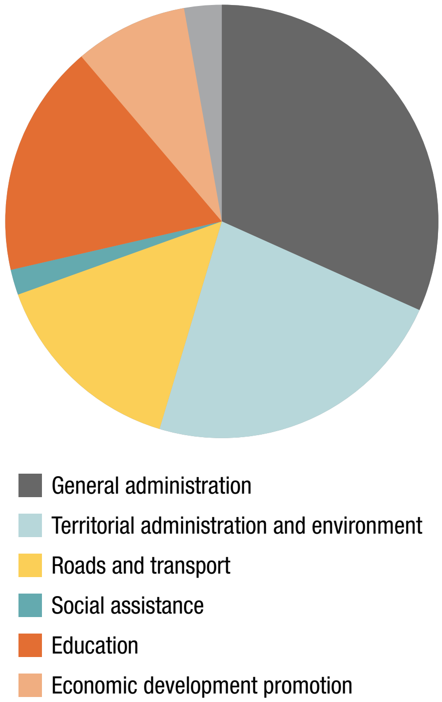
[14] The assertion that municipalities play a larger role in social assistance than provinces is demonstrated when comparing Chart 1 and Chart 2.

Figure 1. Italy: Functional composition of municipal expenditures, 2014



Source: ISTAT, 2016.

Figure 2. Italy: Functional composition of provincial expenditures, 2014



Source: ISTAT, 2016.

LOCAL REVENUE AUTONOMY

Since the 1990s, Italian municipalities have been assigned significant sources of own revenues, defined here as revenues for which they can set rates (at least within a range) and possibly have some autonomy in defining the base. These revenues include a surcharge of up to 0.8 percentage points on the national personal income tax, a property tax (*IMU*), an additional property tax to cover the cost of indivisible local services, a tax for waste collection and disposal (TARI), a tax on hotel occupancies for touristic localities (*tassa di soggiorno*), other user fees, and fees for building permits and other licenses. In addition, municipalities receive a share of a number of national taxes related to real estate, including on the transfer of properties and on rents.[15]

Provinces have traditionally had more limited revenue autonomy, their main source of own revenues being the taxation of insurance policies for motor vehicles. They have also shared in the revenues of some national and regional taxes. Even before the *Delrio* law took effect, in 2014, provincial own revenues were equivalent to less than 14 percent of municipal ones.

Local taxation has been the object of frequent interventions by the CG, responding to short-term fiscal or political motivations with little regard for local autonomy and with detrimental effects on the capacity of both the local governments and their citizens to plan and budget. This has been especially the case with the municipal property tax, repeatedly modified in recent years regarding its coverage, rate structure, and relation with the abovementioned taxes to finance local services. Between 2011 and 2014 there have been some 10 modifications of municipal property taxation.[16]

The 2015 budget framework law called for the creation of a new "local tax" to replace most existing ones, with the aims of simplifying the whole property tax regime and reducing its compliance cost. This reform, however, has not been enactedso far. Instead, in 2016 property taxes on households' principal homes were abolished, a move that reduced the revenue autonomy of municipalities, and could not really be justified in terms of vertical equity, since its benefits to the owners increase with the value of the house. Moreover, the 2016 Stability Law froze the rates of all local taxes (with the exception of the *TARI*). Municipal property taxation remains in need of substantial reform, especially an early updating of the cadastre, which is very much out of line with market valuation of existing properties.

Charts 3 and 4 depict the composition of municipal and provincial revenues, respectively, in 2014 (the last year for which consolidated data are available for each level of government). They show the lesser dependence of municipalities than of provinces on national and regional transfers. They also suggest a greater availability of sources of own non-tax revenues for the municipalities than for the provinces. Both levels of government appear to have made little use of property sales (a potential source of revenues, especially for the municipalities, to finance investments in local infrastructure).

Per capita municipal tax revenues in 2014 averaged 652 euros, but with substantial variance ranging from 443 to 931 euros. The lowest values were recorded in municipalities located in the special-statute regions and in the South, reflecting a mixture of lower revenue-raising capacity and efforts. Correspondingly, the degree of dependence from transfers from higher levels of government also varied significantly among municipalities,

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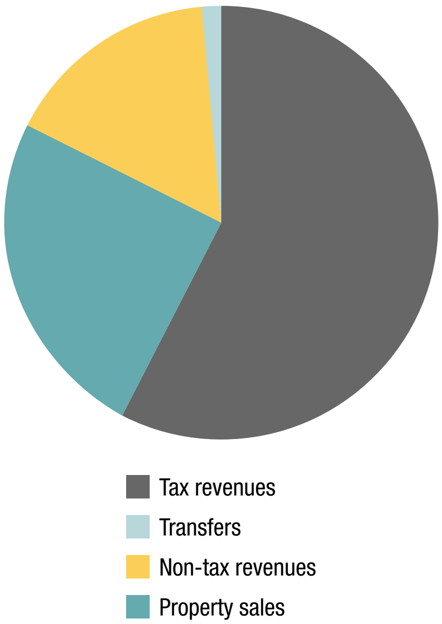
[15] Tax revenues shared with higher levels of government (*tributi compartecipati*) are not *stricto sensu* own revenues, because subnational governments have no control over either their base or their rate structure, although they can choose how to use them without CG's constraints. Nevertheless, in the statistics they are often included in the category of own revenues.

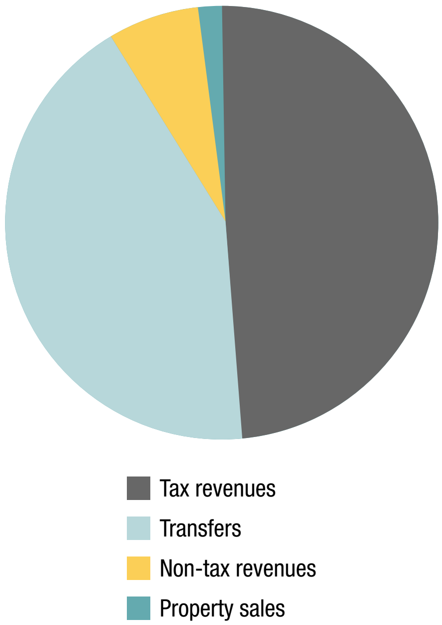
[16] For a detailed account of the travails of municipal property taxes, see Revelli, 2016.

Figure 3. Italy: Composition of municipal revenues, 2014



Source: ISTAT, 2016. Data are on a cash basis. Tax revenues include ones shared with other levels of government.

Figure 4. Italy: Composition of provincial revenues, 2014



Source: ISTAT, 2016. Data are on a cash basis. Tax revenues include ones shared with other levels of government.

ranging between near zero and 11 percent. The degree of dependence tended to be U-shaped, being higher for both very small (up to 5,000 inhabitants) and largest (over 60,000 inhabitants) localities, reflecting, for the former, lower own-raising capacities and traditionally higher CG transfers per capita, and for the latter, the effect of greater access to special purpose grants.

For provinces, per capita revenues averaged 96 euros, also with substantial variance around the mean. Similarly, the dependence of provinces from transfers ranged between 0.5 percent and 13.6 percent, and was substantially higher in the southern regions of the country that traditionally have received more generous grants by the CG and have generally smaller own revenue bases.

INTERGOVERNMENTAL TRANSFERS

The system of intergovernmental transfers in Italy has traditionally been very complex, resulting from the superimposition of many different pieces of legislation that changed frequently until the end of the last decade.[17] The system could be characterized as a mixture of origin-based revenue sharing; some equalization transfers, based in principle on indicators of relative per capita income and demographic characteristics, but in practice on the historical distribution of local spending; and a number of special-purpose grants, to finance specific spending programs. The weights of the different types of transfers have been changing over time, in reflection of shifting priorities given by the legislators to their different objectives. Obviously, this made more difficult an orderly budgetary planning by local authorities and arguably weakened the budget constraint on them.

The framework law on decentralization, Law 42/2009, set out the broad lines of a revamped transfer system, privileging equalization based on standardized indicators of spending needs and revenue-raising capacity. The system is intended to be applied to both the regions with ordinary statute and their provinces and municipalities. However, so far the necessary implementing framework has been developed only for the local level of government. The distribution of CG's transfers to the regions remains largely shaped by historical patterns.

The equalization framework for transfers to local governments covers only general-purpose ones. There still remain special-purpose grants, including capital transfers for investments. Subsequent decree laws have defined more specifically the features of the system, which began to be operational in 2015.[18] Its main features can be briefly summarized as follows.

There is an equalization fund for municipalities (*Fondo di Solidarietà Comunale*, or *FSC*) and one for provinces and metropolitan cities. Both are fed by transfers from the CG, but the *FSC* also receives a portion of the local property tax, the *IMU.*

A distinction is made between "fundamental" and "non-fundamental" local functions. For the municipalities, fundamental functions would include general administration, local police, education, local transport, management of the territory and of the environment, and social assistance, altogether accounting for about 70 percent of municipal current non-interest spending. For the provinces, they would include the functions defined as fundamental by the *Delrio* law.

For the fundamental functions, standard spending needs are calculated taking into account demand (e.g., population and demographic structure) and cost (population density, remoteness, and other geographic characteristics) factors outside the local authorities' control, which are econometrically estimated to affect local spending on the function in question.[19] Thus, municipalities with similar characteristics in terms of these factors are attributed the same standard spending needs.

The differences between actual and standardized spending may reflect differences in the priority attributed by each municipality to the function in question, different revenue-raising capacities, or different levels of efficiency.[20] To correct for the impact of differences in fiscal capacity, standardized revenues have also been calculated for the main municipal taxes, based on the legislation prevailing in 2014. The gaps between standard needs and

[17] A summary of these changes can be found in Piperno, 2013.

[18] Since the new system was expected to involve substantial changes in the distribution of transfers among localities, Law 492 contemplated a gradual transition to it. A transition was also required for the complex technical task of estimating standardized spending needs and fiscal capacities.

[19] The econometric estimates used a vast data panel of municipalities' responses to a detailed questionnaire prepared by the national Ministry of Economy and Finance and the National Association of Italian Municipalities (ANCI).

[20] See IFEL, 2014.

standard revenues are used as coefficients of distribution of growing portions of the *FSC*, starting at 20 percent in 2015 and rising progressively in the following years to 55 percent by 2018.

Current legislation has not yet defined the criteria that should eventually guide the distribution of a portion of the *FSC* to help finance non-fundamental functions of municipalities with below-standard fiscal capacity. In the meantime, the rest of the *FSC* continues to be distributed on the basis of the historical level of transfers to individual municipalities. Even at its initial level, the new system has involved a significant redistribution of resources from smaller to larger municipalities. This could provide an incentive to fusion of small municipalities.

The estimated standard needs and fiscal capacities for individual municipalities are available to the public through the website *OpenCivitas* (www.opencivitas.it). They will need to be revised to take into account the important changes that have been introduced with the *Delrio* law, in particular regarding metropolitan cities and the recent changes in local taxes, and to update the econometric estimates on the basis of more recent data.

FISCAL RULES, LOCAL GOVERNMENTS' DEBT, AND INTERGOVERNMENTAL FISCAL COOPERATION

Since 2001, local governments have been subject to the so-called Internal Stability Pacts setting targets for their fiscal balances and, in some years, limits on the nominal growth of their expenditures. These pacts were customarily discussed within the various forums for intergovernmental cooperation (see Box 1), but were ultimately decided by the CG. Small municipalities (those with fewer than 5,000 inhabitants) have been generally excluded from the pacts.

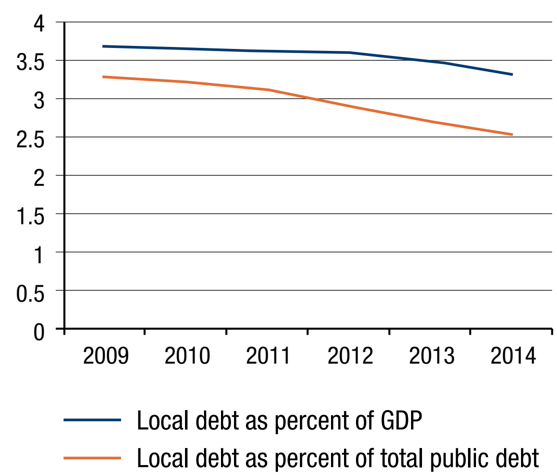
Since 2003 the pacts have included various types of sanctions for non-compliance, mostly in the form of cuts in transfers from the CG and freezes on hiring, but the application of such sanctions has been uneven. In the more recent years, monitoring of compliance by the national Ministry of Economy and Finance (MEF) has been strengthened regarding both timeliness and enforcement. As a result, compliance has improved. In 2013-14 only 1.5 percent of municipalities subject to the pact did not comply with its provisions. The majority of non-complying municipalities were concentrated in some southern regions and in Sicily.

The combination of tightening of constraints, including on total spending, under the pacts and of cuts in CG's transfers to the local governments during the recent crises has had a strong adverse impact on the local governments' investments, which fell by more than 50 percent between 2007 and 2012 (Ambrosanio and others, 2016).

With a view to arresting and ultimately reversing this trend, the national law implementing the EU Fiscal Compact has introduced a degree of flexibility in the fiscal rules for local governments. Specifically, it has given regions the power to use part or all of their surpluses to offset deficits of their respective municipalities. The latter are also allowed to lend or borrow among themselves any imbalances they might have. The flexibility clause was intended to allow localities to borrow from each other's (or their region's) temporary surpluses to fund lumpy public investments. However, little use has been made of this clause.

The tightening of financial constraints on local governments has been reflected in some improvement of their fiscal balances—with municipalities recording near balance and the provinces small surpluses in recent years—and in some a decline in their debt, as percent of both GDP and of the total public debt (Chart 5).

Figure 5: Aggregate debt of provinces and municipalities



Sources: IFEL, 2015, and ISTAT

An unfortunate side effect of the tightening of constraints under the Internal Stability Pacts has been a growth of both off-budget debts (debts not properly recorded according to accounting rules) and of arrears of local governments. Estimates by the Supreme Audit Institution (*Corte dei Conti*) put the amount of off-budget debts of municipalities in 2013 at over 1.5 billion euros,[21] involving nearly

[21] See *Corte dei Conti*, 2014.

Box 1. Intergovernmental cooperation forums in Italy

Well-functioning forums for intergovernmental fiscal cooperation are especially necessary in relatively fragmented systems of multilevel governance, such as Italy's. Potential gains from such cooperation include a reduction of adverse spillovers and a fuller exploitation of positive externalities, synergies from participants' actions and policies, and economies of scale. Intergovernmental fiscal cooperation can be beneficial in different aspects of policy, namely:

- Macro-fiscal management.
- The design and reform of intergovernmental fiscal arrangements.
- Sectoral policies, including service delivery.
- Subnational revenue and expenditure management.

A further benefit of intergovernmental fiscal cooperation is that it facilitates the exchange of relevant information among participant governments, leading to a better understanding of respective objectives and constraints, as well as the identification of viable policy synergies and trade-offs that can be taken into account in the design and implementation of reform packages. This exchange of information and experiences also facilitates the identification of good and bad practices by peers that face similar policy challenges.

Intergovernmental cooperation can take different forms: among different levels of government (in vertical forums) or within each level (in horizontal ones); among executives or parliaments; with decision-making power, or only consultative; through standing bodies, or ad hoc forums; and can cover more or less broad ranges of intergovernmental issues.*

Italy has a number of intergovernmental cooperation forums:

- Some vertical executive-level ones:
  - A State-Regions-Provinces Conference.
  - A State-Municipalities Conference.
  - A Unified Conference in which all four levels of government are represented, chaired by the prime minister. Within this broader forum, a standing Conference has been in place since 2013 for the coordination of the public finances, charged with reviewing the national and subnational budgets for compliance with the above-mentioned fiscal rules and with promoting dialogue on other aspects of inter-governmental fiscal relations.
- Parliamentary Committees on inter-governmental fiscal reform.
- Horizontal cooperation fora within each level of government, with primary advocacy functions. At the local level the main such forum is the National Association of Italian Municipalities (ANCI).
- A special mechanism is in place for consultation with the SNGs regarding EU legislation.

These forums are of a consultative nature but have been influential in several cases, especially regarding the implementation of legislated reforms (e.g., the redistribution of functions among the different levels of government ushered in by the Delrio law and the homogenization of accounting standards across the whole general government). They could also, in a future perspective, play a greater role in promoting intergovernmental agreement on the vertical distribution of fiscal balances compatible with the constraints of the national fiscal rules.

* For a more detailed discussion of the theory and international practice with intergovernmental fiscal cooperation, see Ter-Minassian and de Mello, 2016.

2,000 municipalities. There are no official estimates of the local governments' arrears, the growth of which was fostered by the fact that spending limits under the Internal Stability Pacts were specified in cash, rather than accrual, terms.[22] The CG repaid in 2014 some 7 billion euros of arrears of provinces and municipalities to private suppliers.

Legislation has been passed in recent years to facilitate an orderly resolution of local financial crises. The law (modeled on Chapter 9 in the U.S.) allows municipalities in financial distress to seek protection from creditors and a restructuring of their debts, but at the cost of substantial loss of financial and political autonomy (dismissal of the mayor and council, appointment of a commissioner, increases in local taxes and user fees, hiring freeze, liquidation of assets, etc.).

Not surprisingly, there has been little use of these bankruptcy procedures. More recently, the *Corte dei Conti* has been given the power to call for the initiation of bankruptcy procedures for municipalities judged under severe financial stress. However, a growing number of municipalities have been availing themselves of an alternative procedure allowing those under incipient financial stress to prepare multiyear adjustment plans, to be implemented by the existing local authorities, with endorsement and support from the CG.

[22] This has now been modified. The structural balance is calculated with current expenditures on an accrual basis and capital ones on a cash basis.

LOCAL GOVERNMENTS' ENTERPRISES, PPPS, AND ASSET MANAGEMENT

Recent decades have seen a rapid growth of partial or full ownership of enterprises by Italian municipalities and provinces. Between 2000 and 2007, the number of firms with local government participation rose on average by 400 a year. Even in more recent years, their number has continued to increase by some 200 a year, to over 6,000 in 2013.[23]

Of these enterprises, 13 percent provide services (information technology, property management, catering, etc.) directly to the local governments; about 42 percent provide services to the population (e.g., street lighting, security, maintenance of cemeteries) paid by the local government; 23 percent provide network services (e.g., electricity, water, transport or waste disposal) partly or wholly paid by user fees; and the remaining 22 percent are engaged in activities typically undertaken by private enterprises (e.g., pharmacies, tourism facilities, casinos, even dairies).[24] Only some 20 percent of these enterprises are wholly owned by the local governments; in more than half, most of the capital is in private hands. In some 1,400 of them, the local governments own less than 5 percent.

It is difficult to escape the sense that in many cases the decision to enter into such participations (a decision which until recently could not be challenged by higher levels of government) is motivated mainly by a desire to create well-paying jobs for local constituents. In this respect, it should be noted that some 1,300 such enterprises have a board but no staff, and in 2,000 of them, board members outnumber employees.

The limits on local spending and deficits under the Internal Stability Pacts are likely to have constituted an additional motivation for such proliferation of local enterprises, since outsourced activities would not come under such limits, unless the enterprises received more than half of their revenues from the local government.

An important source of concern is that a sizable number of these enterprises record losses, amounting to some 1.2 billion euros in 2012, and many receive subsidies from local budgets. A significant part of these losses is attributable to the sector of local transport, which compares poorly with other European countries in terms of operational costs and revenues per kilometer.[25]

Moreover, concerns have been raised about the value for money provided by many local enterprises in the delivery of essential public services, particularly in water and sanitation, and especially in cities in the Center and South of the country. However, a rigorous analysis of the efficiency of these enterprises is hampered by the lack of measurement of standard costs in the production of such services.

In a 2013 report, the *Corte dei Conti* expressed serious concerns about the state of the local enterprise sector and called for increased transparency of its finances and urgent corrective measures. In 2014, the Commissioner for the spending review submitted to the national government a set of recommendations to streamline and improve the performance of the sector.[26] These recommendations included:

- Requiring approval of the national Competition Authority for the creation of new local enterprises in non-core sectors.
- Strictly limiting indirect participations and requiring the sale of existing "micro-participations."

[23] See ISTAT, 2015. This number is likely an underestimate, because it is based on a survey of the national Ministry of Economy and Finance, and municipalities tend to underreport indirect participations (i.e., participations of their enterprises in other firms).
[24] See Cottarelli, 2015.
[25] The operational cost per kilometer in 2012 was 3.3 euros in Italy, compared with a 2.8-euro average for France, Germany, Spain, and the U.K. The corresponding figures for revenues per kilometer were 1.4 and 1.9 euros, respectively (Bain and Company, 2012).
[26] See the website of the spending review: http://spendingreview.gov.it.

- Closing or privatizing enterprises with a very small volume of sales or number of employees.

- Forbidding municipalities with fewer than 30,000 inhabitants to hold equity in local enterprises, except through the unions mentioned in Section II.

- Undertaking urgent studies to measure sectoral standard costs and rates of return, with a view to identifying significant inefficiencies of remaining municipal enterprises and requiring well-tailored adjustment programs from them.

- Increasing local transport tariffs (especially monthly tickets) and taking steps to improve enforcement on public buses.

- Ensuring appropriate reassignments, retraining, or unemployment benefits for affected employees.

These measures were expected to drastically reduce over time the number of local enterprises (to around 1,000 by 2018) and to produce fiscal savings of 2 billion to 3 billion euros a year. The government included the reform of local participations within the broader program of reform of the public administration, for which a framework law was enacted in 2015.

Implementing legislation has introduced by the government incorporating several of the commissioner's recommendations. It requires local governments to prepare annual reports on the state of their enterprises and specific plans to improve their performance. It also requires the closure of enterprises with sales or staff under given thresholds, and of those that are serial loss-makers. Experience will tell how much these reforms will succeed in streamlining the local enterprises' sector and ensuring a sustained improvement in its financial performance.

Local governments have also engaged actively in public-private partnerships (PPPs) since their introduction in 1998. Resort to PPPs by all levels of government rose rapidly through 2006, decelerated in the wake of the recession induced by the global financial crisis of 2008-2009, and recovered briefly in 2010, before falling again during the euro crisis. According to a recent study by the national Ministry of Economy and Finance,[27] PPPs accounted for about a quarter of public works in 2013. Municipalities were responsible for over one-third of such PPPs, concentrated in infrastructures for public transport, social housing, schools, and cemeteries.[28] Municipalities in the North were distinctly more active in PPPs than those in the Center and the South.

The initial spurt and the subsequent deceleration of PPPs are partly related to their treatment in the public accounts. Initially they were largely off the books of the public partner, thus easing budgetary constraints under the Internal Stability Pacts. In more recent years, under the guidance of Eurostat, PPPs have begun to be treated as on- or off-budget depending on the distribution of the risks they involve (construction, availability, demand, and other financial risks) between the public and the private partner. According to the MEF study, over 70 percent of investments financed through PPPs in 2010-2014 were classified as public.

PPPs are notoriously complex to negotiate, and require a careful evaluation of the risk and their assignment to the partner best equipped to bear them. Best practices suggest that decisions to do public works through PPPs, rather than through direct public procurement, should be guided by the preparation of comparative analyses of the

[27] *Ragioneria Generale dello Stato*, 2015.
[28] A large portion of PPPs is in the health sector (hospitals and local health care units, which are financed and overseen by the regions).

costs and benefits of the two options (the so-called public-sector comparators). Most municipalities lack adequate technical expertise to prepare such analyses, and there are no national sector-specific guidelines in this area.

Finally, an area in which most Italian municipalities could make progress in mobilizing resources for investment is the management of their non-financial assets.[29] Naturally, performances in this area vary significantly across municipalities, but there are widespread examples of poor use of the land and buildings owned by municipalities. Many don't have even complete lists of all their real estate holdings, let alone of their current market worth. Many lease them out at prices well below those of private comparators.[30]

[29] Since 2012, all subnational financial assets have to be deposited with the Central Bank of Italy and the remuneration of these accounts is transferred to the national Treasury (the so-called *Tesoreria Unica*), to help reduce public debt costs.

[30] For example, according to a recent survey, only 16 (less than 0.1 percent) of the 42,000 buildings owned by the municipality of Rome paid rents of over 1,000 euros per month. Almost one-third of the buildings were rented for less than 10 euros per month! See Corriere della Sera, June 21, 2015.

CONCLUSIONS

Significant progress has undoubtedly been made in improving local finances in Italy in recent years. In particular, the *Delrio* law represents an important advance in streamlining the sector, by reducing the superimposition of different levels of government, promoting various forms of association of small municipalities, and putting the creation of metropolitan cities on a sound legal footing.

The focus of future reform efforts concerning governance and functions of local authorities should be on the implementation of the law, a further clarification of the role of metropolitan cities and their relations with the regions, and strengthening incentives to the merger of small municipalities. The rejection of 2016 referendum implies that provinces will continue to exist, albeit with reduced functions

On the revenue side, international comparisons suggest that Italy fares relatively well regarding the assignment to local governments of appropriate sources of own revenues. However, there is scope for improvement in this area. First, it would be desirable that the CG refrains in the future from frequent interventions regarding the definition of the base and the rate structure of local taxes. The recent record in this respect has been detrimental to the ability of local governments to plan and budget, and has increased compliance costs for taxpayers.

Second, it would seem urgent to review and update property cadastres, to bring them in line with market valuations. This is likely to require substantial efforts and time, a fact that adds to its urgency. Third, there appears to be scope for increasing some user fees, notably some public transport tickets, and to reduce exemptions and special treatments in this area.

Fourth, there is clearly significant scope for municipalities to improve the management of their properties (in particular lands and building), by completing inventories of such properties, estimating their market values, leasing them out at realistic rents, or disposing of some of them through a well-structured program of sales.

Substantial progress has been made in recent years in rationalizing transfers to local governments, in particular by setting in place an equalization mechanism based on estimates of standard spending needs and revenue-raising capacities. The phasing-in of this system seems appropriate, to smooth the inevitable gains and losses that the reform entails for individual municipalities. Further progress is needed in defining appropriate criteria for distribution of transfers to finance the non-fundamental functions of municipalities, as well as in implementing the equalization reform at the regional level. A politically sensitive issue is the scope for reform of transfers to municipalities located in the regions with special statute, to which the new equalization system does not apply.

Probably the biggest challenge for municipalities is now how to finance a recovery of local public investments, while conforming to the constraints of the legislation implementing the EU's Fiscal Compact. This will likely require a multipronged approach, carefully tailored to local situations, including in the first place actions to increase municipal current surpluses through, in particular:

- Some of the steps mentioned above to raise own tax and non-tax revenues, as appropriate in individual municipalities' circumstances.

- Increased efforts to make local spending more efficient, including through better exploitation of economies of scale.

- Reducing subsidies to municipal enterprises and drastically cutting back their numbers, especially in non-core public services.

In addition, it may be worth exploring ways to better use the flexibility provided by the current fiscal rules, for instance by promoting the development of a market backed by interest-bearing securities for the trading (regionally or even nationwide) of temporary fiscal imbalances among municipalities. Also, the CG and/or the regions could use available fiscal space under their respective rules to support priority local investments through matching capital grants or co-financing. Finally, there may be scope for the larger municipalities to use well-structured PPPs to exploit the efficiency gains that an appropriate sharing of risks with private partners could bring to the building of major infrastructures.

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Fiscal Decentralization and 21st Century Cities in France

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Cities worldwide are facing growing challenges, as a result of rising urbanization, citizens' expectations of better local services, migration, and environmental concerns, among others. That such challenges have to be met in a context of tightening resource constraints adds urgency to the imperatives of effectiveness and efficiency in local spending, and of growth-friendly, sustainable, and equitable generation of local revenues. Cities are meeting these imperatives in different ways and with different degrees of success.

The Brookings Project on 21st Century City Governance explores the norms, institutions, and networks that power successful cities in a complex world. This background paper aims to contribute to the project by providing a brief, yet comprehensive, overview of local and national fiscal systems and governance structures in France.

THE VARIOUS LEVELS OF LOCAL GOVERNANCE AND THE DISTRIBUTION OF COMPETENCIES

Administrative divisions

France recently introduced a series of legislative changes to its territorial organization, resulting in significant alternations to both physical boundaries and the division of competencies. These reforms continue a decentralization process that began in the 1980s. The most recent changes will unfold through 2020 and will be described at greater length in following sections.

There are three levels of local government: the communal bloc, departments, and regions.

The lowest level of territorial governance consists of complex groupings commonly referred to as the ***communal bloc***. In terms of urban territorial classifications, this administrative unit most closely corresponds to the "city" in terms of spatial and population size. However, this division lacks judicial and fiscal autonomy. The communal bloc can be further divided into two administrative and functional units, each with distinct characteristics and compositions:

- ***Commune***. This designation encompasses administrative units that vary in size from a hamlet, an entity with a population no greater than several hundred, to large metropolitan cities. There are about 36,000 communes in France, an important distinction as French communes account for half of all communes in the European Union. The governing assemblies, municipal councils, are elected through *direct universal suffrage* via *two-round list-ballot* *majority voting* (see Box 2). This process extends to the election of the mayor, who jointly manages the affairs of the commune with the local council. The administrative powers of the governing body are uniform, regardless of commune size, although the size of the municipal council greatly varies depending on population size.

- ***Intercommunalities***. These consist of cooperative groupings of communes, the size and scope of which vary drastically. Although this agglomeration was codified in 2001, it was fairly common for communes, particularly with smaller populations, to voluntarily enter cooperative agreements to facilitate service provision. There are 2,100 intercommunalities. Governing assemblies for these bodies are elected through *indirect universal suffrage***.** Intercommunalities can take several forms and titles, depending on the size and location of the communes.

  Territorial evaluation and designation are particularly complex in France. Public establishments for cooperation among local authorities (établissement public de coopération intercommunal, or EPCI) and official communal groupings are myriad. Often differentiated by population size, the most common groupings, listed from smallest to largest, include community of communes (*communauté de communes*), agglomeration communes (*communauté d'agglomération*), and metropolis. Not all groupings are subject to population thresholds, such as the community of communes designation, which requires only geographical continuity. Groupings with higher population requirements tend to be less tightly integrated, although all permutations are governed by a representative council. In the case of communes whose population numbers fewer than 1,000 but are part of an intercommunal grouping, the representatives at municipal boards are not directly elected but are often selected from existing officeholders, such as mayors and city council members. Additionally, there are a number of less formal intercommunal cooperation arrangements, such as city networks and agreements.

The second level of territorial governance is the ***department***. This administrative level is a tier above the communal bloc in terms of territorial size. Structurally, departments are further divided into arrondissements and cantons. These units have no functional autonomy but are used to effectively organize service provision and, in some cases, administer elections. There are 95 departments within Metropolitan France (the official territorial designation of continental France, which excludes overseas regions, collectivities, and the sui generis collectivity of New Caledonia). Departmental boundaries have not shifted since the 1900s, although the regional division was almost abolished in 2014 as part of the national discussion on territorial reform. Governing assemblies, termed departmental councils, are elected through *two-round binomial majority voting* within cantons. Each department has a president of the council, as well as departmental advisers, selected by council representatives. Elections for the two departmental advisers are unique because of gender parity requirements, which ensure that elected advisers are of opposite gender.

The highest level of territorial governance is the ***region***. Despite their size, regions lack legislative power, a long-standing point of contention. Regional assemblies are elected through *two-round, list-ballot majority voting* and function much like departmental councils. In January 2016, a law reduced the number of regions in France from 22 to 13.

Division of competencies

Over the course of the 20th century, a series of decentralization reforms and territorial restructuring created a fairly well-structured system of governance. Capitalizing on economies of scale,

Box 1. The Metropolis

In December 2010, France passed a law establishing the creation of metropolises, with the aim of consolidating the role of large agglomerations as a key driver of economic growth. A metropolis is defined as a "public cooperation entity, which groups several communes and promotes economic educational environmental and cultural development in order to improve their region's competitiveness and cohesion" (General Code on Local Governments). Fourteen metropolises have been created: Bordeaux, Brest, Grenoble, Lille, Montpellier, Nantes, Rennes, Rouen, Strasbourg, Toulouse, Nice Côte d'Azur, Aix-Marseille-Provence. The metropolis of Grand Nancy will be created on July 1, 2016, bringing the total to 15.

The list of metropolises cited in the paragraph included the following Metropolises: Grand Paris and Grand Lyon. The two have a special status within France. The Métropole du Grand Paris, a recently created cooperative structure that oversees the capital city and surrounding urban area, is a complex entity tasked with the responsibilities most commonly assigned to the first two tiers of local governments (commune and department). Although the city of Paris has held a unique position within the governance structure of France, legislative reform in 2016 saw the administrative structure of Grand Paris grow to incorporate communes from three departments. The area is governed by a newly constituted metropolitan council, and its basic competencies will include urban planning, housing, and protection of the environment. Additionally, the Metropolis of Lyon, or Grand Lyon, like Paris, was granted expanded powers and scope in 2016. This administrative unit replaced the urban community of Lyon and has the competencies of a department and metropolitan area. The special status of Grand Lyon will be examined in greater depth in an upcoming publication.

Despite their special status, French metropolises are under the umbrella of the communal bloc; their finances are reported under the "communal bloc" label.

Box 2. French electoral system lexicon

Universal suffrage: The right to vote is granted to every citizen who meets the electoral requirements: age, nationality, moral capacity, and voter registration.

Direct universal suffrage: Voters directly elect their elected officials. The French president is elected via direct universal suffrage.

Indirect universal suffrage: Voters elect delegates who in turn select the elected officials. The U.S. president is elected via indirect universal suffrage.

Uninominal voting: One candidate is elected. The French president is elected via uninominal voting.

List ballot voting: Voters elect a list of candidates. The governing assemblies of communes are elected through list ballot voting.

Majority voting: The winning candidate (or list of candidates) is attributed all the seats at stake.

Proportional voting: Candidates are attributed seats based on the proportion of votes they received.

Two-round voting system: When a candidate (or list of candidates) fails to obtain an absolute majority of votes (more than 50 percent), runoff elections are organized between the two candidates (or list of candidates) who obtained the most votes in the first round.

local governments in France play a central role in the distribution of services and tax collection, and have a fair amount of influence over social, economic, and education policies. Although the division of responsibilities among tiers of local government has undergone significant alterations since the second stage of decentralization in 2003, competencies continue to be allocated uniformly across corresponding administrative authorities. This ensures that each level has a consistent set of responsibilities and attempts to reduce any redundancies in spending and service provision. However, the 2003 Act on Experimentation by Local Governments allows for some variation in the delegation among government levels.

France is one of the least decentralized European countries, particularly when compared with larger EU countries (i.e., Germany). As it is not a federal state, local governments lack legislative power and cannot impose their jurisdiction or control outside their boundaries. Instead, the central government exercises authority and control *a posteriori* over the actions and finances of local governments. This process is facilitated via the Office of the Prefecture and Sub-Prefecture; federally appointed representatives of the national government that operate within the departments. "Regalian" powers (defined as the functions that reflect the sovereign attributes of the nation-state), such as national defense, lawmaking, health care, and funding for educators and public researchers, are almost entirely endowed in the central government.

With respect to subnational governance, the communal bloc (communes, intercommunalities, and metropolises) is by far the most influential entity. It is the only level of local administration that has retained a "general competency" clause that enables it to intervene in most areas of administrative activity, excluding the provision of essential functions related to national sovereignty (justice, national defense, foreign affairs, security, etc.). Communes, intercommunalities, and metropolises share functions related to early childhood education, roads, urbanism and public transport, culture, sports, after-school programs, housing and accommodation, and economic development through the economic activity zones.[31] Division of labor is a particular concern as these duties often overlap. Recent legislation, discussed at greater length in Section II, has attempted to reduce service duplication and excess spending by clarifying competencies among local governments. Concerning the division of labor between the groupings of communes and within intercommunalities and metropolises, responsibility-sharing arrangements vary depending on the size of the associated units and agglomeration area. The transfer of resources from the communes to the intercommunalities is monitored and financially incentivized by the central government.

Departments are primarily responsible for the implementation of social policies: inclusion and social welfare, social aid, care for senior and disabled

Box 3. Intergovernmental cooperation and consolidation

The central government has long recognized the potential pitfalls of a lack of coordination within a highly localized, and overlapping, subnational government structure. Colloquially referred to as a *mille-feuille*, or multilayered and highly bureaucratic, structure, local entities are often controlled and governed by overlapping authorities and jurisdictions. Coordination among complex local levels of government can lead to costly redundancies in service division and is often compounded by the high number of very small municipalities.

In recent years, the federal government has responded with a series of structural reforms and departmental committees that have sought to simplify intergovernmental cooperation and local government structure. A key example can be found in the Departmental Commission for Intercommunal Cooperation (CDCI), which dates back to 1992, a representative body that draws delegates from the communal, EPCI, general, and regional councils to develop plans for increased cooperation and dialogue among local governments. Moving beyond the commission, in 2010 the Departmental Plan for Intermunicipal Cooperation (SDCI) was established to streamline local governments. The SDCI has developed in-depth schemes for departmental cooperation which have led to the restructuring of local entities and the creation of population requirements for certain designations. The most recent adaptations took place in January 2017.

[31] Economic activity zones in France are zones reserved for the creation of businesses within a given perimeter.

residents, public health, youth services, departmental transport, economic development, vocational training, environmental services (including waste and water plans), ordinary secondary education, social solidarity, and territorial solidarity (providing financial assistance to poor communes).

Despite being the largest local administrative level, regions have fewer responsibilities and smaller budgets relative to other tiers of government as well as to their European counterparts. Regional governments are the lead actors in the following areas: regional transportation (notably trains, civil airports, etc.), professional training, building and maintenance of high schools, and support staff. Additional services also include academic and scientific research, local economic development (often overlapping with departmental activities), exports, sports, culture, tourism, and international cooperation. The regions handle the entirety of European Structural and Investment Funds, amounting to about 20 billion euros. Recent legislation, examined in Section II, attempted to solidify regional control over fund dispersal and economic growth.

Box 4. Fiscal decentralization and income distribution

At the national level, the central government often argues that the taxation and benefits system is inherently redistributive and effectively reduces income inequality and compensates for differences in regional wealth distribution. Therefore, there is less of a need to implement more aggressive redistribution policies at the national level. An analysis of the data supports the national government's claim that its redistribution taxation system and public services help compensate for inequality among regions. A 2014 Organization for Economic Cooperation and Development (OECD) study found that France's system of taxation and transfers created the largest reduction dispersion of poverty rates, based on disposable income, of all OECD countries. Despite this claim, the OECD has often found that while redistribution and social benefits do help reduce income inequality, these funds are ineffectively distributed so that the bottom 30 percent of households received slightly less social funding than the average household, while the top 30 percent enjoyed about a quarter more than the average.

A failure to properly redistribute funds based on economic need and circumstance is increasingly worrisome given the trend to devolve responsibilities and services to lower levels of administration (see Table 1, Appendix). These additional competencies and corresponding increase in expenditures for lower levels of government authority have become a growing drain on local resources. This has resulted in an increase of inequality among territories, particularly in smaller communes and departments that lack the institutional support and funding to manage and meet the needs of their constituencies without increased financial and administrative assistance from adjacent communes and higher levels of government.

Additionally, in early 2017 the Monitoring Committee of the Council of Europe explicitly expressed concern over the state of France's financial equalization system, citing fears that the redistribution of resources among authorities is insufficient to compensate for financial disparities. Given significant territorial reforms and steps toward greater decentralization, the Congress of Local Regional Authorities has stressed a greater need for consultation among levels of government to ensure that local authorities, particularly in rural areas, have the appropriate financing to fulfill their responsibilities and properly serve their constituents.

RECENT DEVELOPMENTS

Two important laws recently changed the structure and responsibilities of local governments in France.

Modernization of Territorial Public Action and the Affirmation of Metropolises[32]

Adopted in January 2014, Modernization of Territorial Public Action and the Affirmation of Metropolises (MAPTAM) attempted to clarify the competencies of local administrative bodies through a structural reorganization of highly integrated municipal areas as well as the creation of consultative bodies among communities. It also established a framework to facilitate the eventual transfer of responsibilities from the newly incorporated communes to the metropolitan governments, a process slated for completion in 2020. This law is a continuation of the decentralization process in France. Although MAPTAM has been in effect only since January 2016, it affirmed the role of metropolises through the creation of new metropolitan entities and classifications. The metropolises of Grand Paris, Grand Lyon, and Aix-Marseille-Provence increased in territorial size, with the latter two gaining new competencies and influence. Although Paris has had special status for quite some time, Lyon experienced the greatest changes as it became the second metropolis in France.

Not without controversy, the creation of metropolises and cities with special status and competencies has been the center of ongoing discussions regarding the division of power among government levels. This is particularly pressing for the newly established metropolises, as before MAPTAM they had cooperative structures as urban communities (a subdivision of communal bloc) that were uprooted by new regulations. Moreover, MAPTAM affects the local electoral process, as it mandates that all metropolitan assemblies must be elected through direct universal suffrage by 2020. This paradigm shift will re-center policy debates on metropolitan issues and will likely lead to further difficulties as metropolitan councils try to meet the needs of much larger constituencies.

New Territorial Organization of the Republic

Similar to MAPTAM, New Territorial Organization of the Republic (NOTRE) seeks to reinforce the competencies of regions. Adopted in August 2015, this law clarifies territorial organization and condenses the size of lower tiers of local government. First, the population requirement for intercommunalities increased from 5,000 residents to 15,000. This drastically reduced the number of intercommunalities to 1,500, forcing over 500 communal groupings to redefine their legal designation and scope. The responsibilities of restructured intercommunalities will increase as responsibilities are transferred from the communes or departments. Second, NOTRE transferred several departmental responsibilities to regional governments. New regional competencies include land-use planning, environmental and climate change issues, professional training, transport, and mobility. The most notable change is the transfer of control over economic development, which is under debate, particularly within the metropolises.

This territorial restructuring decreased the number of regions from 22 to 13, thereby creating larger regional governments with greater territorial scope and responsibilities. The passage of NOTRE and MAPTAM laws can be viewed as an attempt to replicate key aspects of the administrative structures of neighboring countries that have strong regions and metropolises. Nevertheless, France continues to have a relatively higher number of territorial levels and a hazy distribution of responsibilities.

[32] *Modernisation de l'Action Publique Territoriale et d'Affirmation des Métropoles.*

Evolving political divisions among regions and metropolises

Recent attempts to simplify the distribution of responsibilities among administrative levels and empower regions and metropolitan areas are indicative of a highly adaptable, and evolving, organizational climate. Due to their recent implementation, it is difficult to draw conclusions about the effectiveness of MAPTAM and NOTRE. Moreover, significant confusion over the implementation of that legislation continues to play out in parliamentary debates, creating some issues for first adopters. Two key difficulties should be highlighted:

1. **Economic intervention.** Drawn into contention after the passage of NOTRE, as the law failed to adequately delegate the responsibility of economic development to a particular administrative level. While the law created a generic division of regional competencies, the updated administrative responsibilities have significant overlap with competencies assigned to metropolises. As of 2016, both regional governments and communal administrations have the same rights in relation to economic assistance for the internationalization of local firms and the support of research and development—often the only way to assist private companies within the confines of EU regulations.

2. Although the debate over economic development highlights power rivalries and hostility, it symbolizes a deeper divide over the drivers of innovation and economic development. Metropolises argue that they elevate the surrounding areas through "spillover effects." Alternatively, regions believe they are uniquely able to prevent polarization caused by the flight of capital and human resources, often created by metropolitan areas, emphasizing examples of territoriality (as seen in the case of the Italian "industrial district") that promoted innovation and economic development. The debate continues.

3. **Public transport and mobility.** Tensions relating to the provision of transportation services arose because of conflicting aspects of the MAPTAM and NOTRE laws. As it expanded the role of metropolitan governments to cover sustainable mobility, which includes urban transportation as well as parking, streets, and some aspects of regional transit, MAPTAM created the Metropolitan Authorities for Sustainable Mobility. This joint assembly capitalizes on the role of agglomerations and metropolises in organizing mobility services, an arrangement reflective of France's highly developed urban public transportation system. Conversely, NOTRE created a transportation scheme termed the Regional Transport Blueprint, which has the potential to restrict and clash with metropolitan authority and planning. While the blueprint is intended to increase collaboration among the levels of local government, there is no indication that harmonization of projects and tariffs will be easily achieved.

Box 5. Tensions between metropolises and surrounding territory

With the adoption of the MAPTAM law, metropolitan cities within France gained new competencies and importance. The new metropolitan councils can deliver most services across the city, notably gaining control of social and welfare services. In particular, Grand Lyon significantly increased in size and administrative control, assuming powers and control over areas formerly outside its purview.

Territorial reorganization was presented as a means to ensure that communes, and inhabitants, would have greater access to administrative and financing sources to support economic growth and cohesion. There has been some localized pushback from the host regions as well as the surrounding departments and intercommunal areas that are now part of, or border, the metropolises. Citizens from surrounding departments and communes, particularly in more rural or sparsely populated areas, have begun to view the growth of metropolitan areas as detrimental to the economic and social health of their cities and towns. Citing a "desertification" of resources and skills, departments and communes outside the periphery of large metropolises view urban growth coming at the expense of small and medium-sized towns as funding, services, and businesses leave less populated areas.

The reduction of services to underpopulated areas could bring some benefits. For example, closing some of the smaller rural hospitals would allow economies of scale and greater investment in new technologies, which could increase quality of service provision. There has been a general push from organizations such as the OECD to decrease the powers of communes in order to consolidate and expand the size and responsibilities of higher levels of administrations to both increase efficiency and reduce losses from overlapping of responsibilities and expenditures among lower levels of government.

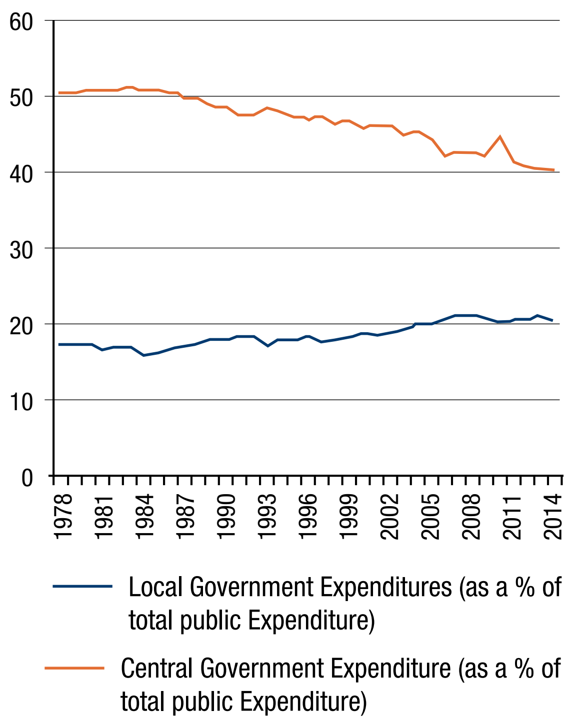
This tension is also reflected within metropolitan areas, where many view outlying towns and departments as being "free-riders" that benefit from substantial wealth transfers and knock-on benefits without financially contributing to the city. This has become a particular issue for Grand Lyon, which transfers substantial amounts to surrounding departments and its regional government. Large metropolitan areas often view themselves as the drivers of economic and social growth for their regions, stating that the benefits of increased innovation, public spending, and economic growth will often flow down to surrounding cities and departments.

LOCAL GOVERNMENT SPENDING

The growth and diversification of local expenditure

The overall analysis of local government spending as a percentage of GDP and as a percentage of total public spending demonstrates the growing fiscal importance of the local governments. Since the first decentralization laws of 1982, subsequent legislative reforms have continued to strengthen the role of local governments and increase the scope of service provision and responsibility of local administrations. This trend is also reflected in the rapid increase of the local to central government spending ratio. Additionally, a recent study by the Bank for Official Deposits demonstrates[33] that local governments drive 74 percent of public investment in France.

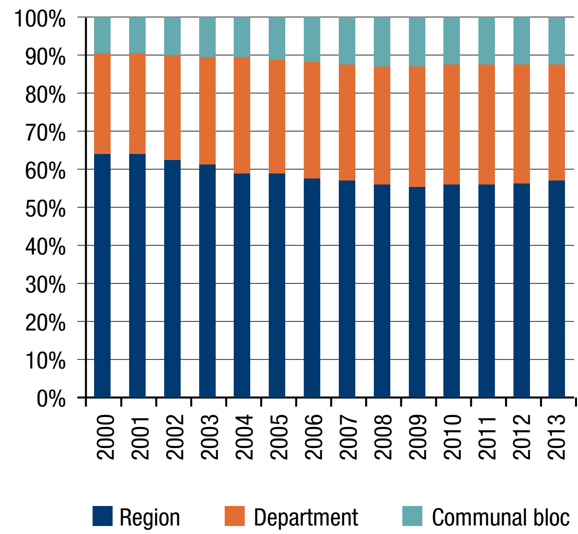
Figure 1. Local and central government expenditures, as a percentage of total public spending (excluding social security expenditures)



Source: Institut national de la statistique et des études économiques (Insee)

These figures and trends demonstrate the increasing influence of the communal bloc, particularly with intercommunalities, which represent about half of all spending within the communal bloc. Conversely, the sum of spending by the regions in relation to total government spending continues to be small in comparison with neighboring EU countries.

Figure 2. Local government expenditures by level (%)



Source: Direction générale des Finances publiques (DGFiP)

Expenditure across the levels of local government

The distribution of resources and competencies among the tiers of local government has led to significant variations within local public expenditures. The provision of public goods and services can be examined as follows:

- **Direct operating expenditure.** This category encompasses all the expenditures necessary for service delivery by local

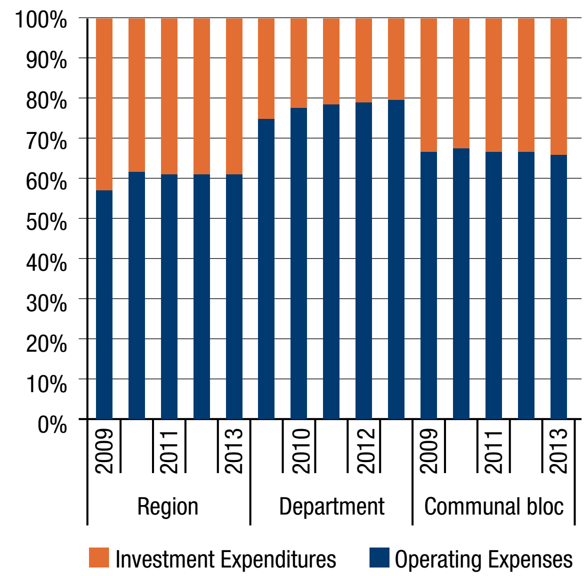
[33] "2012-2015: Observatoire de l'évolution de la commande publique," Assemblée des communautés de France, February 2016. http://www.adcf.org/files/Finances-et-fiscalite/2Commande-publique-note-AdCF-fevrier-2016.pdf.

governments. These expenditures are recurring and account for about two-thirds of total local government spending. Operating expenditures include staff salaries, utilities (water, telephone, electricity, etc.), allowances for elected officials, fees related to the interest on debt repayment, and spending related to maintenance and stationaries. Additional expenditures include ***operating expenditures for "intervention,"*** such as subsidies to associations, human capital investment, public services (e.g., transportation), and assistance to senior citizens. These are applicable to regions and departments as both are responsible for social security.

- **Investment expenditure**. This reflects the appreciation or depreciation of the value of the assets held by the local governments. Covered expenditures include the purchase of durable materials, the construction and maintenance of buildings, infrastructure development, real estate acquisition, debt reimbursement, etc. Investment expenditures account for about one-third of total spending. These are accrued at all levels of local governance with a stronger weight in communes and intercommunalities. Local governments are the largest public investors in France. This is driven, in large part, by structural investment such as public transport.[34]

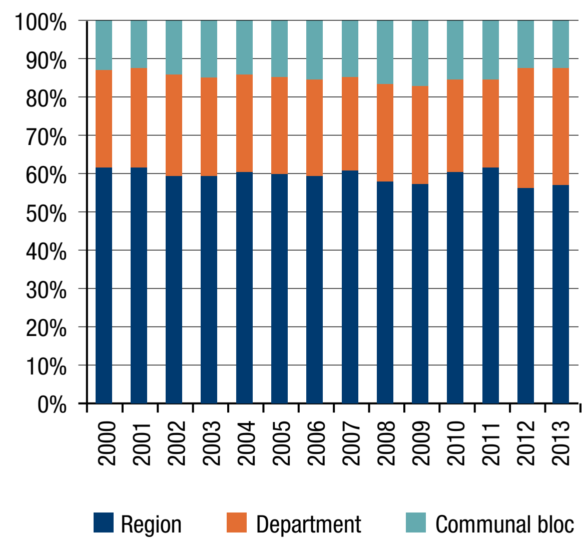
Investment expenditure has been dominated by the communal bloc, which accounts for almost two-thirds of all investment by local governments. Annual variations in spending levels are almost nonexistent, and the department and region spending represent 20 and 16 percent, respectively, of all investment by local government. Figures 3 and 4 illustrate that the bulk of investment spending occurs at the most local level (communal bloc), while departments and regions supplement the projects and investment plans undertaken by communal or national actors.

Figure 3. Breakdown of budgetary expenses, by governmental level



Source: DGFiP

Figure 4. Breakdown of investment expenditures, by governmental level



Source: DGFiP

[34] "Les dépenses des collectivités locales," Vie publique, Direction de l'information legale et administrative (DILA), last modified February 8, 2016. http://www.vie-publique.fr/decouverte-institutions/finances-publiques/collectivites-territoriales/depenses/comment-repartissent-depenses-collectivites-territoriales.html.

LIMITED REVENUES

Operating revenues and the realignment

Independent fiscal structures

Historically, local fiscal governance and funding were the responsibility of the respective local administrations. Local revenues are overwhelmingly collected from respective local communities. This system helps to create and reinforce important disparities among local governments. The differences among communes, departments, and regions can be attributed to the political decisions regarding the level of service provided to residents, as well as wealth disparities (or fiscal potential) among constituencies. Income distribution is a particular concern within and among urban areas and has been exacerbated by the sheer number of communes in France .As a result, it is not unusual for residents from neighboring communes to be subject to very different tax rates, because of different tax effort, even though their administrative governments bear similar expenditure burdens and provide comparable services.

In the past, government expenditure was financed via an even balance between business and household taxation. Now, local government revenue increasingly draws on private households through indirect taxation. Prime examples include taxes on gas and automobiles, which are collected at the regional level, and estate taxes, which are enforced by departments. Additional measures have been adopted that bolster the ongoing horizontal realignment within local governments, including the transfer of jurisdiction over business taxation from the intercommunal to the national level.

These structural changes have made France's administrative structure more closely resemble its European neighbors, where disparities in competency distribution are less prevalent. But recent reforms ought to be examined within the context of the French system, which is notable for concentrating redistributive efforts at the national level. For example, a recent analysis of taxation in Paris and Lyon has demonstrated that, despite a relatively weak tax system, revenues from these local household taxes strongly contribute to the financing of public services throughout the country and across administrative levels.

However, this topic is relatively difficult to address quantitatively and is the subject of ongoing debate. This issue will be discussed at greater length in a forthcoming paper on Lyon.

Reassertion of central controls

In recent years, the central government has expressed an interest in decreasing the overall tax burden. As part of this process, efforts have focused on reforms at the local level, resulting in the abolishment of key local taxes, including the occupancy tax (*taxe d'habitation)*, an important subsector of household taxes, and the professional tax (*taxe professionnelle)*. A system of compensation was created to help local authorities recoup the loss of tax revenue. However, the new compensatory process has undermined the fiscal autonomy of local governments, as the proposed transfers are evaluated by the central government on an annual basis and do not fully compensate local authorities for loss of tax revenue. Therefore, an important percentage of local revenue is determined at the national level, where an identical tax rate across local governments is set. Revenues from local tax collection are ultimately transferred to the National Treasury before any redistribution, which is also determined at the national level.

Other revenues

Often called "estate" revenues, this income is made up of user fees from public services. Overall, these revenues make up a negligible portion of local government budgets (with the exception of the commune level, where they make up 20 percent of operating revenues[35]) for two main reasons:

[35] Figure estimated by B. Soulage.

1. Most public services—such as preschools, public lectures, roads, and public spaces—are free.

2. When these services have associated fees, the generated revenues do not cover their costs.

Investment revenue

Before addressing this topic, it is important to note that by law local governments are not allowed to run an operating deficit.

Consequently, local governments have substantial operating surpluses, or gross savings, which are often over 10 percent of total operating revenues (see Figure 10, Appendix). Additionally, all levels of local government have positive net savings (gross savings/debt reimbursement) of 7 percent of all local government spending combined, as of 2013 (Figure 5). It is important to note that as of 2014, both investment spending and savings have seen negative growth (about negative 9.2 and 2.7 percent, respectively) while expenses continue to grow at a higher rate than total revenue for local governments.[36]

Investment revenue can be divided into four components:

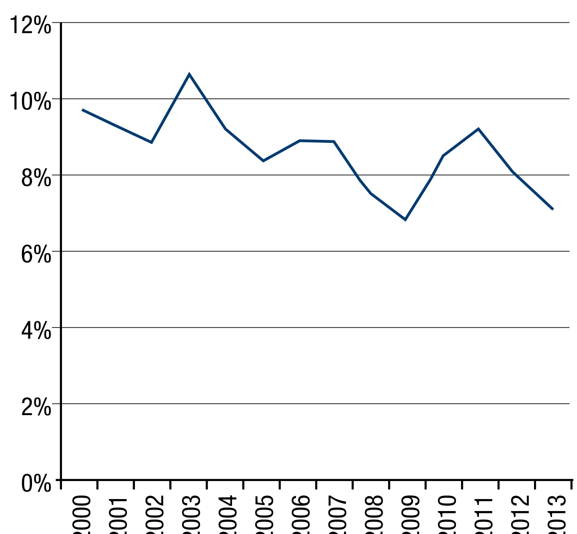
1. Gross savings.

2. Subsidies received from the central or other local government within the context of partnership through investment projects.

3. Reimbursement of value-added taxes (VAT) by the central government for the work it does. In 2014, regions within metropolitan France received about 434 million euros from the compensation fund for VAT, a figure that has steadily declined since 2010.

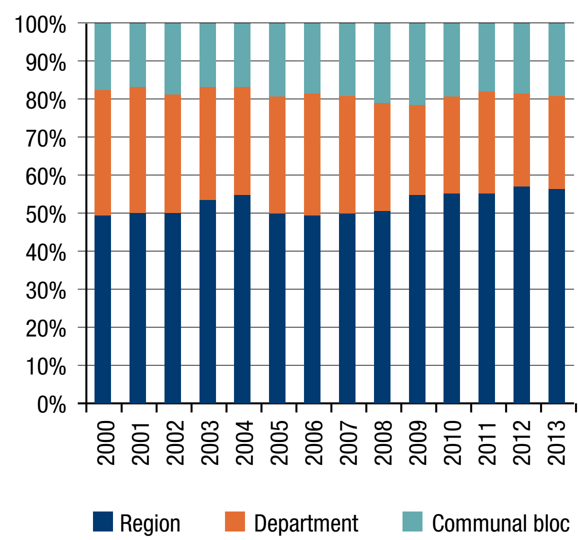
4. European subsidies, notably in the context of European Structural and Investment Funds (ESIF) that represent a small portion of

Figure 5. Net savings as a percentage of total expenses (all local levels of government)



Source: DGFiP

Figure 6. Gross savings

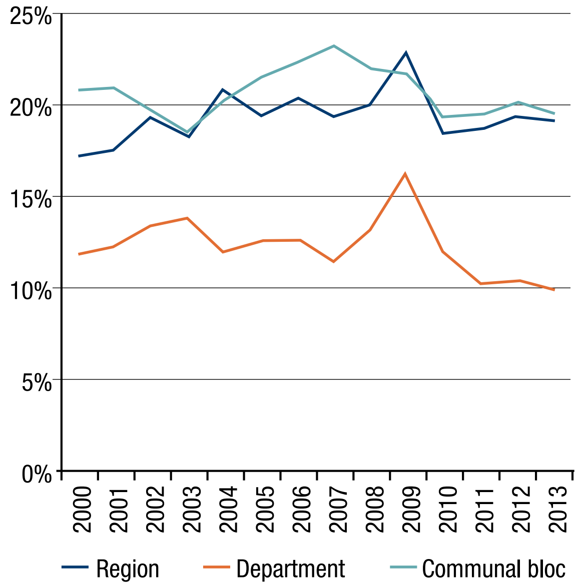


Source: DGFiP

[36] "Les finances des collectivités locales," Collectivités territoriales, Cour des comptes, October 13, 2015. https://www.ccomptes.fr/Accueil/Publications/Publications/Les-finances-publiques-locales3.

regional investment, roughly 2.9 billion euros per year allocated to regional councils. Over the period of 2014-2020, regional councils will receive about 20 billion euros, accounting for over 75 percent of all ESIF financing allocated to France (see Table 2, Appendix).

Figure 7. Investment revenue as a percentage of total revenue

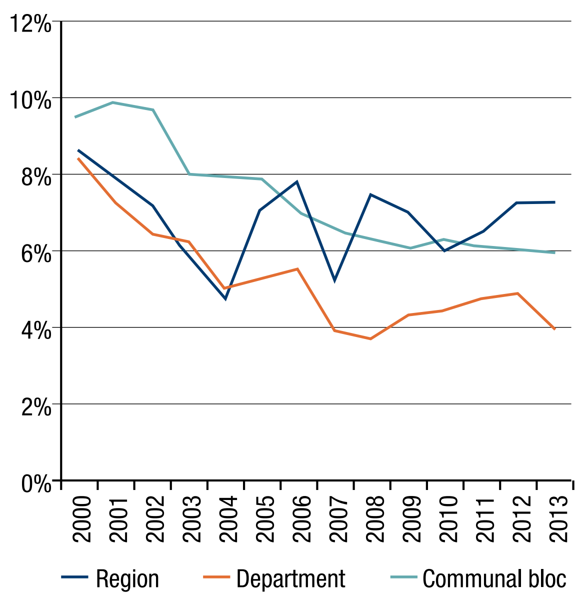


Source: DGFiP

DEBT

Charges related to debt reimbursement (including interest) are below 10 percent of the total budget of all local governments, including regions with strong investment policies (Figure 8). Moreover, the contribution of local governments to the general equilibrium of French public finances—in respect to the Maastricht criteria,[37] which states that national debt cannot exceed 60 percent of GDP—varies depending on the year and is often slightly positive or close to zero.

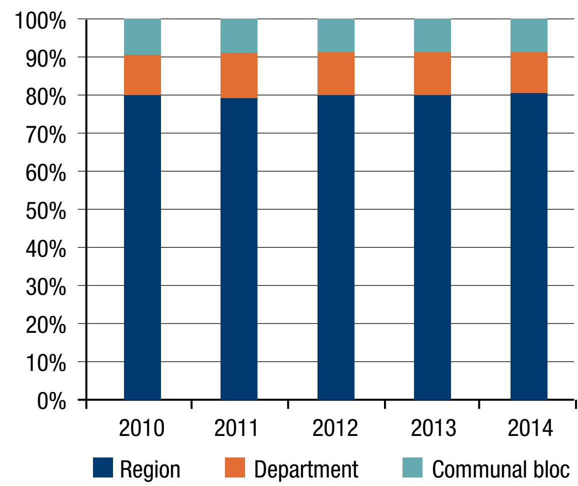
Figure 8: Debt reimbursement as a percentage of total spending



Source: (DGFiP)

Local government debt is relatively low. Currently, local governments hold 9 percent of public debt, while the social security administrations and the central government represent 11 percent and 80 percent of public debt, respectively.[38] Relatively low debt at the local level can be attributed to national regulations on borrowing. Local governments, contrary to the central government and the social security administration, may borrow only to finance investment expenditures. In other words, local governments are not allowed to borrow to finance operating expenditures. These expenditures make up two-thirds of total spending at the local level. Thus, limiting borrowing to investment expenditures reduces the risk of incurring high debt.

Figure 9: Debt as a Percentage of Total Public Debt



Source: DGFiP

The overall debt level of local collectivities is rather moderate as local governments account for less than 9 percent of public debt, while local expenditures represent about 20 percent of total public spending (including social spending). The overall debt ratio to total expenditure stands at 58.8 percent on average. Based on historic gross savings data, it would, on average, take local governments five years to zero their balance sheets, assuming all annual savings would be applied toward debt repayment.

[37] "Finances Locales: La baisse des dotations de l'Etat en question," Vie publique, Direction de l'information légale et administrative (DILA), last modified November 26, 2011. http://www.vie-publique.fr/actualite/alaune/finances-locales-baisse-dotations-etat-question-20141126.html.

[38] "Quelles sont les dotations de l'Etat aux collectivités?" Vie publique, DILA, http://www.vie-publique.fr/decouverte-institutions/finances-publiques/collectivites-territoriales/ressources/quelles-sont-dotations-etat-aux-collectivites.html.

Box 6. Local debt and the Maastricht criteria

Adopted in 1991 and taking effect in 1993, the Maastricht Treaty established the European Union and outlined five convergence criteria in an attempt to forward the creation of the European economic and monetary community. The European convergence criteria, also referred to as the Maastricht criteria, centered on fiscal, debt, and deficit obligations placed on member states that expressed interest in adopting a single currency, the euro. Criteria relating to government budget deficit and debt to GDP ratio are of particular importance when considering local government spending and budgeting within France.

The two criteria that concern government finance require that the member states must not have a public finance deficit that exceeds 3 percent of GDP for all general government and that the public debt cannot be more than 60 percent of GDP. When accounting for debt in relation to the Maastricht criteria, public debt encompasses all areas of the national account—including the accounts of local governments. Additionally, public debt is specifically defined in relation to the convergence criteria as follows:

- Public debt does not include all financial liabilities but only cash and deposits, securities other than shares, which are treasury bonds (BTF and BTAN), fungible treasury bonds (OAT), euro medium-term notes (EMTN), as well as loans; excluded are derivative products and other accounts payable.

- It is calculated as gross debt insofar as liabilities are not subtracted from the financial assets of general governments.

- Debt is consolidated; therefore, the elements of a government's debt held by another government are excluded from debt calculations. For example, deposits of general governments with the treasury are excluded from calculations.

- Debt in the sense of Maastricht is evaluated in nominal value, that is, at the repayment value of the principal. As such, accrued interest not due or fluctuations in the prices of securities are not included in the evaluation of instruments, whereas the re-evaluation of the securities repayment value indexed to inflation (OATi, BTANi and CADESi) is taken into account.

PARTNERSHIP AND COOPERATION

The French system is notable for broad and multilevel cooperation between the local and central governments, within local governments, and among various levels of local government and the private sector.

The financial relationship between local and central government

Vertical interactions can be divided into three types of activities:

Transfers from the central to the local government. There are three specific types of transfers from the central to local government. First, there is the "general operating grant," a substantial figure that can be used by local governments without restrictions but has recently undergone some reform. In 2014, Prime Minister Manuel Valls announced that to decrease public spending, the transfers from the central government to the local government will be reduced in 2015-2017.[39] By 2015, the general operating grant stood at 36.6 billion euros, down from 40.1 billion euros in 2014. The second category of transfer is the "general equipment grant," which assists local government financing of infrastructure and other investment projects. The third type is the "compensation grant," which compensates local government for the loss of revenues due to the transfer of competencies.[40]

Formalized expenditures. Covering investment and intervention, these expenditures are seen in the context of planning contacts or ESIFs, which are distributed over a seven-year period. In France, the planning contract (*contrat de plan*) is an agreement between the central government and a region on the programming and financing of important multiyear projects, such as infrastructure development. Similarly, the ESIFs are deployed within regions to develop local research and innovation capacities.

Co-financing among local governments. Undertaken in collaboration with the central government, these agreements occur on a yearly or multiyear basis, not to exceed three to five years. The co-financing system provides financial support for cultural affairs (such as the opera, theater, and professional training institutions), academic research, sports, tourism, small businesses, and the unemployed. Co-financing provides a perfect example of the *mille-feuille*, or multilayered political system, in action. It creates a process through which stakeholders can present on the current state of their respective regions. Although recent structural reforms, addressed in previous sections, tried to simplify territorial structures and clarify the division of competencies and financing, consistent difficulties in tracking real financial flows remain.

The role of the private sector

The implementation of public policy, particularly at the local level, is a unique form of collaboration between the private and public sectors. France uses the delegation of public services (DSP) model, *délégation de service public*, under which risks associated with investment and exploration (for the construction of a new public service, for instance) are shared between the private sector and the government. The private sector does not play a major role at the local level. Public-private partnerships (PPPs) are undertaken at the central government level.

Contracts and collaboration are generally initiated by the public sector. Private firms submit proposals for the inspection and approval of government authorities to manage and operate a local public

[39] "Debt in the sense of Maastricht (national accounts)," National Institute of Statistics and Economic Studies (Insee). http://www.insee.fr/en/methodes/default.asp?page=definitions/dette-sens-maastricht.htm.

[40] "Les finances publiques locales," Collectivités territoriales, Cour des comptes, October 13, 2015. https://www.ccomptes.fr/Accueil/Publications/Publications/Les-finances-publiques-locales3.

Box 7. Public-private partnerships in France

The history of public-private partnerships (PPPs) is inconsistent, characterized by periods of strong and weak reliance on the relationship between the public and private sectors. France has a long history of state intervention and oversight; for much of the 20th century, PPPs played a role in creating a semblance of cohesion in public service delivery among the large number of communes. However, the focus on PPPs from both the government and the private sector has increased substantially. Since 2004 over 18 billion euros have been invested in PPPs in various economic sectors, such as transport, health, and energy efficiency. Two types of PPPs are mainly used in France: concession agreements (which help to sponsor major infrastructure projects) and partnership contracts (which function akin to a private finance initiative, with private organizations contributing a majority of the funds to projects). In 2014, the EU issued directives on how public concessions and PPPs ought to be legally governed, for partnerships above a certain financial threshold. The French government began incorporating these into law in April 2016 to simplify the legal regime.

service. Most contracts are created with an understanding that the government will maintain long-term control and management of the service and will play a central role in billing and price setting. This form of collaboration incorporates a variety of public-private relationships and risk-sharing agreements related to investment and exploitation.

Related to DSP arrangements, semi-public companies (SEMs), *sociétés d'*économie mixte, is another fairly popular form of public-private partnership. In this instance, private firms are created through a pooling of public and private capital, although the latter provides the majority of funding to deliver a public service. These companies are often created as a result of a DSP agreement. In most cases, SEMs are governed by locally elected officials to ensure efficient operation.

Unlike other countries, France rarely uses the "build-operate-transfer" model. There are a few exceptions, notably in the transport infrastructure sector. Other forms of PPPs include partnership contracts (CPs), *contrats de partenariat*, in which a private firm is granted management of a public authority in exchange for rental or yearly usage fees. While there have been many attempts to launch PPPs in various sectors at the local level (infrastructure, hospitals, prisons, etc.), the central government continues to be the main partner in public-private arrangements. Historically, PPPs have been met with little success.

Relatively low returns to, and interest in, PPPs illustrate a major hurdle for cooperative efforts between private and public actors at the local level. Generally, elected officials have a vested interest in maintaining control over the decisionmaking process, reflected in the success and popularity of DSPs and SEMs. An additional limiting factor for the growth of PPPs can be found in a negative reputation of public-private endeavors caused by past high-profile failures. Several large financial groups, such as Engie, Veoila, and Vinci have undertaken disappointing PPP ventures, which fueled disenchantment with such arrangements near the end of the 20th century. One particularly damaging scandal involved the construction of the Channel Tunnel, which faced severe setbacks and delays across several decades. Overall, the PPP model is neither well-received nor overly popular in France, as it is often viewed as involving unequal risk distribution or cost at a higher rate than publicly controlled services, particularly in a country where people are not accustomed to paying for public goods.

CONCLUSION

Because of recent reforms, France is experiencing substantial shifts that affect the finance and governance of local governments:

1. **Local government finance faces new constraints** because of the loss of autonomy to central control, low global growth that has reduced taxable assets and revenues, and a growing decline of government transfers that began in 2011. Additionally, local governments should continue to expect diminishing transfers from the central government, by an estimated 3.5 billion euros per year through 2017. Communal-bloc governments have begun to divest from non-mandatory responsibilities, and there has been a significant reduction in investment, predominantly by communes and departments, as they bear the brunt of social expenditure. Forecasts for demands on social spending are particularly bleak for departmental governments because of a projected growth in unemployment rates and a rapidly aging population, which promise to be a significant drain on their resources.
2. **Recent legislation imposes significant changes.** The MAPTAM and NOTRE legislation have effectively combined several commune and department governments through the creation of metropolises, removed the general competency clause for the departments and regions, reduced the number of regions from 22 to 13, and altered organizational systems of support for intra-urban transportation and small enterprises at the regional level.

These changes have attempted to simplify the multilayered bureaucracy and local public policy while bringing French administrative systems more closely in line with the practices and standards of neighboring countries without creating a federal state. Although it is too early to assess the results of the reforms, many analysts believe that the institutional results (with a few exceptions) may fall short of initial expectations.

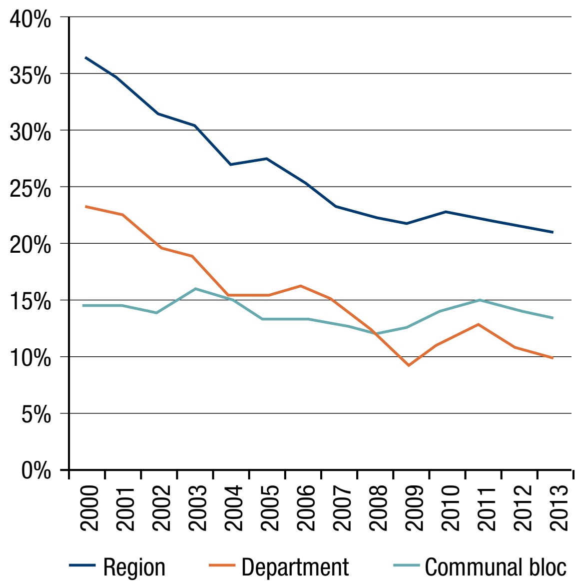
APPENDIX

Table 1. Expenditures powers transferred to local authorities (in EUR mil)

	2005	2010	2013	13/12 in%
Departments				
Welfare	25928	33678	36909	2.8
including Revenu de solidarité active (RSA)	6696	8603	9575	3.9
Allocation Personnalisée d'autonomie (APA)	4113	5372	5662	1.5
Colleges	3345	4304	4100	-3.6
Fire and rescue services	1740	2386	2493	-1
Regions				
Teacher training (continuous and apprent.)	3468	5052	5151	0.7
Education	3964	6326	6020	-1.8
Passenger rail	2859	3195	4108	12.4

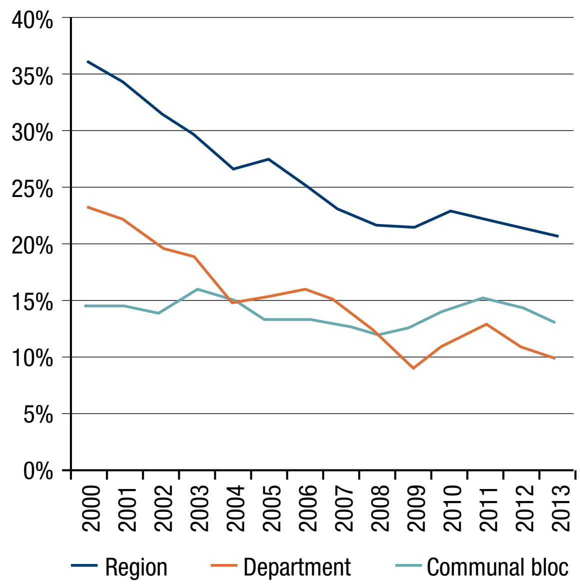
Sources: Direction générale des collectivités locales (DGCL); DGFiP

Figure 10. Gross savings as a percentage of total operating revenue



Source: DGFiP

Figure 11: Gross savings as a percentage of total expenses



Source: DGFiP

Table 2. European Structural and Investment Funds, 2014-2020 (in EUR mil)

	ERDF	ESF	EAFRD	EMFF	Youth Employment	Total	Percentage
Regional Council	7994	1956.7	10308.6	0	94.2	20353.5	76.1%
Others	432.1	4070.2	1076.2	588	216	6382.5	23.9%
Total	8426.1	6026.9	11384.8	588	310.2	26736	100.0%

Source: General Commission for Equal Territories

Fiscal and Federal Structures in Germany

CAROLINE CONROY

Cities worldwide are facing growing challenges, as a result of rising urbanization, citizens' expectations of better local services, migration, and environmental concerns, among others. That such challenges have to be met in a context of tightening resource constraints adds urgency to the imperatives of effectiveness and efficiency in local spending, and of growth-friendly, sustainable, and equitable generation of local revenues. Cities are meeting these imperatives in different ways and with different degrees of success.

The Brookings Project on 21st Century City Governance explores the norms, institutions, and networks that power successful cities in a complex world. This background paper aims to contribute to the project by providing a brief, yet comprehensive, overview of local and national fiscal systems and governance structures in Germany.

CONSTITUTIONAL AND LEGAL STRUCTURE

A federal parliamentary republic, Germany has long favored local self-governance. Lower administrative divisions have a relatively high degree of autonomy, although legislative and financial powers are strongly centralized, which often limits the capacity and capabilities of lower-level governments. The division of power and responsibilities is influenced by the principle of subsidiarity and an emphasis on the merits of local autonomy.

In keeping decisionmaking and federal structures as close to the citizen as possible, the German system endows authority and responsibility to the lowest administrative level so that it can correctly and efficiently carry out necessary functions. In the event that local or state officials are either politically or economically incapable of meeting their obligations, responsibility is shifted to higher levels of government. As a rule, the size of local authority often determines functional capacity; therefore, larger municipalities are endowed with more powers and responsibilities.

Overall governance

The Federal Republic of Germany is a multiparty parliamentary democracy. Executive leadership is divided between a chief of state, the federal president, and a head of government, the chancellor. The legislative branch consists of two houses: the Bundesrat (Federal Council), which serves in an advisory capacity and is the upper house of par-

[41] Although the German legislature is often defined as a bicameral parliament, this terminology is somewhat disputed. The Bundesrat serves as a representative body for state governments, and its status as a second chamber has been contested on multiple occasions at the Federal Constitutional Court.

liament, and the Bundestag (Federal Assembly).[41] The national constitution, or Basic Law, is guided by the principles of popular sovereignty and was designed to protect against the dominance of a strong central government. The constitution also seeks to create equivalent living standards throughout the country.

For the sake of analysis, the governance structure will be separated into three levels: federal (*Bund*), state (*Bundesland* or *Land*), and local administrative units.[42] Power is dispersed among regional governments through the vertical separation of powers. Rules regarding budgets, spending, transfers, and intervention are established in the Basic Law, which defines many elements of federal and state interactions. Because Germany is a member of the European Union (EU) and the Economic and Monetary Union, key aspects of German finance and affairs are under the control of EU authorities.

Level 1: Federation (*Bund*)

Given an emphasis on popular sovereignty, the powers of the executive authority of the federal government are limited to areas that typically fall under the purview of the sovereign state, namely foreign policy, national defense, issuance of currency, etc.[43] Any powers not explicitly assigned to the federal government fall to state governments.

Legislative authority is concentrated at the federal level. The Basic Law grants the federal government the right to issue legislation if a uniform law is deemed necessary for the whole of Germany, even if such legislation falls outside the scope of designated federal authority.[44] While the federal government often dominates the legislative process, any federal law that affects the states or their local authorities requires the consent of the Bundesrat, one of the two legislative chambers that consists of state representatives. In this way, states are active in the formulation of legislation and decision-making. As Germany is a parliamentary system, the division between the legislative and executive branches is less distinct than in democratic systems as federal ministers serve at the leisure of the parliament.

The organizational and self-governing abilities of the 16 states, while expansive, are inherently limited by the federal government, which predominantly controls tax legislation and establishes an equalization scheme among the federation, the state, and local authorities. Additionally, the federal government has the right to set broad standards and targets for areas such as higher education, land management, and regional planning, although states have some latitude in implementation.

Level 2: State (*Länd*)

Bias toward local governance ensures that each of the 16 federal states has considerable regional power and control. Each state has a unique constitution, parliament, government, and courts. Within its jurisdiction, each state is responsible for education, culture, and domestic security (police force, fire protection, etc.). The devolution of responsibilities varies among states because of their ability to individually determine management arrangements and competency delegation, and to establish electoral laws concerning districts and municipalities. Therefore, each state has a distinct governance structure and political climate. Aspects of geography, population density, and size also contribute to variation in the structure and allocation of power for regional and local governments.

As parliamentary republics in their own right, each Land has a head of state, the *Ministerpräsident*.[45]

[42] The district division can be further subdivided into intermediate and local administrative levels. As particular governance structures vary among Länder, specific terminology for divisions of local government is quite complex. This paper will analyze the properties and organization of the most common groupings of districts, and the municipal authorities and division that are nested within.
[43] Article 87, Basic Law.
[44] Disagreements are arbitrated by the Constitutional Court in the instance of Bund-Länder disputes. Such disputes are most commonly resolved via multilateral bargaining and consensus seeking among party lines.
[45] The city-states of Berlin, Bremen, and Hamburg are headed not by premiers but by mayors, whose titles are variations on *Bürgermeister*.

Box 1: Executive and legislative terminology

Federal president
Head of state, the federal president represents Germany at home and abroad. Duties include concluding international treaties, appointing foreign envoys, appointing and dismissing the federal chancellor, dissolving the Bundestag, signing laws, appointing and dismissing federal judges and civil and military servants, exercising the power to pardon, and awarding honors. The president is elected via the Federal Convention, which consists of all members of the Bundestag and an equal number of members elected by parliaments of the *Länder,* determined based on state population. Election takes place via a secret ballot, with no prior debate. Candidates can be proposed by any member of the convention, and the winner is selected by absolute majority.

Bundeskanzler: Federal chancellor
The central executive authority, the federal chancellor, is elected via a secret ballot in the Bundestag. The nominee for the chancellorship is proposed by the federal president and generally comes from, and is the chair leader of, the majority party. The election process can take up to three rounds of voting, but can be completed in the first round if an absolute majority (or chancellor majority) is reached; otherwise up to two subsequent rounds of voting can be triggered. Chancellors are typically elected every four years, with the seating of a new session of the Bundestag. There are no term limits. Specific duties of the office include the nomination of ministers of the federal cabinet, setting of policy guidelines and agendas (*Richtlinienkompetenz*) for the government and federal ministries,

Bundestag: Federal Parliament
Members of the Bundestag, comprising (at the moment) 630 representatives, are appointed via free and direct elections every four years. Half of the members are directly elected from local constituencies, majority or first past the post, while the other half are elected from Länder party lists, proportional. Therefore, Germans vote twice in elections—the first to select their local representative and the second for a particular political party, which determines the relative representation for each party within the Bundestag. Officially, the Bundestag has 598 permanent seats but can expand to include overhang or balance seats to maintain proportionality. The Bundestag is headed by a presidium consisting of a president, who is selected by members from the largest parliamentary group, and vice presidents who are elected after the selection of the president.

Bundesrat: Federal Council
Members of the Bundesrat, the representative body for the *Länder* (states) at the federal level, are not directly elected but appointed by *Länder* governments in delegations. The terms and duration of their service are tied to the specific state government. Each member has a dual role as minister, or minister-president/mayor, in their respective state while also holding federal office. Unlike in the Bundestag, members of the Bundesrat must vote as a bloc, based on their home state. Each state is allocated a minimum of three votes, but can be assigned up to six based on population size. The Bundesrat president is appointed yearly, based on a rotational cycle that is organized by state population size and in keeping with the principle of equal state representation. Appointment does not correspond to party-political considerations; the president must hold the position of minister-president, or state premier, and the two vice presidents are always the former and future Bundesrat president. The Bundesrat president convenes and chairs all plenary sessions, is the legal representative to the federal government, and will assume the role and responsibilities of the federal president if the office falls prematurely vacant or the current federal president is unable to assume his role.

This position corresponds to the role of the federal chancellor, and state premiers are elected by their respective state parliaments, the *Landtag*. Premiers represent their individual state in the Bundesrat and abroad, and have a fair deal of influence on the national level. Although state elections vary somewhat, members of the *Landtag*, a unicameral body, are generally elected via party-list proportional representation and serve terms lasting four to five years.

State governments cooperate horizontally and tend to present a united front at the federal level. Through the Bundesrat, states can exercise concurrent legislative power in tandem with the Bundestag. Areas covered by concurrent legislation include civil and criminal law, public welfare, some economic legislation, labor regulations, promotion of research, environmental protection, and regional planning. While decisions made within Bundesrat committees require a simple majority, there is a strong precedent of coordination among state representatives. State administrators have often relied on inter- and intra-state dialogues to establish political agreements before committee votes on formal decisions. In the case of disagreement within coalition-led state governments, the coalition parties generally abstain from voting in the Bundesrat. This indicates some level of solidarity among state leadership as well as a communal hesitancy to side with the federal government against the interest of a fellow state.

State governments share power in areas such as justice, social welfare, and law. Each *Land* has exclusive legislative control in relation to culture, education, local authority, and police matters. This includes punishment for crimes, care for the elderly and disabled, and salaries and benefits for public employees. Additionally, the state government has the right to deviate from federal legislation in certain areas (higher education, environmental protection, etc.).

It is important to note that there is a fair amount of structural variation among state governments, particularly in relation to official titles and the need for parliamentary approval for premier-appointed ministers. This is a particular issue for the city-states of Berlin, Bremen, and Hamburg. Despite differences in terminology, the governance structure of city-states closely mirrors that of the federal states. Overall, state governance systems are fairly uniform and operate in harmony and cooperation with one another.

Box 2: City-States (*Stadtstaaten*)

The cities of Berlin and Hamburg are denoted as city-states and therefore function as both *Land* and municipal governments. Due to their small size, these entities are subdivided solely into boroughs. This somewhat simplified organization structure is echoed in the administration of these cities, as there are no parallel institutions that serve the needs of only the municipality or the local population. Berlin and Hamburg are administered by a two-tier government. The legislature, or parliament, represents the local population and elects the mayor of the city. The governing mayor holds a dual role, as they also serve as the minister-president of the senate and state. The senate consists of a small number of appointed ministers, limited to eight in Berlin and 12 in Hamburg, who are appointed by the mayor and elected by the state parliament.

The Free Hanseatic City of Bremen

Geographically the smallest Land, Bremen exists in a rather unique state. Although it is often categorized as a city-state, Bremen occupies a unique space in the sphere of subnational government as the only *Zwei-Städte-Staat*, or two-city state, as it consists of the cities of Bremen and Bremerhaven. Although the *Land* is governed by a single, directly elected legislature, the municipalities are administered separately. In Bremen, the city is governed by two locally elected mayors, one of whom also serves as the president of the senate, and those representatives to the senate who were elected by the city. In contrast, Bremerhaven elects a municipal assembly that is distinct from the state legislature, which is led by a head mayor and a second mayor. Additionally, unlike in other *Länder*, the president of the Bremen senate lacks the ability to set policy guidelines as the senate decides matters via simple majority.

Table 1: Administrative divisions

Administrative division	Population range	Number	Regional classification
Länder	664,000-18 mil	16	NUTS-1
Regierungsbezirke	516,000-5.2 mil	38	NUTS-2
Kreise	35,000-3.4 mil	402	NUTS-3
Verwaltungs-gemeinschaften	n/a	1481	LAU-1
Gemeinden	n/a	12066	LAU-2

Source: Eurostat[46]

Level 3: Municipal and local institutional arrangements

This section covers the intermediate and local administrative divisions. While municipal structures are not a discrete tier, they function with a fair degree of autonomy within the state administration. Additionally, state governments may appoint an official to oversee state affairs at the intermediate administrative level, thereby maintaining local oversight. Municipalities have the constitutional right to elect own representation and regulate local affairs.[47] By ensuring local self-governance, the German federalist system provides for limited municipal financial autonomy and heightened political mobilization at the local level. Although the central government does not officially oversee municipal activity, state governments may appoint an official to oversee affairs, thereby maintaining local oversight.

Box 3: Regional government

Due to variability in *Länder* governance arrangements, both two-tier and three-tier administrative organizations exist within German states. The majority of *Länder* exhibit a two-tier system, where the state government exists directly above intermediate/local governments. However, there exists an administrative level between state and *Kreis*, the *Regierungsbezirk* (regional district), a feature of the three-tiered system. The regional authorities lack legislative competencies and are primarily concerned with administrative decisions and enforcement of municipal governments. The associated governing body is the *Bezirksregierung*, regional government, which is led by the *Regierungspräsident*, the region president.

This division has limited presence within modern Germany, as only four *Länder* (Baden-Württemberg, Bavaria, Hesse and North Rhine-Westphalia) use this administrative division. In 2000, state governments began to phase out or abolish the designation in favor of different agglomerations, or simply reassigned the competencies to municipal authorities. The term *Regierungsbezirk* is not universally used across states, as some *Länder* use different terminology, such as *Direktionsbezirke*, to describe similar territorial classifications. Although the administrative district has begun to fade in many federal states, it remains a robust unit within Baden-Württemberg and North Rhine-Westphalia.

While the administration of municipalities and counties is delegated to state governments, local services are commonly devolved to municipal authorities. Delegated tasks are separated into mandatory and optional services; the exact division varies among states.

Despite some commonality, there is no uniform administrative structure across the regions. Local administrative units can be divided into several subcategories that vary, both in form and name, among states. This paper primarily focuses on municipalities (*Kommunen* or *Gemeinden*) and local government institutions, namely districts (*Kreise*) or associations of municipalities (*Gemeindeverbände* or *Verbandsgemeinden*). There are smaller subdivisions as well as different municipality and community designations, dependent on state administrative structure, population, and territorial classification.

[46] The NUTS classification system (Nomenclature des unités territoriales statistiques) used by the EU does not perfectly correspond to the administrative divisions that exist within Germany. For example, it is important to note that while NUTS denotes Regierungsbezirke as NUTS-2, this unit also captures data from other administrative levels, such as Berlin, which does not fit the administrative district designation.

[47] Article 28, Basic Law.

Municipalities

Although there is considerable variation within state constitutions, state governments typically recognize local authority to manage municipal functions with minimal intrusion. The particular governing arrangements are set by state parliaments and codified through municipal (*Gemeindeordnung* or *Kreisordnung*) statutes.

The smallest legal entity in Germany, towns or municipalities (*Gemeinden*), is led by local councils or assemblies, depending on the state and size of administrative unit. Members are typically selected via direct and secret elections and serve five-year terms, except in Bavaria and Bremen where terms last four and six years, respectively. Assembly powers are distinct from those of local mayors, and they are solely responsible for municipal boundaries, issuing local bylaws, and approving local budgets. Mayors are similarly selected by popular vote, giving the office strong local accountability and legitimacy. Mayors are generally the head of the local government and are tasked with chairing the local representative body, enforcing decisions of the local council, and managing general administration, although this is not the case in every state. In some jurisdictions, they may have the ability to appoint members of the executive body.

Administrative structure at the local level is varied. Typically, larger cities have special status within their respective state and are granted the rights and responsibilities of municipalities and counties (termed *Kreisfreie Stadt*). Such district-free, or independent, cities are home to about one-third of the total population. Alternative intermediate administrative associations are numerous but generally consist of groupings of municipalities that have been assigned tasks that are generally reserved for county governments. Municipalities typically have municipal parliaments, which are structurally similar to state parliaments, and are headed by democratically elected mayors. Larger municipalities may also have subordinate districts that assist in service provision and coordination, but these structures vary greatly across regions.

As in other European countries, such as France and Italy, state-level governments have begun to consider territorial reforms in an effort to reduce the number of smaller municipalities. These efforts are distinct from the territorial reorganization that occurred in the 1990s after reunification. Future plans for reorganization have more support in the old, or West German, states such as Baden-Württemberg, that seek to merge municipalities with fewer than 1,000 residents and set population requirements for territorial designations. Although newer, or East German, states have made progress in reducing the number of smaller municipalities, there has been reluctance to centralize power.

Intermediate institutional arrangements

Smaller towns and municipalities typically coalesce to form districts or associations, often termed *Kreise* or *Gemeindeverbände*, and are divided into rural and urban groupings. Such arrangements allow local administrations to coordinate functions and delivery of services (typically education, health, and infrastructure services) that smaller entities are incapable of providing because of size or resource limitations. Although the powers and jurisdiction of these entities encompass the functions of multiple municipalities, districts have the same vertical ranking as municipal governments. Governing assemblies within districts are commonly termed *Kreistag*, a directly elected assembly that is headed by a president, the *Landrat*.

Powers and functions of local government entities

The autonomy and organization of local governments resemble structures found at the state and federal levels. Local governments have the authority to organize, appoint staff, shape territory via urban development, pass municipal bylaws, set budgets, and raise local taxes (such as dog, entertainment or *Land* tax). By law, local governments must provide general domestic security, health care, town planning and construction, maintenance of primary schools, management of waterways and sewage, social and youth welfare, urban development and regeneration, and construction of shared leisure areas. In addition to mandatory responsibilities, local administrations may also influence the creation of incentives for economic growth, housing, social welfare, cultural affairs, maintaining public transport infrastructure, and managing energy supplies.

District and municipal association authorities must provide building and maintenance support, spatial planning at the district level, construction, fire protection, disaster services, nature protection, maintenance of parks, social and youth welfare, building and upkeep of hospitals, schools and technical colleges; waste collection and disposal; food supervision; animal protection; and treatment of aliens. Other areas of administration and control are often supra-municipal powers, which require cooperation with local (city/village) governments and authorities. Such shared duties include supporting cultural activities, maintaining public libraries, and promoting economic activity and tourism. Some state powers have been devolved to the local level in the case of medium-sized towns and urban municipalities. These include registration of births, deaths, marriages, etc.; running of elections; census taking; registration of non-natives; registration of vehicles; traffic management; and the supervision of food and related industries.

Based on the equal jurisdictional status of municipalities and groupings of municipalities, the powers and functions of all encompassed entities are fairly similar. While the specific functions of municipal administration will be discussed in the next subsection, district and association institutions have several voluntary structures that enable leadership to act and advocate at both the federal and state levels. These include groups such as the German Association of Cities (Deutscher Städtetag), the German Association of Towns and Municipalities (Deutscher Städte- und Gemeindebund) and the German County Association (Deutscher Landkreistag). Coordination within these groups enables local governments to advocate for particular agendas, influence legislation, and share operational knowledge. Additionally, the Federation of Municipal Associations (Bundesvereinigung der kommunalen Spitzenverbände) combines the associations for cities, towns, municipalities, and counties to represent local German interests at the EU level. This body is led by the Association of Cities.

Box 4: Formal intragovernmental cooperation

Gesamtstaat (Whole Level)
Coordination and cooperation between the federation and state governments are not limited to interactions with the Bundesrat. At this level, both parties are given equal status and decisions require consensus, and often approval by both legislatures. A leading institution for these interactions is the Conference of Heads of Government of the Federation and the Länder (Ministerpräsidentenkonferenz, MPK). Additional avenues of cooperation can be found via coordinating bodies of political parties and interparliamentary coordination.

Bundesstaat (Federation)
Constitutionally organized relations between *Bund* and *Länder* institutions. Primarily conducted via, and housed within, the Bundesrat, decisions are informed by committee meetings and are often subject to majority voting rules. Of particular note are the Missions of the *Länder* to the Federation. The Committee of Mediation plays a key role in mediating any disagreements between the Bundesrat and the Bundestag.

State Level
Primarily horizontal coordination among states which excludes the federal level entirely. Cooperation can occur among state premiers, Conference of Minister-Presidents, and state ministers.

Local-Federal
Several associations of local and regional authorities represent local communities both at the federal level and to the European Union. The three primary associations facilitate coordination among local governments and allow the local administration to influence federal legislation and promote local agendas.

PRINCIPLES OF FISCAL MANAGEMENT AND ORDERS OF MAGNITUDE

Fiscal management and government finance across subnational governments is fairly complex in Germany. Subnational fiscal responsibilities are established by federal and state constitutions, as well as national and local bylaws. Government finance and regulations are centered on the concept of burden sharing, which ensures that each administrative level is responsible for financing its individual expenditures. This extends to delegated tasks, a particular issue as state governments allocate and assign tasks and service provision to local authorities.

Although subnational governments account for a significant portion of expenditure and are the primary vehicles for tax, and revenue, collection, local government budgets are fairly constrained. Budgetary limitations stem from the primacy of the federal government over taxation policies. The central government has a very broad system of financial equalization; a multistep process that involves the pooling, and redistribution, of state and federal tax revenue through a series of vertical and horizontal transfers. Therefore, the financial status of local governments is fairly dependent on decisions undertaken at the federal level. This system of fiscal transfers, as well as the overall status of government revenue and expenditure, will be discussed at greater length in the following sections.

Division of fiscal competencies

Level 1: Federation

The federal level controls the revenue, levels, and rates of the most significant taxes, including value-added (VAT), income, and corporate taxes. As such, the Bund exerts a fair amount of influence over state government through joint financing arrangements for projects such as coastal protection and social benefits, and through its legislative abilities. The financial equalization system (*Finanzausgleich*) and tax appropriationprocess ensures that states are partially dependent on transfer payments that are often under the purview of the Constitutional Court (particularly in the case of supplementary federal grants, or *Bundesergänzungszuweisungen*). As a general rule, the federal government may directly finance only those tasks specifically assigned to it under the constitution.

Level 2: State

While states do participate in tax legislation through the Bundesrat, they are often excluded from discussions on the volume of taxation.[48] As state governments lack tax-setting autonomy for a majority of significant taxes and are subject to a federal equalization scheme, their total revenue is more or less fixed on an annual basis. This significantly limits the fiscal autonomy of states, as their revenue sources are often constrained by a reliance on federally redistributed taxes and, to a lesser degree, central grants.

State governments have some level of control over spending and executive responsibilities. Individual states must finance their own administrative expenditure. Like the federal government, state governments are responsible for medium-term budgetary planning that incorporates political, social, and economic agendas of ruling parties. The Stability Council, discussed at greater length in another section, coordinates medium- and long-term budget planning between the federal and state governments while ensuring proper budgetary discipline. In recent years, state governments have exercised greater levels of autonomy in terms of borrowing, particularly in the areas of capital market financing. Such latitude is inherently limited by a constitutional rule on federal indebtedness, referred to as the debt brake. Instituted in 2010,

[48] Bundesrat consent is required for federal legislation that affects any tax in which part of the revenue is allocated to state or municipal governments.

the debt brake focuses on limiting permissible net borrowing at the state and federal levels to ensure structurally balanced budgets. This concept will be discussed in greater length in a subsequent section.

Box 5: Refugee resettlement and management

German ministries anticipate up to 3.6 million refugees living in the country by 2020. The rapid influx of the refugee population has led to increased intergovernmental tensions, as local and state governments continue to shoulder most relocation and assimilation costs. The issue of relocation and assimilation funding crystallizes key issues facing municipal administration and capacity, particularly the ways in which cities must tackle rising administrative costs with limited increases in federally allocated revenue. The federal government, under the direction of Angela Merkel, has strongly supported an open-door policy which has placed a great deal of financial, social, and political strain on state and city governments.

While the German government has extolled the long-term economic benefits of increased migration, in the short term, municipalities and state governments face the logistical and financial challenge of housing and caring for asylum seekers. In June 2016, the 16 federal states demanded additional funding of 8.8 billion euros over a three-year period to cover refugee costs, citing complaints that the federal government had not sufficiently shared associated expenses. Finance Minister Wolfgang Schäuble categorically denied additional funding requests, contributing to increased political tensions between the state and federal governments, as well as among the Christian Social Union and Christian Democratic parties.

It is important to note, however, that while state governments are responsible for their own finances, they face significant constraints on the expenditure side. Local administrations have relatively little control over certain factors, such as the number of asylum seekers or school-aged children, that dictate significant aspects of mandatory spending. Additionally, as state governments are responsible for the administration of most public services, taxes, and state and federal laws, associated costs represent a significantly higher percentage of state budgets. State and local governments have publicly expressed frustration with the burden-sharing arrangement.

Level 3: Municipal and local institutional arrangements

Despite a lack of substantial control over significant tax levels, states and municipalities collect the bulk of taxes. Local governments can raise revenue from local taxes, service fees, and internal credit sources as well as receive funding from general or specific grants from higher levels of government within the constraint of fiscal rules on borrowing. In terms of mandatory fiscal expenditures, local governments are often required to provide welfare support and assistance yet have more flexibility in optional activities such as cultural funding. Management of service provision, and budgetary rules, vary state by state and are affected by several factors, such as the average size of municipality.

Local budgets are subject to limited revision and approval, primarily limited to ensure legality of local financing and to supervise the use of funds for mandatory delegated tasks. Budgets for local entities consist of an operating budget and a capital expenditure budget. As a general rule, the operating budget must be balanced, although legislation allows for some exceptions. Intermediate governments have circumvented balanced-budget requirements through a variety of measures, such as public corporations and foundations.

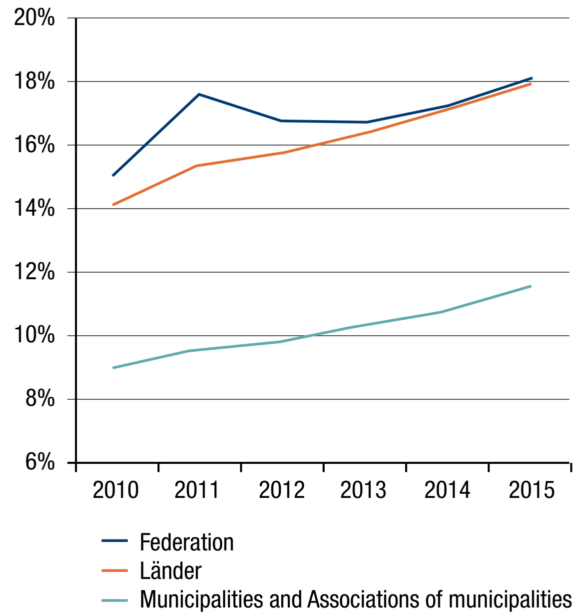
REVENUES AND REVENUE SHARING

In Germany, all levels of government are allotted a share of the public budget, which covers part of affiliated expenditures. State and local governments have some authority to bolster own revenue via local taxes and fees, although this income represents a relatively small percentage of revenue. Concomitant financing (*Konnexitätsprinzip*) dictates that any delegated responsibility to the municipal level must be adequately financed by the state government. Administrative demands, paired with the expansive responsibilities and delegated tasks, can in part account for the relative similarities in the overall public budgets of the state and federal governments.

The public finance system relies primarily on tax revenue and central grants to cover government expenditure. Tax collection, as well as local income tax levels, varies across regions, but the national financial equalization system, discussed in the next section, seeks to create equivalent living conditions and service delivery. Central grants seek to fill financing gaps when redistributed tax revenue cannot cover all expenses. Unfortunately, municipal and city governments have often claimed that fiscal transfers from the state and federal governments are insufficient for all delegated tasks.

In 2012, a Congress Delegation sent by the Council of Europe noted several instances in which local governments could not finance delegated tasks through relevant financial transfers and central grants. In these cases, local governments were forced to rely on local resources to finance delegated tasks, instead of local public services, which undermines the function of own local revenues and demonstrates flaws with the system.

Figure 1. Revenue of the overall public budget by levels, percentage of GDP



Source: Destatis

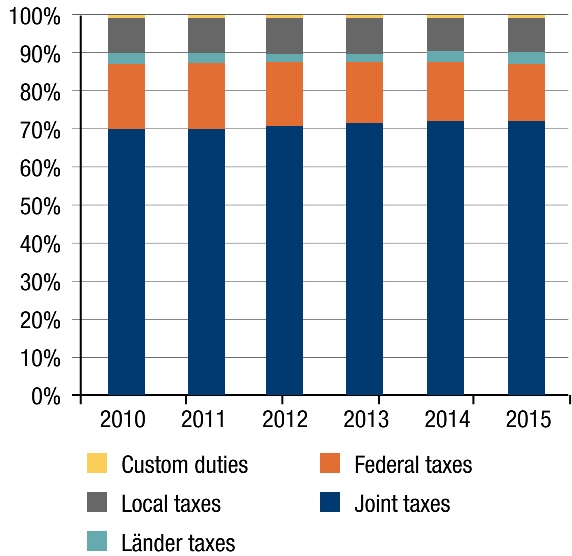
Allocation of taxation abilities/ responsibilities

Subnational governments are quite limited in their ability to alter tax legislation. The bulk of fiscally significant taxes, namely joint taxes,[49] are set by the central parliament, which account for over 70 percent of cash tax revenue overall. Paired with federal taxes, the central government has a dominant influence over more than 80 percent of annual tax revenue. Since state governments bear the brunt of administrative duties, the enforcement and collection of taxes fall primarily to local governments.

Despite limited input, state government revenues are reallocated for national redistribution. This division of power has created national tensions over the fairness of redistribution, but has also caused divergence in tax enforcement across local governments.

[49] Joint taxes refer to the particular taxes that are pooled into the joint system, wherein the federal government designates particular taxes for central consolidation and redistribution.

Figure 2. Cash tax revenue by level, percentage



Source: Destatis

Local sources of own revenue

Excluding central grants and revenue from federal equalization, the primary source of local own revenue comes from local taxes (e.g., local excise and entertainment taxes). The specific taxes, and their rates, are determined by respective local authorities, causing a great deal of variation. The trade and real estate tax represent the bulk of local taxes.[50] State-controlled taxes include real property tax and estate tax, although these and similar taxes account for a very small percentage of overall tax revenue.

Local authorities can set fees and user charges for public services at their own discretion, within reason and in relation to cost of service delivery. At the local level, fees for services such as electricity and wastewater treatment accounted for about 35 percent of own resources. Revenues from services are often used to subsidize local infrastructure projects.

Although state and municipal governments do acquire limited resources from service fees and local taxes, the revenue streams from these sources are often negligible.[51] To finance public expenditures, *Länder* governments rely heavily on debt as a primary source of discretionary financing. This source of financing is dramatically changing due to the introduction of the debt break, which will be discussed in greater detail in a later section.

Financial equalization and intergovernmental transfers

Due to restrictions on the revenue-raising and tax-setting capabilities of state governments, there is a particular reliance on federal transfers, via the equalization system, and borrowing to finance both current and capital expenditures in some states.[52] In an effort to increase national solidarity and to ensure that local authorities have the resources necessary to perform their mandated tasks, Germany has adopted a system of financial equalization aimed at reducing regional discrepancies.

The federal financial equalization system in Germany can be divided into four phases, which represent different forms of redistribution and wealth transfers. The system deals primarily with total tax revenue, collected at the federal, state, and local levels, which is centrally pooled and then redistributed to relevant authorities. It is important to note that the federal government is entitled to the revenue from all federal taxes, which include duties and the insurance tax.

[50] Municipal trade tax consists of fees levied by local authorities on business profits, and rates typically fall between 14 and 17 percent. The municipal real estate tax is levied on local immovable property within a district regardless of business or private designation of the property. Additional local taxes include tax on dog licenses and secondary home taxes.

[51] Although receipts from state taxes vary somewhat on a state-by-state basis, overall revenue from state taxes account for about 7.56 percent of state tax resources, based on 2016 estimates from the Federal Ministry of Finance.

[52] This differs among states. Some states do not receive vertical grants (*Bundesergänzungszuweisungen*) and are (as of now) not dependent on borrowing (e.g., Bavaria); others (especially the eastern states) are particularly dependent on horizontal and vertical transfers.

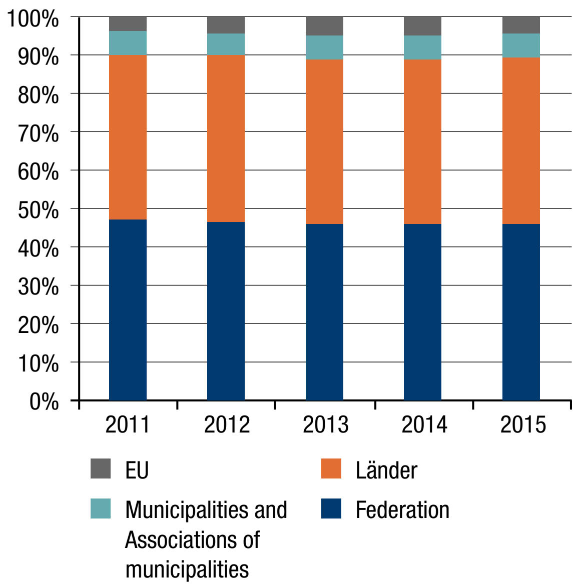
First stage: Vertical distribution

First, total tax revenue is distributed from the federal to state and local governments, after which the *Länder* distribute supplementary revenue grants to local authorities. Affected taxes include income, corporation, and VAT taxes, also referred to as joint taxes. This grouping constitutes a major percentage of all tax revenue. Additionally, state taxes, such as inheritance and transactional taxes, are included in the pooled revenue. Generally, revenue from local-level taxes such as real property, trade, and local excise taxes will remain with local governments. In 2015, the federal government received 42.5 percent of the income tax, half of the corporation tax, and 52 percent of VAT. At the state level, *Länder* received the remainder of the corporation tax, the same share of income tax as the federal government, and 45.5 percent of the VAT. This left local governments with 15 percent of income tax revenue and about 2 percent of VAT.

Second stage: Horizontal redistribution

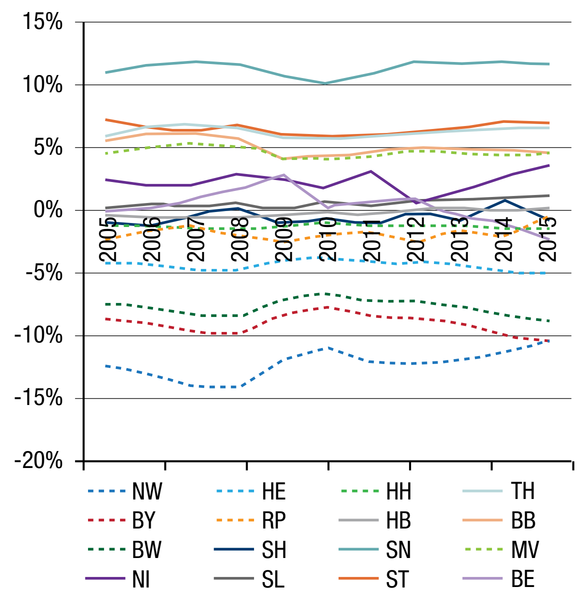
State governments are entitled to the revenue from state-administered taxes in their territory, according to the principle of local revenue. This primarily concerns personal and corporate income tax. Revenues of those taxes are redistributed based on the principle of residence, with corporate taxes being distributed in areas where the company is headquartered. VAT is excluded from this process and is instead allocated as a means of supplementing revenues when an individual state's share of income, corporation, and Land tax falls below the per capita average of all *Länder*. Up to 25 percent of the state portion (45.5 percent) of VAT revenue is available for supplemental redistribution. The allocation of supplemental VAT revenue is not reallocated solely on a per capita redistribution scheme, although it does take into account a state's relative tax revenue. The remaining share of VAT revenue is then distributed by individual state population.

Figure 3. Distribution of tax revenue, by level



Source: BMF

Figure 4. VAT revenue equalization[53] as percentage of GDP;[54] dotted lines denote net payers



Source: Federal Ministry of Finance (BMF)[55]

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[53] Indicates the difference between distribution under applicable law and full distribution by population.

[54] State abbreviations are listed in Appendix 1.

[55] Ibid.

Third stage: Fiscal equalization among states

Moving from redistribution of joint taxes among the federal and state governments, the third tier of fiscal equalization takes place among state governments (*Länder*). To implement and enforce a system of resource transfers, individual states must measure their fiscal capacity and the needs of local and state governments. Financial capacity is measured by taking the sum of state receipts and a percentage of local authority receipts, 64 percent, and dividing that by the financial requirement for state residents.[56] This system is fairly controversial; while it provides an accurate reference of financial capacity, it assumes a standard fiscal burden on each resident across states and does not take into account governance structure, demographics, and financial legacies. This process is partially adjusted for limited population inflation for the city-states of Berlin, Bremen, and Hamburg (respective populations are adjusted to about 135 percent) and for the states of Brandenburg, Mecklenburg-West Pomerania, and Saxony-Anhalt.

Financial equalization among states does not strive to completely equalize tax revenues across districts. Redistribution efforts typically lift underperforming states' revenue to about 90 percent of the national average; adjustments are calculated using a linear progressive schedule. This helps to protect fiscal autonomy and limit adverse growth incentives.

Fourth stage: Vertical grants to financially weak states

The final stage of the equalization system is a series of supplementary vertical grants from the federal government to financially weak states. This complements horizontal revenue transfers and helps eliminate gaps in financial capacity not achieved via other redistribution methods. All federal grants are aimed at helping states meet their financial burdens. Grants are separated into two categories: general supplementary federal grants and supplementary federal grants for special needs. General supplementary grants are allotted to states whose financial capacity per inhabitant, after state-level redistribution of revenues, is below 99.5 percent. Supplementary grants for special needs help specific states meet the demands of unique burdens and are unrelated to their ability to meet their financial obligations.[57] In 2014, the volume of general supplementary allocations drastically increased by 0.3 billion euros in 2013 to 3.5 billion euros.

Since reunification, Eastern German states have received special-need supplementary grants under the terms of the Solidarity Pact II. These transfers will continue until 2019 and are, unlike other grants, earmarked for improvements in infrastructure and increasing local fiscal capacity. These grants account for a substantial source of income for recipient states and are more restricted than other supplementary grants. As with the equalization system, the solidarity pact is a point of contention between West and East German states. In 2012, a group of mayors from West German cities publicly called for an end to the solidarity pact system, claiming that years of transfer payments contributed to the deteriorating financial state and infrastructure of many cities, particularly in the industrial Ruhr. Essen serves as a prime example, as the city had undertaken 2.1 billion euros in debt by 2012, a third of which was directly used to finance its solidarity contributions.

Financial assistance to German states is not limited to transfers to East German states. In 2009, the federal government adopted the Consolidation Assistance Act, which grants fiscal consolidation assistance to the five smallest states (Berlin, Bremen, Saarland, Saxony-Anhalt, and Schleswig-Holstein) to help them meet the requirements of the

[56] Financial requirement per inhabitant is assumed to be the same across *Länder*, with exceptions made for city-states (whose population is notionally increased by 35 percent) because of relatively small populations.
[57] Funds from supplementary federal grants for special needs are not legally tied to a specific purpose.

Box 6. Challenges to the future of the financial equalization system

In 2019 the federal financial equalization system will expire. Efforts to renew and reintroduce the compensation mechanism have brought federal and state tensions to the forefront of national political debate.

Financial transfer systems, in one form or another, have existed in Germany since the 1950s. Mechanisms typically sought to create a minimum standard of living, or equivalent conditions, across state governments to support national solidarity. While tax transfers have provided real benefits across the country, particularly in the years following reunification, the current system has created unforeseen complications. Over the last two decades, several states have consistently been net contributors, leading to protests from state leadership that view the system as an unfair burden that reduces their budgets and limits their ability to provide basic services. This fact, paired with complications associated with implementing the debt brake by 2020, has led to a unified push by Länd leadership for greater tax autonomy and a fundamental restructuring of future financial relations between levels of government.

The heads of state governments and federal leadership (*Regierungschefinnen und Regierungschefs von Bund und Ländern*) held series of meetings and conferences throughout 2016 in an attempt to craft a new compensation system. The conference of minister-presidents has presented a united front at negotiations*, and in October it seemed that an agreement had been reached establishing new regulations for 2020 that significantly reduced the financial burden for state governments, strengthened the Stability Council, increased the fiscal capacity for state governments, and set the stage for the digitization of the tax system. Unfortunately, this consensus was short-lived, and at the end of November a joint statement was released by the *Länder* governments rejecting a draft bill from Minister of Finance Wolfgang Schäuble.

Local media reported discontent among state leadership, who believed that Schäuble overstepped terms of the initial agreement, which was reached on October 14 at a federal-state summit, and that the bill in its current form significantly extended the legislative competencies of the federal government at the expense of the state and federalism.*** More specifically, state leadership rejected endowing the Stability Council with complete control over debt limits for individual states, a clause that would allow the federal government to dictate the local fiscal administration, and stipulations tied to restructuring funds among other concerns. This rejection has triggered a new round of meetings between the heads of the federal and state Chancellery. As the proposed reforms to the equalization system would require amending aspects of the Basic Law, there is a particular sense of urgency to pass the reform as quickly as possible.

Efforts to reform the fiscal transfer system predate the current negotiations. In 2013, Bavaria and Hesse, net payer states that see more than 10 percent of their state budgets reallocated per year, petitioned the federal government to introduce a cap on state transfers and implement an incentive program that would encourage net receiver states to balance their finances. In December 2015, state leaders set forth a joint proposal that would have scrapped horizontal financial equalization in favor of a mechanism that redistributed turnover tax revenues that would target structurally weak states.

debt brake by 2020. Special considerations were made for these governments, because they have a relatively small share of the population and will therefore face the greatest difficulties in reducing long-term structural deficits. Additionally, smaller states often receive special-need supplementary grants to compensate for higher administrative costs.

Central grants

Central grants are distinct from federal transfers or the equalization system. As of 2006, the federal government cannot directly finance projects and services transferred to local governments.[59] Transfers from state governments have been found to be insufficient to cover the delegated administrative

[58] There are several crucial exceptions, particularly regarding investment projects at the state or municipal level that would prevent drastic economic disturbances, promote economic growth, alleviate undue financial burden, or enable economic equalization across the territory. Such exceptions are often determined via federal legislation or executive agreements.

and budgetary costs for local authorities. This has necessitated the increasing use of local revenues to supplement operational costs for services allocated by state governments This fact is problematic insofar as the system of transfers was initially set up to ensure that the state would finance delegated tasks through transfers, ensuring that local authorities could use own local revenue to fund local public services, as defined by their constitutions, also known as concomitant financing.

European Structural and Investment Funds (ESI Funds)

As part of the EU Cohesion and Structural Policy, public funds are made available to member states to promote and reinforce economic, social, and territorial solidarity across regions. For the 2014-2020 period, Germany was allocated a total of 27.87 billion euros from the collective ESI Funds. These funds were allocated as part of the Multiannual Financial Framework and consist of five component financial instruments: European Regional Development Fund (ERDF), Cohesion Fund[59] (CF), European Agricultural Fund for Rural Development (EAFRD), European Maritime and Fisheries Fund (EMFF), and European Social Fund (ESF). This round of funding is closely tied to the Europe 2020 Strategy, focusing on smart, sustainable, and inclusive growth at the regional level.

ESI Funds are allocated at the regional level via operational programs that conform to the specific aspects of individual partnership agreements. Therefore, individual state governments are responsible for implementing related programs and providing progress updates to the European Commission to ensure continued financing from the EU. While state governments manage program operations, the federal government, via various ministries, coordinates all ESI funds, sets policy objectives, and represents the interests of the country in relation to structural policy to the European Union.

For the current programming period, allocated ESI Funds will target energy and climate issues, promote youth labor market and skills, provide skills training to disadvantaged groups, strengthen biodiversity, improve regional resilience, increase competitiveness and innovation in small and medium-sized enterprises, and increase innovative capacity within research and industry. As funding is targeted at the regional level, operational programs often benefit at the lowest administrative level.

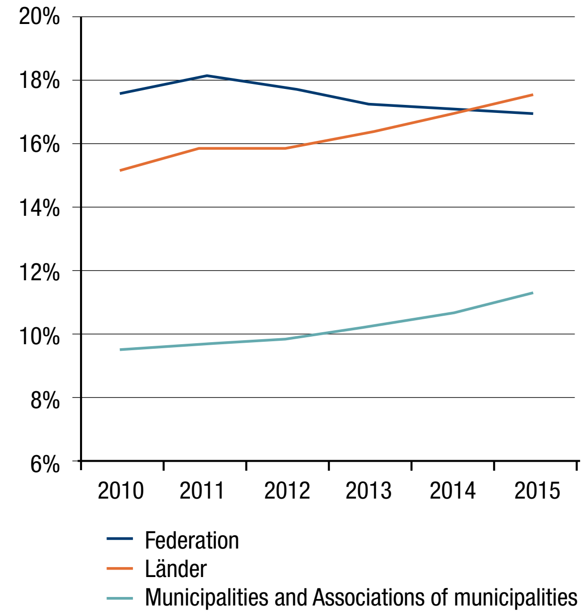
[59] The Cohesion Fund primarily targets economic and social disparities among EU member states, and is therefore limited to states whose gross national income per inhabitant is below the 90 percent EU average. Germany does not qualify to receive any funding through this instrument.

EXPENDITURE

Basic Law guarantees autonomy to the federal and state governments in reference to budget management. The budgets of local and state governments are subject to review by the Financial Planning Council, chaired by the Federal Ministry of Finance. The council's decisions and agreements are non-binding and inevitably, budgetary decisions taken at the state level are not coordinated among states or with the central government.

Basic Law mandates that the federal and state governments finance their own expenditures. Given the governance structure and delegation of primary and mandatory duties, local expenditures fall primarily under state regulation and financing, as the federal government is particularly limited in its local competencies. As duties and powers are delegated to respective local authorities, there is a concurrent obligation to provide implementing actors with sufficient funds.

Figure 5. Expenditure of the overall public budget by level from Q1 to Q4, percentage of GDP



Source: Destatis

Länd specific and mandatory expenditure[60]

Unfortunately, state governments are often fairly constrained by structural factors in terms of annual expenditure obligations. Realities such as population aging, the number and percentage of school-aged children and pensioners, and regional price disparities often play an important role in dictating local spending levels.

Public-private partnerships (PPPs)

Public investment in Germany has been relatively low, particularly in comparison with investment rates in advanced economies. At the federal level, PPPs are used in a limited capacity, typically relating to the maintenance of federal transportation, namely highways. In general, the build-operate-transfer (BOT) model is preferred. Federal PPP activity is recorded in the national budget. As of 2014 there were 18 active projects, totaling about 24 million euros in expenditure. Due to the division of responsibilities and the devolution of functions and services, subnational spending on PPPs is significantly higher than federal spending. Estimates reported by the Finance Ministry place the local PPP volume at 7.5 billion euros as of 2013. Unfortunately, a lack of reporting requirements for local projects has led to imperfect statistics on the size of the local PPP market.

The dominant size of state and local government PPP expenditure is related to the constitutionally assigned, and devolved, functions and obligations. Land and lower-level administrations are responsible for all mandatory services, but also have a fair amount of autonomy when it comes to the dele-

[60] Sections relating to subnational expenditure have been limited as each administrative level bears the financial burden for mandatory and optional service provision, such as social assistance and transportation. The responsibilities and functions assigned to various levels of government, discussed in a previous section, are accounted within federal, state, and local governments. In the interest of brevity, these competencies and associated fiscal responsibilities will not be reiterated at length.

gation of services and responsibilities and have the right to contract outside service providers. Although most public investment is executed by local, or municipal, governments, regional budget constraints as well as a lack of financial control have hindered investment projects across the country.

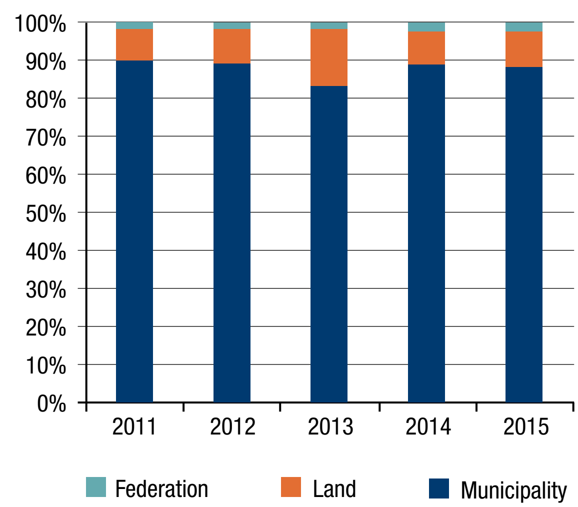
Based on estimates from Partnerships Germany (ÖPP Deutschland AG), a federally established PPP competency and consulting center, there were about 230 regional projects as of 2016. Overall, local public infrastructure investment is particularly low across the country. Declining infrastructure investment, which has fallen from 25 percent of total economic output in the early 1990s to 19.7 percent in 2013, has contributed to growing concerns for the health of public infrastructure. The German Institute for Economic Research (DIW Berlin) estimated in 2013 that the annual investment gap was 3 percent of GDP, outstripping the EU average of 2 percent. This gap translates to a missing 80 billion euros in investment per year.

There has been a push for PPP reform and increased investment at the local and federal levels. In 2012, both the Social Democratic Party and the Greens submitted initiatives to the Bundestag calling for increased transparency and consensus on PPPs in infrastructure. Additionally, the federal government created the Municipal Investment Promotion Act (Kommunalinvestitionsförderungsgesetz), which established special funds to promote investment in financially weak municipalities, to be delivered as public works. This program will free up to 20 billion euros for investment, of which 7 billion has been earmarked for public transportation, digital infrastructure, energy efficiency, climate change, urban development, and resilience with 3.5 billion allotted specifically for municipalities. The funds are available until 2018, and Partnerships Germany anticipates that these measures will help bolster the local PPP market.

Public funds, institutions, and enterprises (FEU)

Public investment has been particularly low relative to other OECD countries. Defined as non-market producers that are controlled by the government, FEUs hive off tasks from the core public budget, such as water and energy supply enterprises. These companies provide services or support economic activity. In national accounting, FEUs are excluded from public investment accounting. According to a 2012 DIW Berlin study, FEUs contributed about 11 billion euros to net investment overall, with 4.8 billion euros invested at the municipal level. In 2013, there were a total of 15,314 registered FEUs[61] with proceeds exceeding 513 billion euros. Outsourcing of core responsibilities occurs overwhelmingly at the municipal level.[62] About two-thirds of FEUs provide water, sanitation, energy supply, and real estate activities.

Chart 6: Number of public funds, institutions, and enterprises (FEU) by owner



Source: Destatis

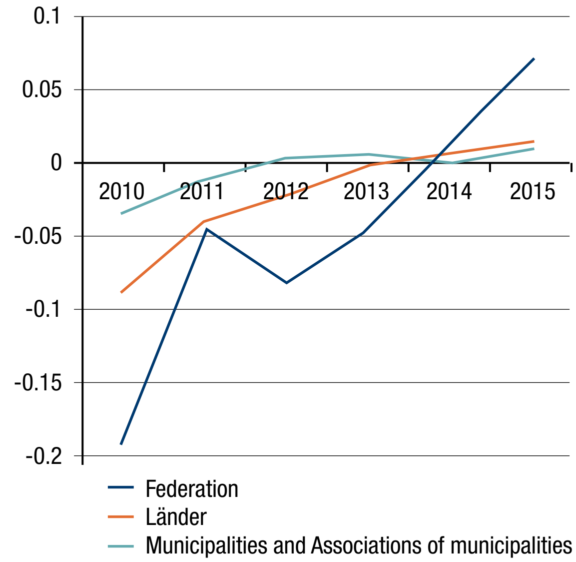
[61] Excluding small corporations.
[62] Municipal level includes ownership by city-states.

BORROWING AND DEBT

In terms of budgetary control, the federal constitution grants state governments relative autonomy—which is extended to municipal administrations. Although federal and state budgets are required to be balanced[63] without revenue from credits, state governments can regulate budget details within their constitutional powers. As discussed in previous sections, tax revenues and central transfers are often insufficient to cover all related government expenses. In these instances, subnational governments have several options to cover budgetary gaps. Outside of local tax revenue, local governments can shore up administrative budgets through several different financing options.

Basic Law places specific limitation on the borrowing of funds at the state and federal levels. Article 115 stipulates that borrowing activity can be subject to authorization by federal law and outlines a general rule that federal revenue obtained by borrowing shall not exceed 0.35 percent in relation to the nominal gross domestic product. For the states, this limit is set to 0 percent as of 2020. It further outlines general practices of extraordinary borrowing practices, including reduction procedures.[64] Within these limits, local governments can finance their expenditures through loans. Generally, smaller municipalities primarily rely on local savings banks and internal loans to finance short-term gaps. If local governments require longer-term financing, relevant authorities must get the approval of the state interior minister, who will try to ensure that local governments do not run the risk of insolvency. Given strict budget constraints and oversight, municipal and local governments tend to have relatively low debt rates when compared with higher government levels.

Figure 7. Financial balance of the overall public budget by level, ratio of GDP



Source: Federal Office of Statistics (Destatis)

While subnational governments are prohibited from declaring bankruptcy, the issue of local debt is quite nuanced. The federal constitution outlines specific instances in which federal assistance to states facing financial difficulty is permissible. Under Article 104b, the federal government is allowed to provide state governments with financial assistance for important investments undertaken by state or municipal governments.[65] In previous years, particularly indebted states have sued the federal government for bailout assistance. A prominent example of such action occurred in 1992, when the Constitutional Court granted Saarland and Bremen a federal bailout, in the form of conditional grants to alleviate the public debt burden. In less drastic cases, it is common for *Land*

[63] Article 109, Basic Law

[64] Flexibility is allowed in the case of natural disasters, emergency scenarios, and unique situations that threaten the financial stability of the government. Restrictions and regulations regarding borrowing are outlined within individual state constitutions, although the historic exceptions to debt and borrowing limits have led to instances of high debt spending and fiscal imbalance among several states.

[65] These investments are limited insofar as they either avert a disturbance to the overall economic equilibrium of the state or country, seek to equalize economic capabilities, or promote economic growth (these are quite general limitations, hardly a constraint). Additionally, the federal government may provide direct financial assistance in the instances of natural disasters or exceptional emergencies that both occurred beyond governmental control and threaten the financial stability of the government.

government, via supervisory authorities, to enact financial rescue programs and remedial measures to rehabilitate local finances.

Federal and local debt issuance

German state governments can issue bonds in their own right, an option that individual states have embraced at different levels over time. In recent years, many *Länder* budgets have drastically shifted from loan to capital market financing. From 2000 to 2013, *Länder* bonds outpaced direct loans and accounted for about 60 percent of total state debt. Despite the differences in the debt levels, economic output, and liquidity of individual states, historic yield spreads between federal and state bonds were relatively low until 2008.

Subnational governments have had fairly limited deficits, and most states have high credit ratings.[66] Strong ratings have been attributed to joint liability between the federal and state governments and have rewarded reforms implemented in preparation for the debt brake. This mechanism was introduced in 2009 as part of the second federal reform. While the budget position of individual *Länder* is fairly variable, recent federal legislation aimed at limiting public debt throughout all government levels has had a great deal of success in controlling local finances. The particulars of expenditure limitations and regulations will be discussed at greater length in a later passage.

Stability Council

The Stability Council comprises the federal minister of finance, the federal minister for economic affairs and energy, and the finance ministers of the *Länder*. Together with Germany's debt brake rules, the creation of the Stability Council in 2010 aimed to strengthen the fiscal institutional framework and refocus the government on the long-term sustainability of public finance at the federal and state levels. The role of the Stability Council is set out under Basic Law and includes a mandate to avert budget crises and, in the case of looming crises, to implement fiscal restructuring. Soon after it was formed, the Stability Council did declare a need to reform in the face of a looming financial crisis for four states. In recent years, the council has focused more heavily on monitoring state compliance with federally set deficit ceilings and providing consolidation assistance. The council, along with other financial advisory and expert boards in the country, was involved in the submission of and revisions to the German Stability Program.

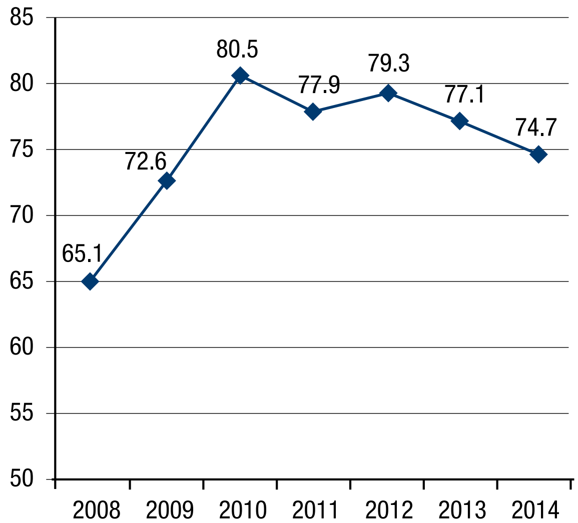
Debt brake

Approved in 2009, the *Schuldenbremse*, or debt brake, is an amendment to the Basic Law that provides clear budget constraints. Predating the European debt crisis, the debt brake was introduced in response to debt-to-GDP ratios in Germany that exceeded the 60 percent threshold established in the Maastricht Treaty. Responding to the financial strain caused by reunification measures, in particular the *Solidaritätszuschlag* (solidarity surcharge), the federal government sought to eliminate, or significantly reduce, structural deficits throughout public budgets, affecting local fiscal policy.

The debt brake provides both a target and a timeline for the federal and state governments to improve the sustainability of public finances and fiscal coordination across administrative levels. An additional concern that prompted the change in the national fiscal policy was the rapid increase in the national debt-to-GDP ratio in the aftermath of the global financial crisis. In seeking balance to public finances, the debt brake limits the ability to run cyclically adjusted budget deficits (structural deficits) at the federal and state levels. Accordingly, the structural federal deficit cannot exceed 0.35

[66] As of November 2015, seven German states maintained their AAA long-term foreign credit rating from Fitch Ratings. Along with reaffirming a stable outlook for the individual states, the rating company also reaffirmed a short-term foreign currency issuer default rating of F1+.

Figure 8. Total government debt as a percentage of GDP, Maastricht debt level

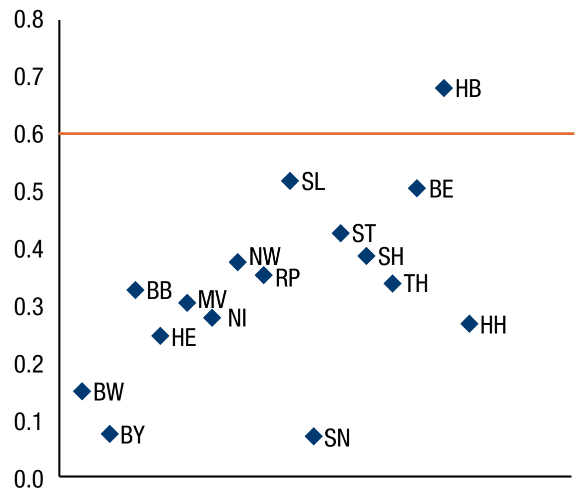


Source: Deutsche Bundesbank

percent of GDP, starting in 2016. State governments face tighter restrictions, as they are banned from running any structural deficit. States have been given until 2020 to meet new budgetary requirements.

The debt brake underpins EU fiscal governance rules, which will be addressed at greater length in the following section, and effectively replaced the long-standing "golden rule" of German public finance.[67] Similar to the golden rule, the debt brake allows for flexibility in times of crisis but focuses on structural net borrowing to ensure that the debt-to-GDP ratio is reduced on a sustained and long-term basis with the aim of achieving long-term growth and sustainable development. Although the debt brake is relatively new, there has been some success in lowering the debt-to-GDP ratio. The financial balance within states remains somewhat varied, although the majority of *Länder* have balanced structural budgets. As of early 2016, the Stability Council announced that both Berlin and Schleswig-Holstein should complete their budgetary recovery procedures, although Bremen and Saarland will continue to need assistance because of high deficits and debt levels.

Chart 9: Debt to GDP by *Länder*,[68] 2014



Source: Destatis and Statistical Offices of the *Länder*

In the past, individual states set limitations on net borrowing levels in their respective constitutions, but vague definitions regarding volumes of investment and exemption clauses helped create excessive debt in some states. Tools such as the debt brake, or internally imposed debt limitations within specific states, have attempted to tackle high government debt.

Elimination of structural deficit

As a member of the EU, Germany's financial ministry is required to submit a medium-term fiscal plan to the Economic and Financial Affairs Council.[69] Strong fiscal policy and favorable conditions

[67] Before 2009, Basic Law mandated that debt could not exceed investment spending, with notable exceptions.
[68] State abbreviations are listed in Appendix 1.
[69] The Economic and Financial Affairs Council, or Ecofin, is a configuration of the Council of the European Union and is responsible for economic policy, taxation, and the regulation of financial services. It also manages economic relations with external countries. The Ecofin council prepares the EU's annual budget and coordinates economic policies of member states with the aim to increase economic and budgetary convergence.

have led to solid postings of growth and domestic robustness. After peaking in 2010, general government debt has fallen, and the debt-to-GDP ratio is expected to decline consistently to below 60 percent by 2020. Still, the German economy must be prepared for imminent challenges, such as the normalization of these favorable interest rates and impactful demographic changes due to aging and high migration into the country because of the refugee crisis. That said, in 2014, Germany had a general government budget without a deficit for the third year in a row. The government surplus in 2015 (0.3 percent of GDP at the federal level and 0.1 percent of GDP at the level of the *Länder* and local authorities) has made it possible for the government to balance its budget by avoiding deficits on all levels. *Länder* were assisted in achieving these surpluses in part by the Consolidation Assistance Act, which provided for a fixed amount of financial assistance to five *Länder*, financed from the federation and the *Länder*, subject to conditionality including the elimination of the structural deficit in those five *Länder* by 2020. From 2016 to 2019, the federal government will support the *Länder* with an additional 500 million euros per year, given that the responsibility of assimilating and assisting the large number of refugees in the country will fall primarily to local and regional authorities. This base figure has been increased, and supplemented by additional funds, as the refugee population continues to expand.

ROLE OF THE EUROPEAN UNION

As a founding member of the European Union, Germany has seen European policy play an increasingly important role in domestic affairs in recent years. The EU has assumed control over several competencies that cover monetary, foreign, and security policies. These include monetary policy, competition rules, environmental policies (such as conservation), commercial policies, and the negotiation of some international agreements. The EU shares various competencies, such as social and economic policies, and can enact regulations that affect national governance at all administrative levels. The federal government and the Bundestag play the largest roles in influencing European policy.

Germany holds 96 seats in the European Parliament (EP), down from 99 in 2014 because of the application of the Lisbon system, which capped the number of allotted seats at 96. As the country with the largest population, Germany commands the highest number of members of the European Parliament (MEPs), although membership is allocated via digressive proportionality. MEPs are elected every five years via a closed-list proportional system, whereby votes are cast for political parties which in turn appoint MEPs. Until 2014, political parties had to meet an electoral threshold of 5 percent (*Sperrklausel*, or exclusion clause) to be eligible for a seat in the EP. Following a series of legal battles, the 2014 European election saw the threshold requirement abolished and the election of fringe political parties.

Stability and Growth Pact and the Excessive Deficit Procedure

The Stability and Growth Pact (SGP) is an agreement among the members of the European Union to encourage the pursuit of stable and sustainable fiscal policy. The pact came fully into force in 1999 and consisted of two arms: the preventive arm and the corrective arm. The preventive arm requires all member states to outline a comprehensive medium-term fiscal objective. Countries must demonstrate the stability of their own public finances, or at least demonstrate conscious and rapid progress toward a stable budget. The corrective arm comes into force when a country's deficit rises above 3 percent of its GDP, or its public debt-to-GDP ratio rises above 60 percent, and is not shown to be diminishing at a sufficiently rapid pace. Under the Excessive Deficit Procedure, countries receive warnings and guidelines for the future of their public finances, and in some cases are sanctioned or fined. Continued overspending and increases in debt can even lead to an interest-bearing fine of 0.2 percent of the country's GDP. When the Excessive Deficit Procedure is triggered, the efforts of the country in question are evaluated through an Assessment of Effective Action to see if external events have affected public finances, despite the country's best efforts. Events such as an EU-wide or global economic downturn diminish the likelihood of sanctions and fines from the SGP Council.

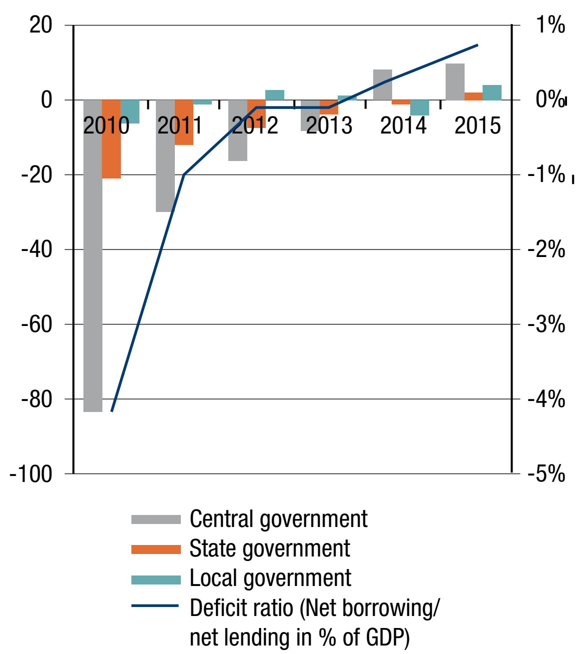
The SGP was very much the brainchild of larger economic powers in the late 1990s; Germany and France played key roles in its formation. The implementation of the SGP arguably spurred the creation of Germany's own Stability Council, which controls the borrowing practices of the state governments to ensure that irresponsible local spending does not affect the state of national public finances. The SGP, however, has come under consistent criticism since the early 2000s for its constraining fiscal rigidity and inconsistent application across member states. For instance, when Germany and France crossed the 3 percent of GDP spending limit in 2003, they rallied member state finance ministers to stop the imposition of any sanctions, setting a precedent for the inconsistent application of fiscal discipline across the EU. Recent reforms under the Open Method of Coordination in 2011, however, have proven to be promising in their acknowledgment of the need for flexibility within the financial constraints of the SGP.[70]

[70] Reforms adopted under the Open Method of Coordination primarily refer to the creation of the Euro Plus Pact. Created in response to the 2010 debt crisis, the pact aimed to increase economic and fiscal discipline.

Since 2012, the German general government budget has met the requirements of the Stability Program by being close to balanced. As reflected in Chart 8, general government debt peaked in 2010 but was quickly reined in after the adoption of a federal budget that eliminated new borrowing. In 2016, the Federal Ministry of Finance estimated that the annual government debt-to-GDP ratio would fall under 60 percent by 2020, allowing Germany to fall below the Maastricht limit.

In 2015, Germany had a registered government surplus of 0.7 percent, second to only Luxembourg within the euro area and EU28 countries. That being said, government debt as a percentage of GDP remains relatively high, at 71.2 percent, although the euro area and EU28 average debt-to-GDP ratio remains higher at 90.7 and 85.2 percent, respectively.

Chart 10: Net borrowing/net lending by level, bn euros



Source: Destatis

APPENDIX 1

Länder	Abbreviation
Baden-Württemberg	BW
Bavaria	BY
Berlin	BE
Brandenburg	BB
Bremen	HB
Hamburg	HH
Hesse	HE
Mecklenburg-West Pomerania	MV
Lower Saxony	NI
North Rhine-Westphalia	NW
Rhineland-Palatinate	RP
Saarland	SL
Saxony	SN
Saxony-Anhalt	ST
Schleswig-Holstein	SH
Thuringia	TH

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Features of Territorial Governance in Europe

BERNARD SOULAGE
IN COLLABORATION WITH
NICOLAS LÉTÉ

This analysis is provided within a context of a movement in favor of decentralization, witnessed more or less worldwide. This movement has strongly manifested itself on topics linked to the fight against climate change or to local economic development, where the various levels of local governments (cities, metropolitan areas, provinces, regions, federal governments) have taken a growing role in the debates and political engagements in different countries.

Nevertheless, this decentralization movement shows significant disparities, resulting both from governments that do not want to see internal outbreaks of opposition and from the difficulty for local and regional authorities in taking on the responsibilities that they demand.

Further, the movement was followed or even preceded by the financial crisis of the past 10 years which has, in most countries, put considerable pressure on public finances, whether those of central governments or of local and regional authorities.

In this context of crisis, local and regional authorities, particularly in Europe, are powerfully affected, possibly the most affected, by budget cuts. This article will look at the specific consequences which then arise for them.

It remains nonetheless true that local and regional authorities are the source of the major share of public investment, and, as we will see, this share is increasing.

In this context, reforms and the global operations that constrain local and regional authorities have a crucial impact on the competitiveness, sustainable development, and social cohesion of European countries.

This paper mainly focuses on the synthesis of three studies and therefore aims at, but is not limited to, highlighting various trends of so-called multilevel governance, which is a key issue for European governance. We aim to highlight the convergence toward a trend of a growing power allocated to local governments in the three countries, as well as the persistence of models specific to these countries. Still, the most important topic seems to be the state of the exact relationship among the levels of local governments in a globalizing world.

THE PROCESS OF DECENTRALIZATION AND DEVOLUTION OF POWERS IN THE THREE COUNTRIES

The different systems

Very different points of departure

The three systems that we are examining have very different origins, whether considered from a broad, historical perspective beyond World War II or considered in terms of the consequences of the war.

In effect, France has had a centralized structure for centuries, and the few attempts at decentralization that were realized through the revolution, and then through the birth of the republic, were primarily initiated by the national government, for example, through the creation of departments.

Italy exhibits radically different characteristics. The country was founded less than two centuries ago by bringing together very small structures, mostly resulting from a very strong urban architecture, from "principalities" handed down from the Renaissance, and from large-scale urbanization movements from the middle of the last millennium.

Germany's creation is broadly contemporaneous to Italy, and the country is predominantly constituted of *Länder* (in English, we would refer to counties and regions). But World War II imposed a radical transformation on the country, determined by the Allied victors, requiring a radical federalism to avoid any reconstruction of an all-powerful state in Germany.

We can see, then, that the three countries, present, from the point of view of territorial organization, very important historical differences even within a relatively recent period, for example, at the end of the 1960s or 1970s.

Convergent trends

However, since this period at the end of the "Glorious Thirty" in Europe, there has been a trend toward convergence among these three countries at the level of institutional organization and, in particular, organization of local and regional authorities.

The main features of these trends, some of which are detailed below, concern, on the one hand, the increase in power at the regional level—in France, very modestly from 1963 to 1982 and then in a more determined manner; in Italy, through continuous development over the past 20 years; and in Germany, as a result of economic success, more and more powers being given to *Länder*—and, on the other hand, inter-municipal cooperation both at the city level through the creation of urban agglomerations or metropolises and, rurally, through groupings at the community level in France and Italy or at district (*Kreis*) level in Germany.

One trend that is less often highlighted is of great importance for our considerations.

It pertains to the number of levels of local authorities. It is common belief that the efficiency of local public policies is hindered by the juxtaposition of the different regional authorities (cities, provinces, regions). From there emerges the habit to refer to the French institutional "*mille-feuille*," noting that France has at least five levels of local authorities: communes, inter-municipal associations, departments, regions, and the central government, or even six if we add the European Union. Thus, we can see that Italy has had, for a long time, a system showing close parallels to this, and that Germany, which did not have a province-type system (and thus had one less level), has created this system in several key *Länder*, for example, Baden-Württemberg and Bavaria. Therefore, the relative number of local authorities, which is often used to explain the differences in performance in the three countries, seems much less important.

The most important trend within the three countries is the rise of urbanization and, more specifically, the growth of metropolitan areas in zones where the population exceeds 300,000 to 400,000 inhabitants. Moreover, we can see the rise of the regional and metropolitan phenomena is not without difficulties or conflict.

Persistent differences

In spite of the trends cited above, the differences in territorial structure among the three countries remain significant.

A major difference concerns the constitutional and legislative role of the *Länder* in Germany and, to a lesser extent, of the Italian regions.

This is reflected by the ability—at the level just below central government level—to prescribe laws and regulations and even to exercise control over local authorities at lower levels. This is prohibited in France and constitutes a clear distinguishing factor among the three systems.

There is also a notable difference in terms of participation of the local authorities in the general governing process of central governments and, in particular, in the legislative process. Germany, through the Bundesrat, instituted a formal system of representation for local authorities and, in particular, for the *Länder* in the legislative process. Italy wanted to establish the same system at the time of the rejected referendum of December 2, 2016. In France there is no such system, and it serves us to recall that Charles de Gaulle left power in 1969 after the defeat of a referendum similar to the recent referendum in Italy, which was to give more power to the regions and was to radically modify the legislative balance between the National Assembly founded on universal suffrage and a Senate representing local authorities.

As discussed below, these institutional differences are also articulated with major differences in terms of powers exercised and finance flows.

The respective powers of each local government level in the three countries

Powers common to all

In the countries studied, a certain number of powers are delegated to local authorities, sometimes with different beneficiaries but broadly indicative of the same structure.

Delegated powers chiefly include:

- Organization of the territorial planning and development system most often at the city and regional levels.
- The same applies for all water and sanitation matters.
- Urban mobility and urban transport, which are most often delegated to community and inter-municipal level, inter-urban transport being delegated to regional level.
- Sports and culture undoubtedly constitute one of the most important domains of powers for local authorities, to the extent that, in Germany, for example, there is practically no federal intervention in this area.
- Education, at least in terms of construction of buildings, their maintenance, and services revolving around the school system, is delegated to local authorities with identical distinctions among educational levels.
- Social support, particularly for young children (crèches, preventive health care, etc.) and for the elderly or dependent people.

Greater powers in Germany and Italy

As the result of its federal character, Germany has attributed much greater powers to local authorities and, in particular, to the *Länder*.

Italy has also tended to significantly increase the power allocated to regions and other local governments. This process started with the decentralization laws of the 1970s and 1980s and the creation of the Regioni a Statuto Ordinario. During the 1990s, this decentralization process strengthened under the pressure of wealthy residents in the North, demanding larger fiscal autonomy.[71] This process was halted by the 2008 financial crisis and the tightening of central government transfers toward local governments.

This is notable, specifically with respect to health care, a subject of intense debate in Italy at the time of the recent referendum, but also with respect to the economy, community policing, and even, more broadly, security.

We have seen recently that the question of refugees is largely addressed at regional and *Länder* level in Italy and Germany, while, in France, the topic is almost solely dealt with by the national government.

Finally, remains the very important question of skills transfer through education (educational programs, hiring and training of teachers, organization of the different school cycles) at the regional level. This issue extends beyond the construction of buildings and associated services (school cafeterias, receptions, day care), which allow the smooth provision of educational services. Germany had a very decentralized system, which simultaneously comprises "education" and the buildings and associated services. However, outcomes being judged to be very poor at the start of the 2000s led to a certain amount of recentralization of curricula, qualifications, and establishments. By contrast, France and Italy were constantly seeking, over the same period, means of deconcentration[72] and decentralization[73] to give greater autonomy to institutions in this area.

The crucial matter of economic and innovation policy.

Beyond an appearance of fairly considerable similarity in terms of the question of support for innovation and economic development, there is a real differentiation between Germany and Italy on one hand and France on the other. This broadly reflects the overall organizational differences of the economic systems, particularly their small to medium-sized enterprises (SMEs) and their performance rankings, particularly with regards to exports.

Therefore, in Germany and to a lesser extent in Italy, by means of "industrial districts," powers and resources in terms of economic development and innovation have long been based at the regional level. Even though Germany has programs that aim to reinforce these regional ecosystems—68 percent and 80 percent of the budgets of the German Research Foundation and the Fraunhofer, respectively, are financed by the central government[74]—the *Länder* have a notable financial economy concerning research and innovation which provides strong support for small and medium-sized enterprises (SMEs) and their exports.[75]

Budget allocations provided for these policies are incomparable, for example, between Germany and France. In France, this issue was only addressed indirectly at the time of the first real decentralization in 1982. It was better addressed recently when laws were passed in 2015—notably ones giving regions

[71] Ter-Minassian, Teresa, 2016. "Local finances in Italy." Brookings Project on 21st Century City Governance.
[72] Deconcentration is an administrative organizational technique that consists, for the central State, in distributing its own civil servants and competencies to administrative authorities representing the central State in local and regional districts. These authorities have no autonomy.
[73] Decentralization is a territorial process of the central State that consists of transferring competencies from the central State to new local and regional entities, with a distinct legal personality and with political autonomy.
[74] Federal Ministry of Education and Research.
[75] Sellenthin, Mark O., and Christian Rammer, 2007. "R&D Policy in Baden-Württemberg: A Focus on Governance Structures and Technology Transfer." Funded by the European Commission—DG Research.

the authority to manage the European Structural and Investment Funds, which are largely centered on innovation and SMEs—but it still remains, to quite a great extent, a matter for the State in contrast with the preceding countries. In France, the central government remains, by far, the largest financial backer for innovation. This does not help in consolidating the legitimacy of regions as drivers of regional economies, despite the responsibility of regional economic development delegated to regions and metropolises.[76] For instance, 87.2 percent of innovation financing in France is done at the central government level against 5.4 percent at the regional level.[77]

This issue constitutes, in the three countries, an ongoing source of conflict between the regions and the metropolises, each wishing to demonstrate that it is better-placed to facilitate harmonious development of the local industrial fabric and economy. The most emblematic case is that of France, where the decentralization law of 2015 could not really settle who is doing what in this area. In fact, the regional schemes for economic development, innovation, and internationalization are formulated by the region. Still, the metropolis can object to it within its vicinity in cases where there is a disagreement at the regional level.

Our feeling is, however, that a strong and coherent economic development and innovation policy at the metropolitan level is key for each country's overall development strategy and for their ability to adapt to globalization.

[76] NOTRE Law of 2015.
[77] Les aides à l'innovation en France (2014, CNEPI).

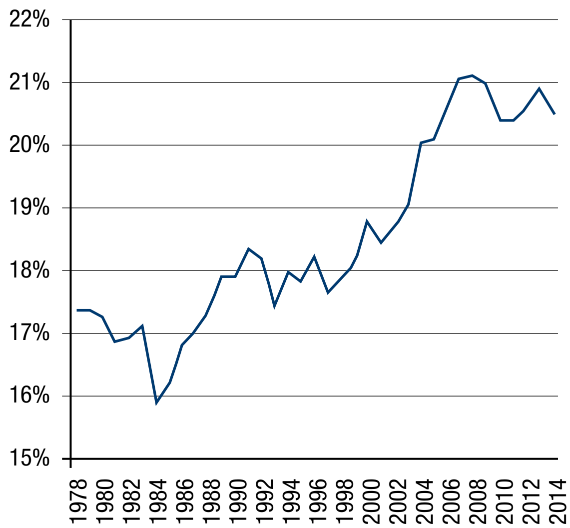
FUNDING

Increasing impact and constrained revenue

An increasing impact on GDP

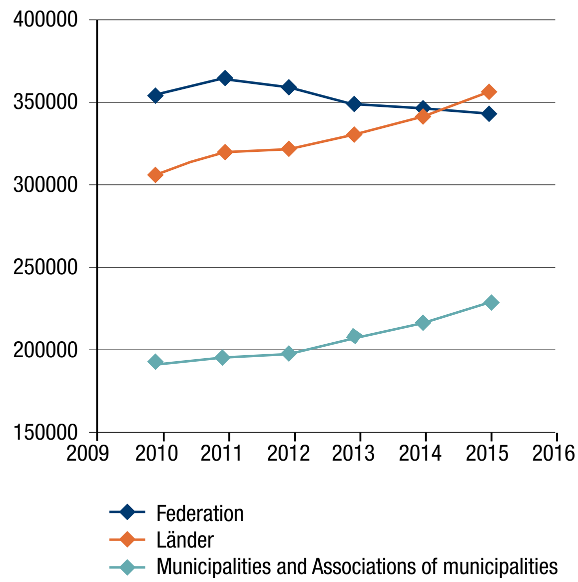
The share of spending by local authorities in the GDP of the three countries has been constantly increasing over the last 30 or so years as we can see here.

Figure 1. Local government expenditures as a percentage of total public spending (France)



Source: Insee, National accounts, Base 2010

Figure 2. Expenditure of the overall public budget by level from Q1 to Q4, million euros (Germany)



Source: Destatis

Nevertheless, and despite considerable developments, particularly in France, this share remains much differentiated according to the country. Thus, France, where the spending of local authorities has increased from less than 8 percent of GDP in 1980 to 11 percent in 2005 and 11.8 in 2014, remains the country of the three where local authorities' share of GDP is the smallest. We can also observe a substantial development in France and

Table 1. Local government expenditures within public spending (Italy)

	2010	2011	2012	2013	2014
State	482.5	445.3	451.1	455.8	463.3
Other central governments	75.7	75.9	78.9	82.0	84.8
Local public administrations	229.8	235.3	244.0	252.2	251.5
Local authorities	210.1	215.5	223.1	231.0	229.6
Social security administration	515.6	532.4	550.2	562.3	575.3
Total public administration	1128.0	1151.5	1186.0	1207.1	1226.7

in Italy in the allocation of spending among the local authority levels for the benefit of the regions and inter-municipalities (under whatever name) and to the detriment of basic municipal units and provinces (or departments in France).

A very different tax autonomy

This is an absolutely key point of this comparative study. The preceding papers on the three countries clearly show differences among the revenue systems of the local and regional authorities. The share of transfers from the central government in this revenue by means, in particular, of allocations of the central government budget is indicated in the table below. Unfortunately, we do not have viable data on Italy.

Table 2. Share of mandatory deductions by beneficiary administrative entities, in percent of total mandatory deductions, 2012

	Germany	France
Central government	46	86
Local and regional authorities	49	13.5
European Union	5	0.5

Sources: BMF, Insee

Differences emerge, although it must also be emphasized that, even within each country, there are considerable variations in the tax autonomy of each local authority or authority level. For example, in France, though the average tax autonomy of the local authorities amounts to less than 40 percent of their funds, the case of Lyon, studied in detail in another publication, shows that, under certain conditions, local authorities may have greater autonomy. This comes from the fact that the local authority benefits from resources from the former Grand Lyon metropolis and the former Rhone department—since the two merged—as well as the local economic force the merger has created, which offers important fiscal revenues based on the rents from local enterprises.

The same applies for the large *Länder* in Germany thanks to their own funds, which they obtain as the result of their strong economic development.

Thus, without covering the case of Spain (where nearly the total revenue of local authorities comes from State transfers, except in the Basque Country), it is noted that even in Germany, the most decentralized country, there is no real tax autonomy for local authorities.

Extremely differentiated equalization practices

The present analysis of the revenue of local authorities follows the preceding logic to show that decentralization does not, in any sense, mean significant tax and fiscal autonomy for local authorities.

In effect, contrary to popular belief, **there is no nexus between the degree of decentralization and the degree of tax autonomy.** We could even say that in the three countries there is inverse proportionality between the degree of decentralization and the real degree of tax autonomy once we have considered the process of revenue equalization.

Thus, in Germany, the constitution explicitly provides that revenue from local authorities of different levels may not deviate from the average by more than 10 percent, which is an extremely small deviation. Evidently, this presupposes very considerable equalization between local authorities and a centralized system enabling such equalization. The article focused on Germany presents the details of this mechanism which we find to a lesser degree in Italy within a particularly complex system, and which is extremely poorly developed in France in spite of recent efforts.

We should emphasize a particular question here, which is very often invoked when studying equalization in France, particularly where this equalization among local authorities is very weak. Administrative units, such as the large cities and metropolises, notably Paris and Lyon, benefit from the greatest revenue per inhabitant and contribute fairly little to equalization between local and regional authorities. At the same time, these cities insist that local authorities make significant contributions to the overall equalization of fiscal revenue at the national level. At the same time, the development policies of the larger metropolitan areas ensure very high income, which in turn generates high fiscal revenue (value-added or income taxes, for example) that is reallocated to the central government, which is then distributed to various local authorities that do not fall under their local authority. This issue is the subject of great debates in France, Germany, and Italy (and, incidentally, in Spain and Catalonia), as it is one of the topical key points of claims for regional autonomy in the regions governed by the Lega Nord in Italy or by the richest *Länder* in Germany.

To our knowledge, there are only a few studies on this subject, which are extremely significant and useful for any interpretation of actual redistribution of revenue in the various countries.

Relatively little impact from the European Union
It is notable that the European Union contributes little to the revenue of local authorities in Western Europe compared with Central and Eastern Europe.

The core European funding for local and regional authorities comes from what are referred to as the cohesion policies notably implemented through the European Structural and Investment Funds (FESI in French), which are principally intended to promote territorial and social cohesion as well as innovation and sustainable development. By and large, these funds concern investment expenditure, and in countries such as Germany, France, or Italy, where the share in the national economy is much less than 1 percent of GDP, this merely represents, at best, a leverage effect on the other funds for local authorities whether provided by the central government or self-generated. This situation serves as the key difference between the three countries studied here and other European countries. In Greece and Poland, for example, where the structural funds can reach up to 2.35 percent of GDP, the funds have a considerable effect on public decisions.

In addition to this, there is some funding from European programs directly managed by the European Commission, notably research and innovation programs.[78] But these also amount to only a few hundred million euros maximum per year within budgets that run into tens of billions for the major local authorities that we have studied here. For example, the four motors for Europe—Auvergne-Rhône-Alpes, Baden-Württemberg, Catalonia, and Lombardy—captured about 1.6 billion euros from the Horizon 2020 program between 2014 and September 2016, while the total annual budget of the Auvergne-Rhône-Alpes region, the smallest of the four, is 3.685 billion euros per year. Moreover, beyond financing, it is important to note that these policies, notably the cohesion policies based on the FESI, contribute to a harmonization of European policies notably as they relate to research and innovation (i.e., regional strategies for smart specialization). Therefore, the cooperation among regions is facilitated through these policies and creates a Europeanization of value chains, favorable to regional economic development.

Financial balances

Increasingly constrained finances
The finances of the local and regional authorities of the three countries studied present **relatively convergent trends** owing to increasing constraints imposed on these authorities.

[78] Horizon 2020 is the EU research and innovation program with nearly 80 billion euros in funding available between 2014 and 2020 for the entire European Union.

Part of these constraints result from the features presented in the preceding paragraph and, notably, the constant influence of States on the finances of these local authorities. Thus, as a logical continuation of policies of "budgetary austerity" implemented in Europe, nations have greatly reduced their support of local authorities whether such support is provided through direct allocations or through the equalization mechanisms outlined above.

Evidently, the weak growth experienced by the European Union over a considerable number of years, in particular since the financial crisis of 2007-2008, has similarly not helped the situation for self-generated revenue for local authorities, as, for a relatively significant proportion, this revenue is directly dependent on business and household funds and often with a fiscal elasticity coefficient greater than 1. We can thus observe a sharp decline in the growth of revenue of these local authorities but also, to a lesser extent, in their spending which has a considerable impact on overall economic growth to the extent that the investments by local and regional authorities are the main victims of these constraints on local finances.

A powerful "scissor effect"

In view of this increasingly small variation of local authorities' global revenue (self-generated or from external allocations), there is a so-called "scissor effect" between expenditure and revenue. The scissor effect corresponds to a decrease in recurring revenue (due to a decline in central government transfers) coupled with the increase in recurring expenditures (for example, due to the increasing wage bill). This scissor effect presents a significant particularity with regard to public local authorities (made up of "protected employees") which is very well-known at State level and is also found at the local level. Public local authorities are most often in charge of public services mostly comprising personnel spending (e.g., the health, education, or security sectors). Thus, the slippage in operating expenditure is very considerable even with a slight increase in salaries. Indeed, with protected employees (this implies lifetime job security and a continuous salary increase with age), local governments have relatively little control over the evolution of their expenditures. This phenomenon, in technical terms, is referred to as the "age-technical skills shift." In the three countries, salaries in the civil service are largely tied to employment seniority and a smooth quasi-automatic career progression, leading to a quasi-automatic increase in the annual wage bill. Thus, the scissor effect previously evoked is composed of the differential growth of revenue and expenditure to the disadvantage of revenue. Every element associated with the self-sustainability of local authorities is affected by this.

These striking elements in the countries observed result in relatively weak investment capacity and thus a decrease in public investment by local and regional authorities in addition to that of the State. Germany and Italy, and France to a lesser extent, strongly exhibit this decline in public investment, particularly at infrastructure level, which has led to well-known problems in these countries. For example, in Italy, investment from local authorities fell 34 percent between 2009 and 2014.[79]

Increasing regulatory intervention by the central government

Added to factors related to the economic environment, spending structures, and revenue of local authorities are factors connected to macro-economic regulation that have been implemented in Europe and in EU Member States over the past decade, and particularity in the eurozone.

We can observe, in the three countries, **increasing pressure by central governments on local and regional authorities to limit their deficits greatly and even to show a surplus.** This is meant to reduce their contribution to the national deficit, thus allowing EU member states to respect their

[79] Ter-Minassian, Teresa. 2016. "Local finances in Italy." Brookings Project on 21st Century City Governance.

communal obligations, notably the Maastricht criteria as defined in the Stability and Growth Pact and 2012 EU budgetary agreements.[80] Each country, of course, has its own means of ensuring such convergence.

For example, since 2001, local and regional governments in Italy have been subject to internal stability agreements, which set targets for budgetary imbalances and limit the potential increase in expenditures at the local level. When these standards are not met, the central government has the right to reduce or halt government transfers to the local or regional authorities. The system has proved efficient as, during the 2013-2014 period, only 1.5 percent of municipalities failed to respect the objectives. These municipalities are mainly located in the South and Sicily. In 2009 Germany's constitution was amended to introduce the *Schuldenbremse* ("debt brake"), a balanced budget provision. The amendment sets quantitative targets, within a specific timeframe, for the central and federated government in order to improve the durability of public finance and fiscal coordination among the different levels of government.

We also note that the European Union intervenes through the cohesion policy and the FESI to promote the reduction in its member states' public deficit. Therefore, Article 23[81] of the regulation on the general cohesion policy allows for the total or partial suspension of payments through the policy if a member country does not respect the Maastricht criteria from the Stability and Growth Pact. This is commonly called a macroeconomic conditionality. The European regions, which manage the FESI, are opposed to this "double punishment" which could lead to the suspension of the European fund they were receiving, when they themselves were not running an excessive deficit (contrary to their central government). This discussion, deeply symbolic of the reality of the autonomy of local authorities, has still not led to a direct action: In December 2016, amid its excessive deficit, Spain was threatened with the suspension of the disbursement of the European Structural and Investment funds, while some of its regions had balanced accounts. However, the European Council is holding off on voting for these sanctions. This debate provides a significant picture of the desire to include local and regional authorities within the European Union's comprehensive approach to budgetary regulation. It is worth noting that France and Italy could find themselves in the same situation as Spain in the near future.

Debt

Regulations specific to each country

It must first be underlined that each country studied presents specific characteristics in terms of fiscal law and, in particular, the borrowing capacity of local and regional authorities. Thus, France prohibits any current deficit by local authorities but does not present any formal limitation in respect to their debt ratio. Only a current deficit may enable intervention by a government authority such as the prefect.

In contrast, in Germany, and to a lesser extent in Italy, regulations were recently passed—such as the *Schuldenbremse* and stability pacts mentioned above—to limit the debt of local authorities, in particular, by regulating the operating expenditure/operating revenue ratio and debt ratios. In Germany, these new rules should lead to a reduction in

[80] The Stability and Growth Pact adopted at the Amsterdam European Council of June 1997 is the first instrument simultaneously adopted by all 15 member states in the aim to harmonize their budgetary policies and avoid the creation of excessive public deficits. This tool, which applies to every EU member country, states that public deficit cannot exceed 3 percent of GDP and that public debt cannot exceed 60 percent of GDP. If a member state fails to respect this criterion, it could face a procedure for excessive deficits as mandated by Article 126 of the treaty on the functioning of the European Union. These dispositions were further strengthened by the fiscal compact adopted on January 30, 2012, and signed March 2, 2012, by all the EU member states except the United Kingdom and the Czech Republic.

[81] The European regulation no. 1303/2013 of the European Parliament and the council of December 17, 2013, on the common dispositions in relation to the European Regional Development Fund, the European Social Funds, the Cohesion Fund, the Agricultural Fund for Rural Development, and European Maritime and Fisheries Fund.

public debt to levels below 60 percent of GDP by 2020. As of 2015, Germany's budgetary surplus is spread out in the following way: 0.3 percent at the central level and 0.1 percent at the *Länder* and other local governments level.

A trend toward increased debt
In view of the preceding features, the general tendency in the three countries is toward **an increase in the debt ratio of local and regional authorities; however, three particular tendencies should be noted**:

- Local authorities' debt remains substantially lower than the debt of central governments, particularly in France and Italy, as these local and regional authorities account for less than 10 percent of the national debt (9.5 percent in France in 2013). In Germany, the *Länder's* debt makes up 30 percent of the German public debt, while the debt of other German local authorities makes up only 7 percent of total public debt.

- Local authorities within each country present levels of debt peculiar to each level of local authority. Thus, *Länder* or regions present relatively high debt ratios, but these are local authorities where the share of investment in total spending is higher. In France, local governments financed 58.8 percent of public investment in 2013.

- Finally, local and regional authorities are considered high-quality borrowers since, in the three countries, a number of them benefit from upper-limit financial ratings.

Off-balance-sheet commitments
It is nonetheless worth noting the levels of off-balance-sheet commitments of the local and regional authorities studied here.

The large, local authorities are often holders of commitments either through public-private partnerships that we will examine in the following paragraph; through leasing—or leasing-purchase—mechanisms that they have often increased over recent decades; or through local company commitments of semi-public company types in France or *Stadtwerke* in Germany. Unfortunately, we do not have precise data on this topic, as they are off-balance-sheet accounts.

Recourse to private capital

Low-level privatization in the strict sense of the term
The three countries do not show **significant privatization of local public services** in the implementation of public policies and exercise of the powers with which the local and regional authorities are endowed. However, this is only true if we are referring to privatization in the strict sense of the term, as in the totality of powers (including pricing) being given to private capital to implement public policy without participation of the local authority in its financing. If we were to make comparisons with the United Kingdom, for example, we would see very big differences, which do not feature here.

Linking of public and private funding
Rather, we observe in these three countries one or another form of linking between private and public funding. This takes the form of public-private partnerships in the Anglo-Saxon sense of the term and, in particular, of "build-operate-transfer." But **we rarely see cases that are truly similar to the Anglo-Saxon cases** where transport infrastructures and mobility are concerned, or even development associated with health care or security, for hospitals or prisons.

Beyond PPPs, this linking presents characteristics specific to each country. France is characterized by the delegation of public services model, which is really just a watered-down version of privatization and, furthermore, is often implemented by semi-public companies which French law requires to be overwhelmingly publicly funded. In this case, the political authority of the local and regional authority remains greatly, even completely, dominant.

Italy has very many local companies held entirely by local authorities which operate under private law but remain very greatly dependent on public money. As indicated in Teresa Ter-Minassian's review of fiscan conditions in Italy, many companies are often fairly inactive and a huge clean-up operation has been initiated by the government authorities. This was to be strengthened by the reforms provided by the end-2016 referendum.

The most interesting case is that of Germany, which has the special case of *Stadtwerke*. These are considered by many observers to be anti-liberal monsters that bring together, at city or *Länder* level, a collection of local public services that are frequently confounded with a great deal of accounting and financial chaos mixing sources of income and deficit without competition being genuinely effective in these sectors. These reveal a Germany that is very different from that of public perception that holds Germany to be spearheading openness to competition in Europe.

A weak impact all in all

Considering the overall picture of the place of private funding within the economic system of local authorities in the three countries studied, we find a relatively minor impact from either former traditions of "municipal socialism," or recent tendencies to keep or bring within public control services that were more or less handed over to private groups that often abused these circumstances.

In addition, low interest rates have not provided an impetus to turn toward private funding or leasing, and the economic and financial crisis has slowed investment, so we can see that private funding is not determinative and that it is uncertain that it will play an increasing role in these countries.

This is one of the reasons that the large corporations, particularly in France and Germany, constituting local public service providers are increasingly looking outside Europe to find sources of growth that they no longer find within their national territory.

CONCLUSIONS AND OUTLOOK

Diversified but convergent structures

In the three countries, the structures of local authorities are the result of long-standing traditions and histories that are reflected in fairly considerable diversity.

Nevertheless, we can observe a convergence around the city (or metropolis)-region pairing to the detriment of basic municipal units and provinces or departments.

However (and the Italian referendum has only served to confirm this), it is very difficult to phase out the territorial level in any of the countries.

For our part, and in contrast with many observers, we are not very surprised by this difficulty, for two reasons. On the one hand, there is such a need for proximity among populations suffering the upheaval of globalization that they become schizophrenic, hoping for rationalization to "avoid the waste" involved but also showing opposition as soon as this involves the local authority to which they belong. On the other hand, there is the resistance of local elected representatives committed to their mandate and able to influence a significant part of the population.

Nonetheless, profound uncertainty remains over what will happen to the basic units that form municipalities, particularly in France, where they are especially numerous (36,000), but also in Italy (8,000) and Germany (11,250), predominantly within large agglomerations where the ascent of metropolises affords much less influence to each municipal unit within them.

... facing common underlying trends

The local and regional authorities examined here face underlying trends that are broadly the same, entailing obligations that must be analyzed to assess the path ahead.

We can note, in particular, among these tendencies, the issues of an aging population, the persistence in many instances of unemployment, and, more recently, the tremendous influx of refugees and immigrants. Added to the decrease in funds allocated by the national government and the decrease of self-generated funds, these tendencies are leading to a significant decline in the capacity of these local authorities to act.

Troubling financial difficulties

Taken together, these tendencies indicate very considerable financial difficulties for local authorities that are not used to experiencing this and which, by contrast, have developed strong policies of investment either in infrastructures or in innovations and economic development. This situation creates great uncertainty for the future of public policy in Europe and the continent's ability to continue to promote a model of development broadly founded on urban life (*"urbanité"*).

Strengthened partnerships

Faced with these circumstances of greater financial difficulty and the decline in government intervention, one of the most powerful responses by local and regional authorities consists of developing partnerships in different forms. The major partners are, of course, local authorities of similar level, whether located domestically or in another country. We can see this happening in the establishment of very many international networks of local authorities, notably over the last few years, focused on the issues of climate change or on developing innovation.

This politics of partnership is also found among different levels of public local authorities. In France, this has been the case for a long time focusing on the issue of Central Government-Region contracts. This approach has been closely studied in other European countries. The increasingly contractual policy which unites the European Union with local, European authorities, by means of seven-year European funding cycles, should also be factored in.

This tendency toward partnership and cooperation should be studied in the medium term, as it may be an appropriate response to the scarcity of funds and the necessity of more rapid adaptation based on cooperation.

Weak role played by the private sector

In spite or because of the deteriorated financial situation of local and regional authorities, we do not see a large role being given to the private sector in the design of the public policies examined, and nothing leads us to assume that this will change over the next few years. There is, therefore, a considerable difference when contrasted with countries such as the United Kingdom, the United States, and even China. One of the questions to be asked of Europe is whether this model, to which the countries examined remain very committed, has long-term viability.

The challenge of economic development

Among the questions invoked here, **the role of local and regional authorities within the countries' economic development dynamics is certainly, today, the most important and the most debated question.**

In this respect the models of the three countries undoubtedly exhibited the most differences one or two decades ago.

Germany has always relied on local and regional authorities to promote innovation and local development.

Italian local authorities supported a strong local and entrepreneurial dynamic by means of "industrial districts."

France, for its part, mistrusted local authorities and continued to promote a "Colbertist" model.

Today, at the confluence of the rise of the regional phenomenon and the desire to promote a "green economy," it seems that local authorities—in the studied countries and the ones in many OECD countries, starting with the United States—have, to a certain extent, taken leadership of territorial economic development, basing it on SMEs and start-ups.

Is this a sustainable tendency? As things stand, we would consider this to be entirely realistic. And that leads us to a final question.

Can we speak of a so-called glocalization in Europe?

At the end of this study, we can answer that question in the affirmative.

Whether we are talking about the aspirations of populations, the impecuniosity of States, the metropolization dynamic and networking of metropolises, or the rise of infra-national structures of regional or *Länder* type, all of the ingredients appear to be assembled for a new territorial dynamic to fall into place. Receptivity to globalization rests on the capacity of territories to adapt and respond, especially in countries whose comparative advantage predominantly stems from innovation and service economies. This response is also adapted to the aspiration of populations to hold on to neighborhood bonds. From which stems the word "glocalization," a fusion of "globalization" and "localization."

It is, perhaps, in this new articulation among the territorial levels that the principal opportunity for the European model to survive resides along with its ability to differentiate itself from other models, which are apparently more competitive.

However, sometimes different dynamics are in progress on other continents and, in particular, among emerging countries. It will always be interesting to review these against a few lessons learned from the analysis of these three European countries and their local and regional authorities.

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