Too soon to sound the all-clear – coronavirus may yet hit municipal finances where it hurts

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Municipalities in Germany managed to close the coronavirus year 2020 with a financing surplus. Although they posted a negative fiscal balance in the first three quarters, financial support from the federal and state governments towards the end of the year prevented the worst outcomes. Still, the outlook for the current year and the near future is uncertain. Municipal treasurers have become much more pessimistic. This can adversely affect investment and non-mandatory public services. For the moment, municipal investment is still resisting the crisis. The responses from municipalities under the KfW Municipal Panel 2021 show that, for now, investment plans remain steady in the crisis. Nevertheless, even the increased investment is hardly adequate to maintain existing capital stock. As a result, the perceived investment backlog has grown by around EUR 2 billion to now EUR 149 billion in total. Meeting this investment challenge – including those involving urgent megatrends such as digitalisation and climate action – requires municipalities' investment capacity to be sustainably strengthened.

Municipalities' financial position is marked by great uncertainty

In the first three quarters of 2020, the financial statistics of municipalities indicated the largest financing deficit since the global financial crisis. Only the support measures provided by the federal and state governments, which became cash-effective particularly in the fourth quarter, prevented the worst and led to a financing surplus of EUR 2.2 billion. But up to then, the coronavirus year 2020 was characterised by great uncertainty regarding the financial impact the crisis would have for municipalities, as revealed by the responses received from the 765 treasurers to the survey conducted by the German Institute for Urban Affairs (Difu) for the KfW Municipal Panel 2021. Their assessments of the current financial situation deteriorated substantially. The mood plunged even more steeply with a view to the coming years. Whereas municipalities managed to get through the last year with surprisingly few bruises, the outlook for the current year 2021 and the near future is uncertain. Many consequences of the crisis will only appear in the medium term, so it is still too soon to give the all-clear.

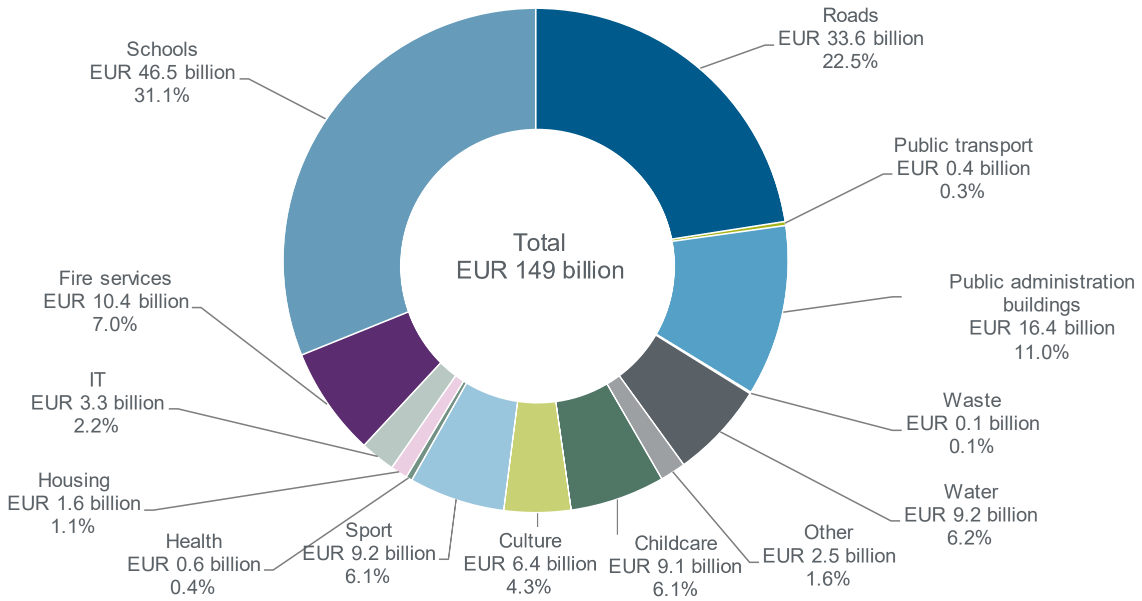
Municipal investments still resist the crisis

Municipal investment activity is of great importance for Germany. Municipalities are responsible for around one third of overall public investment expenditure and a good one half of public construction measures. They make a crucial contribution to the transformations that need to be undertaken to reach climate neutrality and digitalise public administrations. So it is all the more pleasing that municipalities have not (yet) cut their investment activity despite the crisis. At EUR 39.2 billion, municipal treasuries expect a further increase in their planning for 2021 as well. In this way, municipalities contribute not just to stabilising the business cycle but also to securing the competitiveness of the business location and achieving good living conditions for local residents.

But even the increased investment level is still hardly sufficient to make up for the asset erosion already taking place in existing infrastructure. Net municipal investment has been consistently negative since 2003. This is also reflected in the perceived investment backlog, which increased to a total of EUR 149 billion in 2020 (see figure). This represented a minor increase of EUR 2 billion on the previous year. In view of the crisis, municipalities could also have undertaken a reassessment of their unmet investment needs. In reality, the consistent response behaviour illustrates that municipal investment is determined by structural and, hence, more long-term influencing factors.

Recent increases in construction prices have been among the drivers of the investment backlog because, although they were spending more, municipalities could not build more infrastructure. But price growth took a break in 2020. Increasing maintenance deficits are a further issue. Of those municipalities that reported a severe investment backlog, 46% indicated that they were unable to cover the maintenance of their infrastructure in the past five years, or only a small portion of it, whereas 85% of municipalities with only a minor investment backlog reported that they were largely able to cover their ongoing maintenance costs. This disparity is evident despite the positive economic environment of the past years and it might be further accentuated by the economic consequences of the crisis in the future.

Municipalities' perceived investment backlog in 2020



Source: KfW Municipal Panel 2021, conducted by Difu from September to December 2020

The crisis has changed investment priorities

There have been no major variations in the structure of the municipal investment backlog. Roads, schools and administrative buildings remain the areas with the widest investment gaps. The cross-cutting task of 'digitalisation' has gained in importance, however, with 64% of surveyed municipalities predicting a growing share of investment expenditure in this area. Only around 32% expect this to be the case for climate action and only 22% for demographic change. The vast majority does not expect the crisis to have caused any change here. But that does not apply to many non-mandatory public services, particularly in the arts and culture as well as in sport. In these areas, 42 and 32%, respectively, predict that they will have to cut funding if the budget goes into deficit. Should (tax) revenues remain significantly lower, 57% of municipalities predict that investment will also have to be reduced – irrespective of priority.

The importance of municipalities' own resources for municipal investment cannot be rated highly enough. The financing mix includes 19% general public funds, which are mainly composed of tax revenues and fiscal transfers, as well as 17% liquidity reserves from the surpluses of previous years. These types of revenues in particular are suffering under the crisis. Tax revenues have already visibly decreased and municipalities now fear a delayed adjustment of fiscal transfers. It is therefore not surprising that 55% of municipalities expect more investment to be financed on credit in future in order to offset revenue losses. Financing alternatives such as the sale of assets have, therefore, also been mentioned much more often already.

Stabilising municipalities' investment capacity requires measures that work in the short and long term

Long lead times are the reason municipal investments do not respond immediately to an external shock such as the coronavirus crisis. This opens up a window of opportunity in which policymakers can initiate measures aimed at stabilising investment. The federal and state governments have done this successfully for the past year but municipalities do not have the financial planning certainty they need for the current year and the near future. However, once investments have been halted it takes time to gradually ramp them up again. Not least, this affects personnel capacities which already present a bottleneck. The crisis can cause a setback here because 65% of municipalities fear a further crisis-induced deterioration of their personnel situation in planning-relevant areas. But, with a view to the significant challenges, Germany cannot afford to allow municipal investment to lose momentum.

The municipalities themselves mentioned compensation for crisis-induced revenue losses (e.g. as a result of tax shortfalls) as the most important short-term measure to stabilise their investment activity. For the long term, they mentioned structural reforms more often, including modifications to the distribution of public finances. This opens up opportunities that point beyond pure crisis management. These ongoing policy issues must be addressed without delay. After all, the great structural challenges are not taking a break and will become all the more urgent once the coronavirus crisis has been overcome.

The KfW Municipal Panel

The KfW Municipal Panel is based on an annual survey of treasuries of cities and municipalities with more than 2,000 inhabitants and of all rural districts. The survey is conducted by the German Institute for Urban Affairs (Difu) and supported by the leading municipal associations. The panel advisory board includes municipal representatives and researchers.

The complete KfW Municipal Panel can be accessed at www.kfw.de/kommunalpanel (in German only).

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