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Coronavirus update on municipal finance: 2021 will be another nail biter

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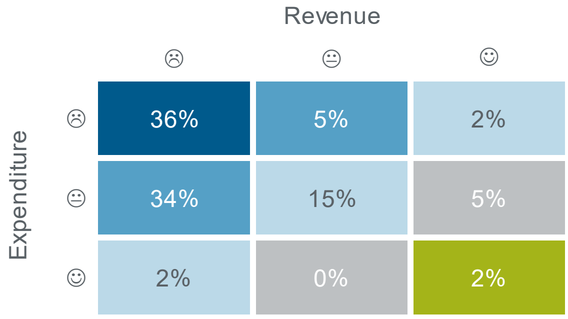
The coronavirus crisis has been going on for almost a year now. Although the German federal and state governments introduced a range of measures in 2020 to ease the strain on municipal budgets, municipalities continue to face considerable uncertainty, especially beyond the year 2021. This is evident from the responses returned by the municipalities surveyed for the KfW Municipal Panel 2021. In a preliminary evaluation we analysed expectations regarding the development of municipal expenditure and revenue. To be sure, public investment continues to ignore the crisis but the picture is clouding over especially in financially weak municipalities. With a view to the near future, there is a risk of significant cuts to investment and above all to discretionary spending on culture and the arts, sport and social services. Both expenditure categories, however, are of great importance for public services and quality of life in Germany. The uncertainty for municipal budgets thus threatens to unleash negative consequences that last well beyond the crisis period unless financial planning certainty can be created for municipalities.

The coronavirus crisis still has Germany firmly in its grip. The economic impact also has consequences for municipalities' financial position. The crisis left a deep hole in public coffers already before the second lockdown began. Overall, by the third quarter of 2020 the revenues of all state levels were around 4.3% lower than in the same period in the previous year, while spending levels were 11.6% higher than in the first three quarters of 2019.[1] But it will probably take months and years for the magnitude and extent of the crisis to become completely clear. That is also reflected in the responses municipal treasurers gave for the KfW Municipal Panel 2021. This paper provides a preliminary evaluation of the current impact of the coronavirus crisis and compares the findings with survey results from May 2020.[2]

Coronavirus crisis has a negative impact on finances

The current findings illustrate that municipalities believe the situation has not eased at all during the course of the year. On the contrary: compared with the first assessment at the outset of the crisis, the mood soured further up to the end of the year. In the current survey, some 73% of municipalities responded that their financial and budget situation – in terms of revenue – was poorer or even much poorer than they feared at the start of the crisis.[3] Only 18% saw no change in the course of the year, and just under 9% reported that their revenue situation was currently better than in April / May 2020. This assessment was significantly influenced by the fall in tax revenue, with commercial tax playing a particular role for municipalities.[4] For 70% of the surveyed municipalities, tax revenue was lower or even much lower than they had expected when the crisis began – even though the federal and state governments had already pledged to reimburse commercial tax revenue shortfalls totalling EUR 11.8 billion at the time of the survey.[5]

Figure 1: Sentiment in municipalities has deteriorated further

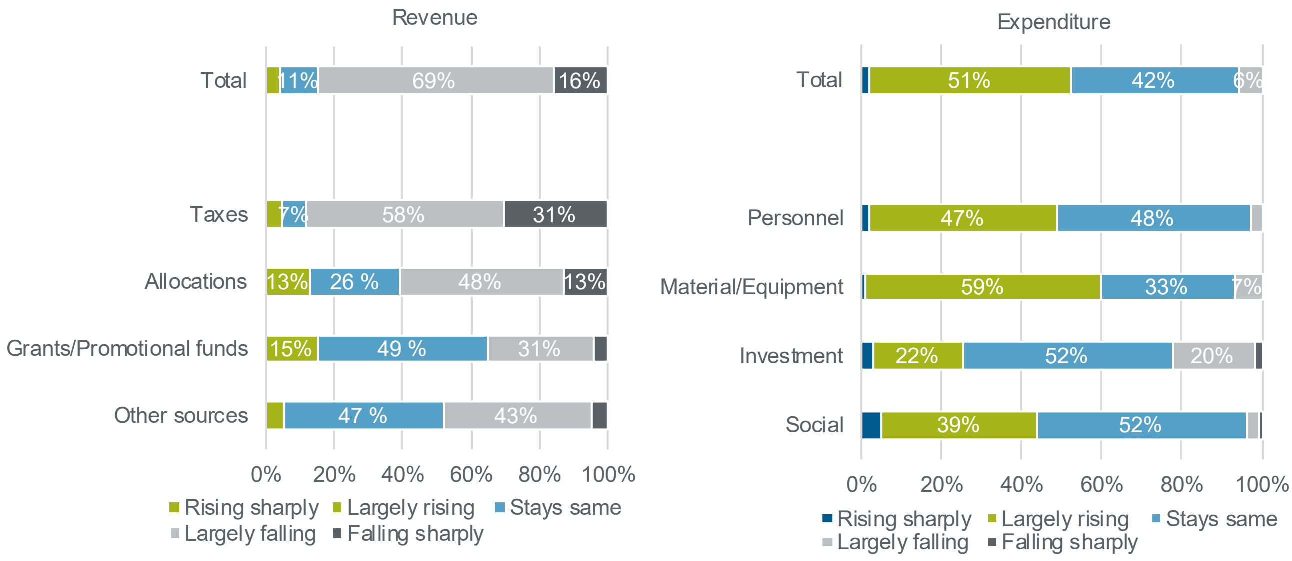


Guide: The figure displays the combination of assessments by municipal treasuries for the year 2020. A '☹' means that the municipalities currently regard the situation as 'rather worse' or 'much worse' than they did in April / May 2020. A '😐' therefore means an unchanged assessment, while a '☺' stands for a more positive assessment.

Source: KfW Municipal Panel 2021.

A considerable proportion of surveyed municipalities also hold a more pessimistic view of the expenditure side than in the spring of 2020. To be sure, some 54% of municipalities believe their expenditure situation is unchanged from their assessment in May 2020. At the same time, however, 43% regard their current expenditure situation as worse or even much worse. This development is mainly due to costs incurred for materials and equipment (e.g. pandemic-related personal protective gear and devices for home working), for which the situation at the end of 2020 was more negative in nearly 60% of municipalities than at the beginning of the coronavirus crisis. Here the expenditure and the revenue situation both deteriorated in more than one third of municipalities (36% – Figure 1).

Figure 2: Expectations for the future: Coronavirus crisis is leaving a mark in municipal budgets beyond 2021



Guide: The figure illustrates the expected effect of the coronavirus crisis on municipalities' medium-term financial and budget situation.

Source: KfW Municipal Panel 2021.

Another one third (34%) face lower revenues but unchanged expenditures, while expenditures and revenues have remained largely steady in a further 15%. Thus, during the course of the year 2020, the mood in municipalities with regard to both the revenue and the expenditure side deteriorated overall yet again.

Medium-term outlook shows stabilisation on low level

With a view to the year 2021 and beyond, the expectation is for the situation to at least stabilise, if on a low level. Overall, 85% of the surveyed municipal treasurers currently expect revenue for 2021 and the following years to decline in comparison with the budget situation before the pandemic (Figure 2). In May 2020 that rate was on a similar level of around 88%. A mere 4% currently expect revenues to outgrow their initial budget planning. The development of tax revenues has the strongest impact for the medium term as well, with 58% of municipalities (52% in May) expecting revenues to decline, while a further 31% (37% in May) even expect revenues to drop sharply in the years from 2021. Only 5% currently expect tax revenues to rise.[6]

The same applies to expectations on the expenditure side. Around 52% of municipalities currently expect overall expenditure to grow, while that figure was around 61% in May. Only 6% of municipalities can imagine reducing expenditure in the years ahead (10% in May). Many also expect individual types of expenditure to rise as a result of the crisis.[7]

The medium-term outlook for municipal investment has brightened slightly. Whereas just under 26% of surveyed municipalities expect higher investment as a result of the crisis, 22% predict a decrease (in May 2020 the ratio was still 26% to 31%). The proportion of municipalities that expect higher investment, however, is probably in part the result of a crisis-induced shift in political priorities and investment needs. At the same time, the share of municipalities that expect a decline in investment is a sign of decreasing budgetary scope cause by the crisis. This mixed picture is likely due to the great uncertainty about further developments. A majority of 52% of municipalities therefore prefer to wait and see, commenting that their investment expenditures will not be influenced by the coronavirus crisis in the medium term. However, the average investment level of the past years can be maintained only if the losses in revenue are not as heavy as is being feared. Municipalities will have to reduce their investments especially if their own funds decrease as a result of the crisis, an effect which 57% of municipalities are expecting.[8]

In the crisis, municipalities expect more investment in digitalisation and climate action

Even if the medium-term investment of the coming years cannot be estimated with much certainty at this stage, shifts among investment priorities are already becoming apparent. Despite expected crisis-induced revenue losses, investment in digitalisation is becoming most important for a majority of municipalities.[9] Among the surveyed municipalities, 51% expect investment expenditure on digitalisation to increase, and a further 13% even expect a sharp increase. Only around 8% believe that the crisis will dampen investment in digitalisation as well. The associated expectations, however, are definitely mixed. Barely 51% of municipalities agree with the statement that digitalisation will make administrative processes easier in the medium term, for instance because processes can be simplified or organised more cost-effectively.

Municipal investment in climate action and climate change adaptation also appears to largely ignore the expected revenue losses. Around 33% of municipalities actually expect investment in this area to grow, 50% expect investment to remain steady and only 16% expect a decline. The trend in investment measures aimed at adapting to demographic change is similar, where 23% of municipalities expect an increase in investment expenditure while only 18% expect a drop. It remains to be seen in what ways municipalities may deal with the contradiction between declining overall investment and growing investment in individual areas, which essentially could be dissolved only by reducing investment shares devoted to other areas.

Discretionary activities in culture and the arts, sport and social services are most likely to be reduced

Budgetary leeway is diminishing as revenue falls and expenditure grows. German local government associations expect annual financing deficits of around EUR 10 billion in the coming years.[10] As many expenditure items (especially human resources and social services) are prescribed by law, consolidations can be realised primarily in disposable investments and discretionary activities.

Of the discretionary activities surveyed for the KfW Municipal Panel, business promotion is the only area where investment may grow – with 20% of municipalities expecting to increase their expenditure. An equally large percentage expects to spend less, however. Culture and the arts will be hit harder. Owing to the expected revenue losses resulting from the coronavirus pandemic, 42% of municipalities expect to spend less on cultural activities in the future. Only 6% can imagine spending more on theatres, museums and other cultural offerings. Sporting activities are similarly affected, for which 32% expect a decline in expenditure and only 9% an increase. Other social services, such as those for young people or senior citizens that are not already established by law in the form of social security benefits, are also likely to be reduced, with 27% of municipalities anticipating falling expenditures and just under 12% expecting an increase.

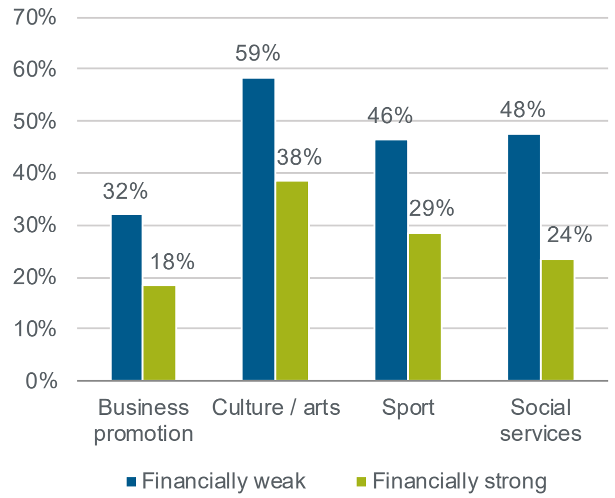
A municipality's financial strength plays a major role for its future expenditure on discretionary activities. Across all fields of activity surveyed, declines are expected by a significantly higher share of financially weak municipalities than financially strong municipalities (Figure 3).[11] That is an indication that in future, offerings in the areas of culture and the arts, sport and social services will be affected by coronavirus-induced spending cuts primarily in municipalities, cities and districts where budgets were already tight.

Initial financial relief measures were helpful; in the medium term municipalities see a need for structural adjustments

The federal government pledged financial relief to municipalities to address their concerns over massive revenue losses during the crisis. This, too, is the preferred short-term support measure which 64% of surveyed municipalities mentioned first. Significantly fewer municipalities, on the other hand, see the relief provided for social expenditure, e.g. through payment of 74% of housing expenses,[12] as an important contribution to immediate crisis management.

By contrast, municipalities regard structural adjustment to the allocation of financial resources as the second most important measure. This includes both raising the municipal share of Community taxes like VAT and reforming the municipal fiscal equalisation systems. But these are both conflicting policy proposals which are realistic over the medium term at best. Additional promotional programmes also tend to be seen by municipalities on a long timescale and tend to rank only third on the list of helpful medium-term measures.

Figure 3: Financially weak municipalities are more likely to expect cuts to discretionary activities



Guide: The graph shows the shares of financially weak and strong municipalities that expect 'largely' and 'strongly' decreasing expenditure in the areas stated as a result of the crisis. See footnote 11 for definition of 'financially weak / financially strong'.

Source: KfW Municipal Panel 2021.

Conclusion

Roughly a year into the coronavirus crisis, a first, cautious interim conclusion can be drawn on its financial impact on municipalities. The initial fears of revenue losses have materialised in many places. The financial support measures introduced for municipalities by the federal and state governments are therefore rated positively. But the full impact of the crisis on municipal finances will only be seen slowly over time. Over the medium-term outlook, the problem does not consist solely in expected revenue shortfalls but in simultaneously rising expenditure as well. High budget deficits are therefore foreseeable.

These financing gaps mean that discretionary municipal expenditure items are most at risk of cuts. And although municipal investment in cross-cutting areas such as digitalisation, climate action and demographic adaptation is turning out to be surprisingly robust in the crisis, a significant number of municipalities still expect investment expenditure to fall in the medium term. Once again, this particularly affects financially weak municipalities, thus following the familiar pattern of regional disparities in Germany. However, given its role in ensuring the functioning of a range of infrastructures and, hence, equitable living conditions in Germany, municipal investment activity is of particular importance. The only way in which the investment backlog, which according to the KfW Municipal Panel 2020 has accumulated to EUR 147 billion in the past years, can be cleared is by continuing along the path of increasing investment that municipalities have recently embarked on. This could contribute to strengthening the business cycle and achieving Germany's sustainability targets at the same time.[13]

Municipal investment plans respond to external shocks such as the coronavirus pandemic with a delay because of long lead-up times. A slump in investment expenditure can therefore not be identified yet. However, the current uncertainty makes it more difficult to plan investments for the coming years. If municipal investment loses steam, it will become harder to pick up the pace after the crisis and tackle the transformative challenges the nation is facing. Therefore, all policymakers should now pursue the goal of creating the financial planning certainty that municipalities need.

The detailed findings of the survey presented here can be viewed in a presentation that is available at **www.kfw.de/research-kommunen**.

The KfW Municipal Panel
The German Institute for Urban Affairs (Difu) invited an initial 2,205 municipalities to participate in the KfW Municipal Panel 2020 on behalf of KfW in the period from September to December 2020. A further 1,450 municipalities were surveyed in a supplementary sample from October. They were selected in accordance with a method that has been further developed since 2009 with the aim of gathering representative findings for all cities and municipalities with more than 2,000 inhabitants and all rural districts.[14] The survey response rate was 659 municipalities based on the initial sample, or 29.9%, and a further 106 municipalities from the supplementary sample, or 7.3%. A total of 765 municipalities thus participated. Representatives of municipal researchers and municipal practitioners contribute to the development of the questionnaire as members of a panel advisory board. The annual survey is supported by the German local government associations.
The KfW Municipal Panel 2021 is scheduled to be published in mid-May 2021 and will then be available for download at www.kfw.de/kommunalpanel.

[1] Cf. German Federal Statistical Office (2021): 'Öffentliche Ausgaben in den ersten drei Quartalen 2020 um 11,6 % höher, Einnahmen um 4,3 % niedriger als im Vorjahr' (*Public expenditure up 11.6% in first three quarters of 2020, revenues down 4.3% from previous year* – our title translation, in German only), press release no. 005 of 6 January 2021.

[2] For the results of the May 2020 survey see: Brand, S., J. Steinbrecher and Krone, E. (2020): Kommunalfinanzen in der Corona-Krise: Einbruch erwartet, Investitionen unter Druck (*Municipal finances in the coronavirus crisis: slump expected, investment under pressure* – in German only). Focus on Economics No. 289, KfW Research.

[3] The categories 'slightly lower' and 'much lower' were combined into 'lower', and the categories 'slightly higher' and 'much higher' were combined into 'higher'. In the following questions, the surveyed categories 'largely falling' and 'falling sharply' were combined into 'falling', and 'largely rising' and 'rising sharply' were combined into 'rising'. Unless explicitly stated, the remaining shares fell into the category 'remaining unchanged'. Deviations by one percentage point in the percentage values from the sums of the individual data in the figures of the combined categories provided in the text are due to rounding. 'Expenditures' and 'revenues' were surveyed for communities applying cameralistic principles, and 'disbursements' and 'deposits' were surveyed for communities using double-entry accounting, although the cameralistic terminology was used in the text to facilitate understanding.

[4] For a large number of municipalities, the current situation is also worse than was expected in May 2020 with respect to municipal revenues from allocations and fees, contributions and revenues from commercial activity. A substantial change from assessments in the spring can be identified only with respect to grants and promotional funds.

[5] See German Federal Ministry of Finance (2020): Maßnahmen zur Entlastung von Kommunen und der neuen Länder beschlossen (*Measures adopted to ease pressure on municipalities and eastern German states* – our title translation, in German only). Press release No. 14 dated 24 June 2020.

[6] The situation is only marginally better for the other types of revenue. With respect to allocations as well as fees, contributions and other revenues from commercial activity, 61 and 48% expect declines. Only 13 and 5% predict minor increases, while the remaining municipalities do not expect any change. Expectations for promotional funds are slightly better, not least against the backdrop of the economic stimulus programmes, with 35% expecting cuts and 15% forecasting an increase. Here as well, current assessments are very similar to the expectations voiced at the time of the previous survey in May. However, in future promotional funds are likely to become more important for investment finance specifically, as 66% of municipalities agree with this statement. And where municipalities draw on borrowed funds to finance their investments, 77% do not expect tighter borrowing criteria as a result of the crisis. Cf. also Brand, S. and Steinbrecher, J. (2021): Kommunalfinanzierung in der Corona-Krise – Einschnitte, aber eine Zeitenwende (Municipal finance in the coronavirus crisis – disruptions, but no inflection point – our title translation, in German only), Wirtschaftsdienst, 1st half, Year 101, page 46ff.

[7] A medium-term increase in expenditure on personnel and social services is being forecast by 49 and 44% of municipalities, while only 3 and 4% expect a reduction. With regard to the cost of materials and equipment, 60% predict an increase while 7% expect a reduction. Here as well, expectations are on a similar level as in May 2020.

[8] The reply categories 'largely agree' and 'agree fully' were combined into 'agree', while the categories 'don't really agree' and 'completely disagree' were combined into 'don't agree'. Deviations by one percentage point in the percentage values of the combined categories provided in the text from the sums of the individual data in the figures are due to rounding. For more on financing pathways of municipal investments cf. Brand, S. and Steinbrecher, J. (2020): Kommunale Investitionen: Preiseffekte am Bau „fressen" Zinsentlastung auf (*Municipal investments: price effects in construction 'eat up' interest reductions* – our title translation, in German only), Focus on Economics No. 281, KfW Research.

[9] Cf. Brand, S., Steinbrecher, J. and Krone, E. (2020): Digitalisierung in Kommunen: Große Erwartungen treffen auf viele offene Fragen (*Digitalisation in municipalities: Great expectations collide with many open questions* – in German only). Focus on Economics No. 298, KfW Research and Brand, S. and Steinbrecher, J. (2021): Digitalisierung und Fachkräftemangel erfordern neue Personalpolitik in Kommunen (*Digitalisation and skills shortage call for new human resources policies in municipalities – in German only)*, Focus on Economics No. 314, KfW Research.

[10] Cf. Association of German Cities (2020): Finanzlage 2021 – Kommunen warnen vor Finanzloch von 10 Milliarden Euro (*Financial position 2021 – municipalities warn of fiscal hole of EUR 10 billion* – our title translation, in German only). Press release from 1 December 2020.

[11] Financially weak municipalities are defined here as those that were unable to set up a balanced budget in the previous year (2019). If we use other criteria to define financial weakness such as failure to achieve a decent result in the previous year or the existence of a budgetary supervision plan in 2020, the results point in the same direction.

[12] The German Federal Government pledged to permanently cover 74% of payments for housing and heating under basic social security for jobseekers. That translates to relief of around EUR 3.4 billion for municipalities each year. Cf. German Federal Ministry of Finance (2020): loc cit

[13] Cf. Köhler-Geib, F. (2020): **Where to from here? The crucial next steps in the coronavirus crisis**. KfW Research position paper dated 20 August 2020.

[14] For details on the methodological procedure cf. Krone, E. and Scheller, H.: 10 Jahre KfW-Kommunalpanel: Methodik der Datenerhebung und -aufbereitung (*Ten years of KfW Municipal Panel: data collection and analysis methodology* – in German only). Methodology paper on behalf of KfW Group.