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The Global Financial Crisis and Local Government

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The September 2007 sub-prime mortgage crisis in the USA and the subsequent collapse of bank lending pushed the world economy into the worst recession since the 1930s. Ever since there has been a wealth of analysis and debate about the reasons for this so-called global financial crisis (GFC) and how best to rescue large parts of the US and UK banking sectors from total collapse. Governments and central banks have taken unprecedented steps to provide emergency relief to banks, effectively nationalising large parts of the sector. There have also been numerous initiatives to reform the regulatory systems of the financial sector.

The crisis emanated exclusively from the countries of the Organisation for Economic Co-operation and Development (OECD), and in particular from the USA and the European Union. However, it has also adversely affected low- and middle-income countries (LMICs) through the transmission mechanisms of lower world trade flows and reduced foreign direct investment, both of which had expanded rapidly during the globalisation era of the preceding two decades. As a result, economic growth rates in most Commonwealth countries fell sharply from the fourth quarter of 2008 onwards.

Attention has been focused on the impact of the GFC on central government with much

less devoted to its impact on local government, which is the subject of this Discussion Paper. The first section proposes a framework to explore the possible transmission mechanisms through which the GFC impacts on local government income and expenditure, and then assesses the strength of these effects. The second section addresses the wider question of the potential impact of the GFC on decentralisation, which has been a notable feature of the development strategy of many Commonwealth countries in recent decades. The final section suggests that the GFC provides an opportunity for addressing three longstanding structural concerns affecting local government.

Impacts on Finances

Income

In almost all countries, local government income is comprised of own-revenue and inter-governmental fiscal transfers (IGFTs) from central government (and from state governments in federal systems). How is the GFC likely to affect these revenue sources?

The major sources of municipal own-revenue are property taxation, vehicle road tax, and business and commercial licences. In almost all countries property taxation is the most important of these. This is normally assessed on the basis of improved site value

(i.e. land plus buildings), and valuation is based on field measurement of physical characteristics with desk computation based on unit values for specific zones, land uses and standards of construction. Compared to the negative impact of the crisis on sources of taxation levied by central government—such as company tax (through lower profits), personal income tax (through higher unemployment) and VAT (through lower retail sales)—property taxation is ‘relatively’ protected from the crisis for three reasons. First, the asset base on which the tax is levied is highly immobile in the short-run; second, municipal finance laws usually stipulate the tariff rate, expressed as a percentage of the capital value, and central government usually allows little discretion for municipalities to vary this; and third, reassessment of properties to reflect changes in market values is infrequent.

Central governments may view cutbacks in IGFTs to local governments as an ‘easier’ political option

Together, these three factors help to maintain the ‘buoyancy’ and lower volatility of property tax in the face of economic recession. An increase in company failures and in vacant properties would certainly reduce the overall yield of property taxation and make it harder to collect. Nevertheless, other sources of own-revenue such as business licences, vehicle road tax and local service taxes are far more volatile than property taxation when a sudden downturn occurs in the macroeconomic environment.

Regarding inter-governmental fiscal transfers, the second major source of local government revenue, there are three main kinds: revenue sharing; transfers that are earmarked for specific sectors; and,

more recently, funding for targeted poverty reduction programmes.

Revenue sharing usually takes the form of multi-purpose block grants, with local government given a considerable degree of discretion over their use. In sharp contrast to own-revenue, IGFTs in the form of revenue sharing are far more vulnerable to the impact of the GFC. Given the high exposure of central government finances to the crisis—due to lower company and personal tax revenue, VAT receipts, and revenue from import duties and from natural resource extraction—there is likely to be increasing pressure from the central government level to cut back on IGFTs.

As stated in a [recent study](#) by [United Cities and Local Governments \(UCLG\)](#), which advocates for democratic local self-government, ‘The weak level of control that local authorities have over their own resources and their strong degree of dependence on transfers from the State makes their situation even more fragile in times of crisis, since for budgetary reasons, national governments reduce, slow down or simply eliminate the amounts allocated for local authorities’ ([Martínez et al. 2009](#), p. 5).

Even in those countries where laws stipulate that a fixed percentage of national fiscal revenue must be transferred to local government, the absolute level of IGFTs will necessarily fall as total fiscal revenue decreases. In countries where the level of IGFTs has increased substantially in recent years as part of a decentralisation programme, but without any accompanying statutory protection, then cutbacks in IGFTs may be viewed as an ‘easier’ political option than cutbacks elsewhere in central government expenditure.

Overall then, to the extent that municipalities rely on IGFTs or on own-revenue as their major source of income, they are more or less likely to experience problems on the revenue side of the fiscal balance. Here it should be noted that in almost all LMICs the less developed, more rural and demographically

smaller municipalities are more likely to depend on IGFTs than their more developed, more urbanised and demographically larger counterparts. Whether or not this is the case, it would be possible to infer that in most LMICs the GFC is likely to have a negative impact on horizontal (geographical) equity, in the short term. To the extent that this horizontal inequity overlaps with social equity, then these transmission mechanisms of the GFC through local government will have a negative impact on the overall distribution of income.

Expenditure

The typical expenditure profile of local government in LMICs continues to be the provision of basic public services like street lighting, cemeteries, markets, and bus stations, refuse collection and street cleaning. The involvement of local government in basic infrastructure services is usually limited to water and sanitation. In spite of the rhetoric, the involvement of municipalities in health and education continues to be relatively limited except in those countries where local government receives IGFTs specifically earmarked for these two sectors. The involvement of local government in targeted anti-poverty programmes, such as conditional cash transfer programmes, is also limited because central government often implements these programmes directly through newly established 'de-concentrated' agencies.

However, municipalities are likely to be the first to face the consequences of the increased poverty caused by the GFC as citizens turn to them for emergency services, support and safety nets in response to unemployment. The People's Republic of China offers an extreme case where the GFC has led to a sudden reversal of normal migratory patterns as millions of temporary workers have migrated from the large coastal cities back to their places of origin in rural areas because of the sharp reduction in urban job opportunities. This 'de-urbanisation' has

increased pressure on the provision of local services in rural areas, where local governments have least capacity to respond.

In order to counter rising unemployment in the private sector as a result of the GFC, there is likely to be considerable pressure on local government to create new employment opportunities. But there is an associated danger, especially where clientelism is prevalent, that increases in municipal staffing will simply become an 'employment creation' mechanism for its own sake thereby reducing the overall productivity of local service provision. Interestingly, early evidence of this comes from the USA. A [Rockefeller Institute of Government study](#) showed that while the private sector shed 6.9 million jobs between December 2007 and July 2009, state and local governments expanded their payrolls and added 110,000 jobs over the same period. The report highlighted that demand for many of the services government provides was quite stable or even rose in a recession and that there were efforts to preserve these services and the employment they rely on (Boyd 2009).

A further possible effect relates to the impact of the GFC on the distribution of local government expenditure between current spending and capital investment. At a time of fiscal austerity, compounded by the cutbacks on IGFTs, there will be a strong temptation to sacrifice capital investment rather than current spending. Instead of prioritising capital investment, or even imposing an across-the-board percentage cut in both current and capital expenditure, thereby maintaining the relative shares in total expenditure, the 'lumpiness' of capital investment provides a strong temptation to postpone or cancel individual projects. However, as the [UCLG study](#) noted, capital investment has actually increased in some countries because local governments participated in economic stimulus programmes that 'targeted local infrastructure projects as a quick way

to disburse money with a significant multiplier effect on local economic activity and employment' (Martínez et al. 2009, p. 10).

Larger municipalities that are concerned to maintain the schedule of planned investment projects at a time of fiscal constraint (especially reduced own-revenue) may be tempted to increase borrowing. In federal countries, states (or provinces) have greater freedom to borrow and this has sometimes contributed to macroeconomic instability in the past. In the USA the collapse of the municipal bond market in the wake of the GFC has virtually bankrupted local governments in some states. But in most countries there is now more extensive central government regulation of bond issues and bank borrowing by local government. Finally, although remittances are not directly a source of local government revenue, their sudden decrease as a result of the GFC may have a negative impact on municipal investment. This is especially so in those countries where local government 'matches' contributions from remittances for financing of local infrastructure projects.

Impacts on Decentralisation

Decentralisation has become a major component of the development strategy of many Commonwealth countries in recent decades. The reasons for this 'paradigm shift' have been hotly disputed. They include the linkage with democratisation, the need to heal the wounds in the relationship between the state and its citizens, and the search for greater efficiency in service provision based on the doctrine of subsidiarity. But a third explanation—the so-called 'fiscal crisis of the state'—is of particular interest in the present context (Nickson 2006). According to this view, which was particularly prevalent in Latin America during the 1980s, decentralisation was part of a neo-liberal strategy to correct a structural fiscal imbalance inherited from an earlier period of import-substituting industrialisation. The transfer of responsibilities from central to local government, carried out under external pressure from the International Monetary Fund (IMF) and World Bank, was seen as a way of 'offloading' the fiscal burden of service delivery

Box 1: GFC brings belt-tightening to local government in England and Wales

Municipalities in England and Wales are highly dependent on inter-governmental fiscal transfers, which account for 80 per cent of total local government income. As a result of the global financial crisis, the level of inter-governmental fiscal transfers over the period 2010 to 2012 is scheduled to fall in real terms. Own-revenue is also under pressure. Local governments raise £10.8 billion annually in 'user charges' but as residents cut back on their own expenditure, demand for these fee-paying services will inevitably fall.

The slump in the housing market, a major feature of the GFC, is also having a significant effect on local government own-revenue by reducing income from services such as land searches, asset sales, and receipts from developers that fund new investment. Belt-tightening of expenditure is now a priority, especially as the GFC has also come at a time when an ageing population is putting an extra strain on local government finances. Following the introduction of close performance monitoring by central government from 1997 onwards (in categories like 'Best Value', 'Comprehensive Performance Assessment' and 'Comprehensive Area Assessment'), most municipalities have already made the easier efficiency gains. They are now exploring innovative ways to make their money stretch even further. Smaller municipalities have looked at joint purchasing and sharing of highly skilled and specialist staff.

activities, such as health and education, which were formerly directly administered by central government. If this explanation is correct, then we should expect that the GFC will set off a further round of ‘decentralisation’, inspired by the sudden deterioration in the fiscal balance of central government as a result of declines in tax revenue and the accompanying pressures on expenditure to cope with the social consequences of the crisis.

Many countries will see a slow-down, if not a reversal, of decentralisation programmes

So, how is the GFC impacting on the decentralisation process? Is it slowing down this process, having a neutral effect or speeding it up? Are decentralisation programmes being pursued more or less aggressively as a result of the GFC? It is still too early to give definitive answers because the evidence is still so time-limited. But my hunch is that we are likely to see a slow-down, if not a reversal, of decentralisation programmes in many countries in the coming years, a view that is contrary to the earlier ‘fiscal crisis of the state’ hypothesis, which would predict the contrary.

My reasoning is the following. The sharp reduction in global trade and investment flows caused by the GFC, the first for many years, has led to a much greater scepticism in LMICs in general, with regard to the stated virtues of globalisation. The collapse of large parts of the banking sector has also led to a new scepticism with regard to the virtues of deregulation and the ‘free market’. In turn, this has led to a new interest in the so-called ‘developmental

state’ model, of which South Korea is the emblematic example. Under this strategy, central government pursues a vigorous ‘interventionist’ strategy through its close links with the private sector. This is a highly centralised development model in which local government plays a relatively secondary role. To date, there have been few conscious attempts by other governments in LMICs to copy this model. Instead, recent efforts in this direction have been influenced by a strong dose of populism. This has distorted the core concept of ‘embedded autonomy’, which is essential to the ‘developmental state’ model (Evans 1995), in favour of a traditional ‘statist’ approach to development strategy. Early evidence that the GFC is causing a reversal of the decentralisation process can be found in the [UCLG study](#), which suggests that ‘... under the pretext of crisis, in different countries in the South and most notably in Africa, the growing risk of neglect, or even regression, with respect to decentralisation processes has been noted’ ([Martínez et al. 2009](#), p. 5).

Responding to the GFC

There is a growing literature within the general field of ‘the role of institutions in development’ that stresses the importance of crises as mechanisms for altering so-called ‘path dependence’; that is, for altering ‘the way that things are done’ (North 1990). The role of ‘champions of change’ is crucial in bringing about this shift in direction. In this regard, there are three structural issues affecting local government for which the global financial crisis may well be a catalyst for change.

First, there is the question of weak administration of property taxation. There are several reasons why the effectiveness of property taxation (i.e. the amount collected in relation to the potential possible at current specified rates) is low in many countries. The most important reason is that the haphazard revision of the property cadastre often fails to record

the growth in the number of individual properties and their increasing complexity, especially in the informal housing sector. In addition, valuations are often grossly under-reported because of the system of self-assessment whereby property-owners are allowed to complete the forms that determine the declared value of their properties. The widespread use of progressive tariff rates in fixing tax liabilities means that the incentive to under-report is often strong. Furthermore, revaluation of unit values is infrequent—it is often postponed by central government decree, which invariably lags well behind the rate of inflation (except where automatic indexation is the norm). Finally, exemptions are rife in many countries. These may include government buildings as well as residential buildings of historical value. Although in most countries municipalities are legally empowered to tax rural as well as urban properties, in practice the latter are usually exempt. So the GFC could be a ‘blessing in disguise’, breaking the entrenched ‘path dependence’ by providing the ‘political’ opportunity for local government

increased in many countries as a result of attempts by local communities to better access inter-governmental fiscal transfers. At the same time, this significantly increases the overhead costs of service provision, especially where fragmentation takes place in rural areas. Even before the advent of the GFC, territorial amalgamation of municipalities had taken place in England and Wales, the Baltic nations and several countries in Eastern Europe in an attempt to reduce the unit costs of service provision. Although the GFC is likely to encourage this process, the prospects for such territorial amalgamation are bleak in many Commonwealth countries because it would be considered as a flagrant violation of municipal autonomy. However, it could provide the stimulus for much greater collaboration between municipalities in the shared provision of both services and skilled personnel.

Third, there is a need for local government to do more in support of the growing global concern to halt climate change and protect the environment. Most municipalities in the Commonwealth have yet to sign up to the [Local Agenda 21](#) package of measures arising from the [1992 Earth Summit](#) in Rio de Janeiro. It is clear that we are living on the cusp of a major shift in human behaviour in response to climate change. Just one recent example will suffice to demonstrate the potential role that local government can play. In a move designed to reduce carbon emissions, the importation of 100-watt traditional incandescent light bulbs into the EU was halted on 1 September 2009. The energy-saving light bulbs that have replaced them use 80 per cent less electricity. There are enormous savings that local governments throughout the Commonwealth can make in relatively simple ‘energy audits’ to reduce their own energy costs through the promotion of energy saving light bulbs, as well as the introduction of solar heating, proper building insulation, and automatic temperature controls on municipal

The GFC could provide opportunities to reform property taxation, and clamp down on tax evasion and avoidance

authorities in many Commonwealth countries to push through reforms in the administration of property taxation, clamping down on tax evasion and tax avoidance.

Second, there is the rigid manner in which municipal autonomy is understood in many countries. Territorial fragmentation has significantly

buildings. Recycling of domestic waste, now the norm in the EU, is still the exception not the rule in many Commonwealth countries. Indeed, times of crisis can be times of innovation and there is much that local governments can do by 'thinking global and acting local'.

Conclusion

The old maxim that 'every crisis is an opportunity' can be applied to the challenges posed by the global financial crisis to local governments throughout the Commonwealth. The need to protect jobs, incomes and municipal services from severe fiscal adjustment

Box 2: Cape Town investing in people

Despite the global economic downturn, there is 'no sense of a crisis' in Cape Town, South Africa, where investors are still pouring millions into inner-city developments. But the economic downturn has made the private sector more cautious and the public sector has been picking up much of the investment opportunities. Nevertheless, the locality is engaged in comprehensive long-term development plans that are indirectly helping the local economy and population to get through these turbulent times. These plans include a 15-year infrastructure development programme based on projected load growth and the assessed remaining life of the equipment. Hosting the 2010 FIFA World Cup gave the City of Cape Town a unique opportunity to improve its infrastructure and market itself to the world.

The 2009 pro-poverty-alleviation budget offered more support to those in need than any previous budget in the history of the city. Some examples of the allocations:

- R1.01 billion for free basic services, more than double the 2006 allocation of R456,000;
- Each household continued to receive 6,000 litres of free water per month;
- Free treatment of the first 4,200 litres of sewerage per household;
- A R3,000 grant to all indigent registered households and residential properties valued at R199,000 or below;

- Fifty free units of electricity to each household that buys less than 400 units per month;
- Free refuse removal at residential properties valued at less than R100,000;
- R10 million for rate rebates to pensioners and disabled people, with the income threshold lifted to R8,000 per month.

In order to further improve living conditions in disadvantaged communities, Cape Town's governance has been continuing to work on violence prevention through the Urban Upgrading programme. The R120 million project has been launched in Khayelitsha, and is starting up in Manenberg. It is a partnership between the City of Cape Town and the German Development Bank and will run over five years. Facilities being developed in the target areas include secure pedestrian walkways and bicycle tracks, well-managed open spaces, business, sport and public facilities, and the so-called 'active boxes', which are multifunctional community centres that will provide places of safety along pedestrian walkways. Typically, these will include a caretaker's flat and a room for area patrols. The project is based on community participation, and will offer a platform for residents to get involved in shaping their own suburb to suit their needs and lifestyle. It will involve the co-operation of 50,000 residents in each of the four areas where it is rolled out.

will be paramount in the short-term. However, the major test lies in promoting new strategies of 'local economic development' that are tailor-made to fit the particular local circumstances and sustainable over the longer term. The capacity of local governments to respond to this challenge will depend on the vision and innovation of their own leadership and their willingness to work in greater collaboration with private business, civil society organisations, different tiers of government as well as other municipalities at home and abroad. This willingness to embrace new strategic thinking about the future is encapsulated in the Barcelona Principles. An international group of municipal leaders devised these standards at a March 2009 workshop in Barcelona, Spain, which sought to identify key issues for local government in responding to the GFC.

The 10 standards known as the Barcelona Principles are as follows:

1. Don't waste the crisis, but respond with leadership and purpose.
2. Make the case for continued public investment and public services, and the taxes and other sources of investment required.
3. In the longer term: build local economic strategies that align with long-term drivers and identify future sources of jobs, enterprise, and innovation.
4. In the shorter term: focus on retaining productive people, business, incomes, jobs and investment projects.
5. Build the tools and approaches to attract and retain external investment over the longer term.
6. Build genuine long-term relationships with the private sector, trade unions and other key partners.
7. Take steps to ensure the sustainability and productivity of public works, infrastructure, and major developments/events.

8. Local leaders should act purposefully to support their citizens in the face of increased hardship.
9. Local economies have benefited and should continue to benefit from being open and attractive to international populations and capital.
10. Communicate and align with national and other higher tier governments.

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