Painting the town red

By David Walker | 1 April 2012

It's not just national governments facing debt crises and ratings downgrades. Local and regional authorities worldwide have been in meltdown, as the credit squeeze hits. But some are starting to fight back

David Unkovic is called the receiver of Harrisburg for a good reason. After the US city declared bankruptcy last autumn, the state of Pennsylvania appointed -Unkovic to drum up revenue wherever he can. Pending legal action against him by the city councillors, he proposes to sell Harrisburg's incinerator, parking, water supply and sewerage system.

The US, as usual, shows the extremes of what can happen, in this case when local authorities are left to fend for themselves in a harsh financial climate. The income of US states fell sharply in the three years to 2011, and they in turn chopped grants to cities and counties, leading to mass layoffs and service cutbacks.

Harrisburg is not the only US local authority in difficulty. Stricken former motor city Detroit has just about resisted takeover by the state of Michigan. But this was only after agreeing a fraught deal with unions to further cut public employees' health insurance rights and pensions – and -charging residents more for refuse disposal. (Eric Pickles, the English communities secretary and fan of free and frequent rubbish collections, should visit.) Meanwhile, vital children's clinics -formerly run by Detroit are kept open only with federal support. Two other struggling Michigan cities, Pontiac and Flint, have had emergency managers imposed on them.

The financial crisis has hit Europe's cities and regions too, if less dramatically. The city of Rome recently pulled out of bidding for the 2020 Olympics, citing money worries. Remaining contenders for the award, due in September 2013, are Tokyo, Istanbul, Doha, Baku and Madrid – the only eurozone city. But its chances are dicey. The Spanish capital's debt in relation to its projected income is at Greek proportions.

Bond markets trembled earlier this year when the Spanish regional authority of Valencia delayed payments on a loan to Deutsche Bank. Standard & Poor's, the -ratings agency, has since pushed Valencia down to BB/B, leaving it teetering on the edge of 'junk' status.

The same story has played out elsewhere – but it's still one of adjustment downwards rather than collapse. Three of Austria's federal states have just been regraded 'negative', in line with national downgrades, and the insolvency of the Dexia bank in 2008 has had ongoing effects on councils in France and Belgium. Last year, at the behest of French Prime Minister François Fillon, a government agency took over the bank's municipal -business, worth about €83bn. Commentators noted that Fillon's boss, Nicolas Sarkozy, had no wish for a funding crisis in the run-up to the presidential elections in May. Meanwhile Belgian councils faced a double whammy: they had invested heavily in Dexia, so missed the income from their stake as well as a source of credit.

When S&P read the riot act to the Croatian city of Zagreb in November, its strictures could easily have applied to a score of others. 'In the years before the global financial crisis, the

city rapidly increased its social spending as well as investments… it remained reluctant to cut its spending such that, with revenues shrinking, it faced an accumulation of overdue payables. The city still appears unwilling to raise taxes or -tariffs, which further restrains its -budgetary flexibility.'

If that sounds like a political -judgement, it probably is. The ratings agencies have won a reputation for the neo-liberal flavour of their conclusions, although they say their calculations are transparent and often amount to no more than comparing income and outgoings. Still, a Harvard-led study published in January concluded that in Germany bond markets put a distinct premium on lending to Länder (federal states) that are controlled by the Social Democrats and Greens rather than the Christian Democrats.

No wonder financial pressure is stoking political tensions. Bavaria, the most prosperous state (controlled by the Christian Social Union), is suing in the Constitutional Court for a cap on the equalisation scheme that transfers spending power and credit between it and poorer Länder such as Berlin. The Bavarian Economy Minister Martin Zeil talks about 'Athens on the Spree', one of Berlin's rivers. It's not meant as a compliment – Athens has become a byword for profligacy, and the Bavarians say they are fed up paying for it.

Perhaps local solidarity and even -'localism' were bound to be casualties of the financial crisis. Councils lost revenue in the recession, just as demand for services was rising. This directed the credit agencies' attention to the estimated 15% of total European Union government debt that can be ascribed to local and regional authorities. In the US, as in other countries, central government came to the fiscal rescue, preventing council bankruptcy but leaving local government more dependent than ever on grants and loans. The Organisation for Economic Co-operation & Development has also reported that -stimu-lus packages have cost local authorities money. In France, for example, when local business taxes were abolished the losses were not fully -compensated for.

The crisis hit when local and regional -borrowing was rising – which has been true in China as well as Europe, North America and Australasia. In Spain, debt attributable to the 17 autonomous regions rose from 2.7% of gross domestic product in 1984 to 14.2% in 2010. In Germany, borrowing by the Länder grew fivefold in the ten years to 2010. The trajectory is soaring upwards in Schleswig-Holstein, one of the northern German states. Klaus-Hinrich Vater, president of the Chamber of Industry & Commerce in the state capital Kiel, says if things continue as they are the state will have a debt-to-GDP ratio of 130% by 2020. That, by no coincidence, is the figure being hung round the neck of the Greeks, as an indicator of their pending bankruptcy.

Despite all this, last year ratings agencies and analysts began to breathe a little more easily. Apart from a few small jurisdictions in the US, local bankruptcies had been avoided. One way or another, local and regional authorities were recovering stability, mixing cuts with extra grants and some revenue supplements. Some were even managing to borrow more.

Remarkably, some are now in ruder financial health than their central governments. Take Spain. S&P puts the current credit-worthiness of the Basque Country and Navarre at AA–, two notches higher than the Kingdom of Spain itself. The agency also recently pronounced as 'robust' the creditworthiness of the 18 larger French local and regional authorities to which it gives ratings.

In Canada, Moody's says that 'despite challenging global economic conditions, the

creditworthiness of municipalities remains solid'. Even across the 49th parallel, municipal debt pressure has eased. US towns and cities might now benefit, if investors turn their way in preference to eurozone countries. The US Securities Industry & Financial Markets Association forecasts that during 2012 total issues of long-term and tax-exempt municipal bonds will rise to $347bn, up from $288bn last year. According to Kim Reuben, senior fellow at the Urban Institute think-tank, that is because many such bonds are still triple-A rated; one result is that the interest rates payable on new bonds are at an all time low.

From the other side of the world come more signs of financial buoyancy. In New Zealand, 18 councils have just come together to launch the Local Government Funding Agency, a debt swap arrangement, which ratings agency Fitch immediately rated as AA+ even before it issued NZ$300m of new debt.

We shouldn't be surprised, says Lars Andersson, the Swedish local finance consultant who has been advising the Association of French Mayors on -creating a credit mutual for French local government. 'Local government accounts for a huge proportion of public spending and investment. Recovery must in some measure depend on investment by local and regional government and, to that end, schemes that support their borrowing potential have a part to play in securing growth. That's why, in several European countries, authorities are examining schemes to pool the -creditworthiness of local authorities.'

But before localists break open the champagne, note how mixed the picture is. Among European cities are stars such as Stockholm, which recorded a €193m budget surplus in 2010 and wins AA+ from S&P. Greater London does quite well, too, along with Istanbul and Gothenburg. 'Cities that show they have their finances under control will achieve not only financial but brand advantages,' predicts Greg Clark, senior fellow at the Urban Land Institute think-tank. But for Lisbon, Budapest and Venice, the outlook is darkening. In La Serenissima an international row is brewing over the council's efforts to raise money by considering the conversion of a majestic canalside palazzo into a shopping mall.

It's not easy to dissociate sub-national from national creditworthiness, and the -ratings agencies often don't. Last autumn when they downgraded Italy's sovereign debt, Genoa, Milan and other public borrowers were pushed down too. Andersson says: 'A big difference between the US and Europe is that we have a "system" joining the tiers of government. Sometimes there is no hard and fast distinction to be drawn between tiers of government, in the sense that implicit -guarantees exist.'

Praising the performance of Canadian cities, the S&P analyst Adam Gillespie credited rules imposed by Ottawa and the provincial governments that limited risk taking and debt issuance by local government. Fitch justified its top-notch rating for the new NZ borrowing agency by noting 20% of its funds came from the government in Wellington, which also offers implicit guarantees.

But if the credit crunch has directed -attention to local government's lack of autonomy, it has also pushed councils to do more for themselves. Scandinavian countries already have credit mutuals. In Finland, MuniFin jointly guarantees €12.6bn of loans to local authorities and the companies they own. Kommunekredit in Denmark, established over a century ago, is based on a joint and several guarantee from its members, albeit one that has never had to be used. Andersson notes that Kommuninvest of Sweden, rated triple A, each year subjects members to searching scrutiny: weaker -brethren run the risk of being expelled.

The Local Government Association has been thinking about similar arrangements. But do English councils trust each other sufficiently? Would the Conservatives who control Westminster extend their credit to Labour-controlled Liverpool? Besides, credit pooling depends on background schemes of equalisation, in which central government redistributes resources. In Sweden, the richer, creditworthy urban areas of Gothenburg, Malmö and Stockholm endorse transfers to poorer, sparsely -populated rural areas.

A year ago, US pundits were -predicting that local and regional indebtedness would be 'the next Lehman'. That now looks far-fetched. Ironically, in Spain, Luis de Guindos, economy minister in the Right-of-centre government elected last autumn, was head of Lehman Brothers in Spain and Portugal until the collapse. Now he says he is legislating 'to establish strict instruments of control over the budgets of the autonomous regions'.

Cynics and Catalonians point out that the indebted provincial government in Valencia seems to have been treated with great generosity by the government in Madrid, and that might have something to do with the fact both are controlled by the Partido Popular.

But the medium-run financial outlook cannot be called bright. In the US, the gap between state income and spending is around $180bn, which is about the total value of Calpers, the California public employees' pension system, every penny of whose assets are going to be needed. In New York – the picture is fairly typical – local authorities were recently found to have made no provision for the $200bn worth of health benefits their former employees could lay claim to as pensioners.

The ratings agencies don't like such social commitments but their main worry is revenues: where will the money come from to pay interest on bonds and loans? The obvious answer is taxes. But across the world, treasuries and finance ministries have been reluctant to cede any new tax-raising powers to regional and local authorities. Cities and regions have in turn not made much effort to claim new sources of revenue – with the exception of German municipalities, which have invented ingenious new charges. These include a €6 per 'trick' charge on prostitutes in Bonn, taxes on second homes in Ludwigshaven and Osnabrück, a hike in the dog licence in Wiesbaden and, in Kassel, a special tax on dangerous dogs.

But such fiscal imagination has not stopped German towns demanding extra grants from the centre. It's a path that cities, communes and regions seem to be on elsewhere, too. In the end we seem to be heading for tighter central control, and an even stricter link between national and local creditworthiness.

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This article first appeared in the April edition of *Public Finance*