Recent signs of improvement, but no turnaround yet

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The KfW Municipal Panel 2017[1] has identified a slight reduction in the investment backlog of municipalities as investment activity has started to pick up. The economic environment and funding opportunities are currently good for most municipalities. Investment activities even increased in structurally weak regions. Nevertheless, regional disparities continue to be a problem. In addition to the sound economic environment, progress in local public investment can largely be attributed to financial relief and investment promotion measures granted by the federal government and the states. The recent upturn in municipal investment activities therefore depends entirely on external factors. A sustainable and lasting reduction in the investment backlog requires further structural improvements of municipal investment capacities, attainable by (more) adequate funding of municipal tasks and strengthening municipalities' external and internal project management expertise.

Perceived investment backlog is decreasing

The KfW Municipal Panel 2017 has identified a drop in the municipalities' perceived investment backlog to EUR 126 billion. The investment backlog reported by the surveyed municipal treasuries has thus fallen below the previous year's level (2016: EUR 136 billion). This trend is in line with the financial statistics. In 2016 municipalities reported a positive fiscal balance of EUR 5.4 billion and increased investment expenditure of EUR 25.8 billion. Current improvements are chiefly driven by high tax revenue and financial relief and investment promotion programmes of the federal and state governments. Low interest rates have also eased the burden on budgets, enabling many municipalities to increase their investment expenditures.

Roads and schools remain major challenges

As in recent years, transport infrastructure (EUR 34.4 billion) and schools (EUR 32.8 billion) remain the areas with the greatest need for maintenance and investment. Public administration buildings as well as sports facilities follow at some distance, at EUR 11.3 billion and EUR 9.7 billion, respectively.

Absolute underinvestment is significantly lower in other areas of municipal responsibility, although some exhibit high percentage increases. Especially in the areas of healthcare, housing and IT infrastructure, the perceived investment needs are on the rise. This reflects current challenges facing many municipalities: accommodating and integrating refugees, digitalising and modernising their administration, adapting to an ageing society, but also the "growing pains" of the regions, whose populations continue to increase.

Expectations are cautiously optimistic

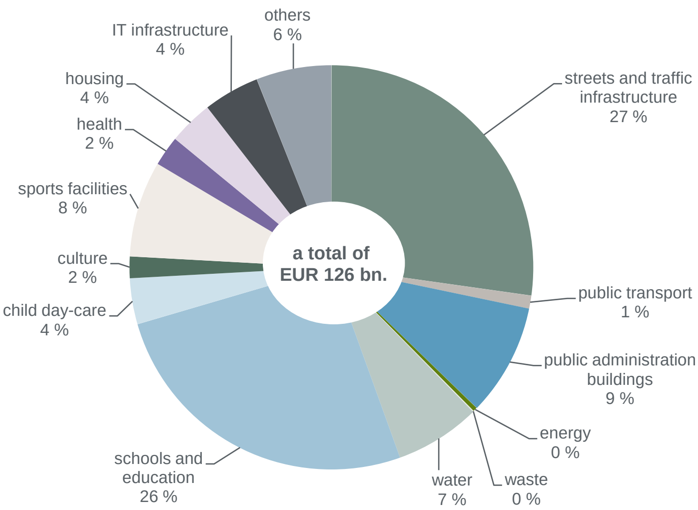
With a view to particular investment areas, the situation appears to be improving for schools and child day-care centres, where most municipal treasurers expect the investment backlog to fall in the next five years. This does not apply to roads, however, where more than one third of them still see a growing investment backlog. Overall, 35 % of the surveyed municipalities nevertheless expect the investment backlog to ease further. However, 20 % still expect a further increase. This ambiguity reflects regional disparities: municipalities that have deplored serious investment backlogs in the past years are less optimistic about the reduction in the future. This might also indicate that deferred investment and maintenance can lead to high follow-up costs, making it increasingly harder to tackle the investment backlog.

Municipal investment activity is picking up

Overall, the surveyed municipalities were planning to step up their investment by around 15 %. Against this background, a further reduction in the investment backlog can be expected. However, municipalities' investment planning is increasingly challenged by limited capacities of local administrations and the construction sector, as well as long planning processes. Investment planning also reflects regional disparities: municipalities faced with budget deficits invest around one fourth less. Although this actually reflects a reduced gap between prospering and weaker regions, the differences remain significant. In consequence, regional disparities are unlikely to diminish.

[1] Cf. Scheller, H. et al. (2017): KfW Municipal Panel 2017, published by KfW Group, Frankfurt am Main.

Figure: Municipalities' perceived investment backlog



Source: KfW Municipal Panel 2017, conducted by Difu from August to October 2016.

Investment finance is adequate

Municipalities primarily resort to self-funding (40 %) and bank loans (25 %) to fund their investments. Purpose-tied investment grants and promotional funds granted by higher federal levels make up nearly one fifth of total investment. Alternative funding instruments have not yet played a significant role for the vast majority of municipalities, chiefly because many of them usually perceive alternative financing as more complex and costly. Since the broad majority of German municipalities are rather small, they indeed struggle to pass the respective efficiency thresholds of alternative financing tools (e.g. EUR 25 million for PPP). Moreover, small municipalities with limited staff are hardly able to provide the extensive expertise required to conduct alternative financing. In consequence, treasurers expect alternative financing to continue to contribute only little to the municipalities' financing, whereas the importance of promotional funds and municipal loans is expected to increase further.

Borrowing conditions for most municipalities are good

The current low interest rate environment makes debt financing particularly attractive. This holds true for municipalities as well. Across all maturities, a significantly higher number of surveyed treasurers have perceived an improvement rather than a deterioration of their lending conditions. Some 60 % of treasurers reported that the number of loan offers they receive has not changed in the past five years. The same applies to large-volume loans with long maturities, which are particularly important to finance investments. However, as the credit volume rises, municipalities are asking for significantly more loan offers, while the gap between loan applications and loan offers is increasing in credit volume. In addition, roughly one third of municipalities, among them highly indebted cities, have already noted a decline in loan offers, particularly for high volumes and long maturities.

Special topic: debt management

Recent developments in the municipal credit market have a variety of causes, both within the municipalities and in the banking industry. This year's special topic addresses municipal debt management and explores how municipalities can respond to such developments. The results indicate that municipal debt management focuses on optimising terms and fixed-interest periods (59 %) and adjusting to the current interest rate level (42 %). Market observation (35 %) and portfolio analysis (28 %) are also quite common measures. Although particularly highly indebted municipalities are seeking a more diversified creditor structure, only 7 % of the surveyed treasurers rate creditor diversification as very important for municipalities' debt management.

In order to improve their credit management, municipalities want simple bank products and procedures (72 %). A closer linkage between debt management and liquidity and financial planning (70 is also regarded as useful, as well as further training of municipal treasury staff (58 %). On the other hand, they do not consider hiring additional staff (9 %) or cooperation with other municipalities (16 %) or the states (9 %) very helpful. ■

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