

»» Crisis as a permanent state? Municipalities under strain from COVID-19 crisis, flood disasters and Ukraine war

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While the KfW Municipal Panel 2022 is focused on mapping the effects of the coronavirus crisis and the flood disaster of 2021, the next challenges for municipalities from the impact of the Ukraine war are already foreseeable. Growing investment needs are creating a higher investment backlog amid significantly higher construction prices. At the same time the budget position of many municipalities remains difficult despite the improved overall situation. It is again becoming clear that municipal finances in Germany need more resilience so that cities, communities and rural districts can cope with the challenges that they face without major disruptions even in times of crisis.

Cautious outlook despite improved economic situation

The KfW Municipal Panel 2022 shows that municipalities have further downgraded their assessment of their financial position. Although the survey year 2021 closed with a financial surplus of +EUR 4.6 billion on the back of surprisingly strong tax revenue growth, around 48% of surveyed municipal treasurers rate their financial position only as 'barely adequate' or even 'inadequate', while only 21% rate their financial position in the second coronavirus year as 'good' or 'very good'.

One likely reason for the cautious assessment is the uncertain and uneven development of their finances. Thus, municipalities benefit to varying degrees from the most recent revenue growth, much of which is due to higher local business tax in structurally strong regions. However, almost all municipalities incur the additional expenditure, for example from higher costs of materials and equipment for their pandemic response. Most municipalities therefore expect their budgets to take two to five years to return to pre-crisis levels.

As a consequence, 70% of treasurers expect their financial position to worsen in the medium term, while only 9% expect an improvement. This shows that the mood has slightly improved on the previous year but remains below the long-term average. The impact of the Ukraine war, which did not yet play a role at the time of the survey, has not even been taken into account here. A follow-up survey to the KfW Municipal Panel of April this year shows, however, that the higher energy prices alone are already having tangible effects on many municipalities and prompting budgetary or energy management adjustments in many places.

Investment in times of rising construction prices

In their investment planning, the surveyed municipalities still expect an increase to EUR 40.6 billion for 2022 despite the financial planning risks. However, assessments for last year have shown again that around one third of planned investments could not be realised. Furthermore, the high amounts should not obscure the fact that a significant portion of the increased investment expenditure is attributable to the steep rises in construction prices, so that it is not necessarily the case that municipalities can indeed undertake more investments in infrastructure in real terms.

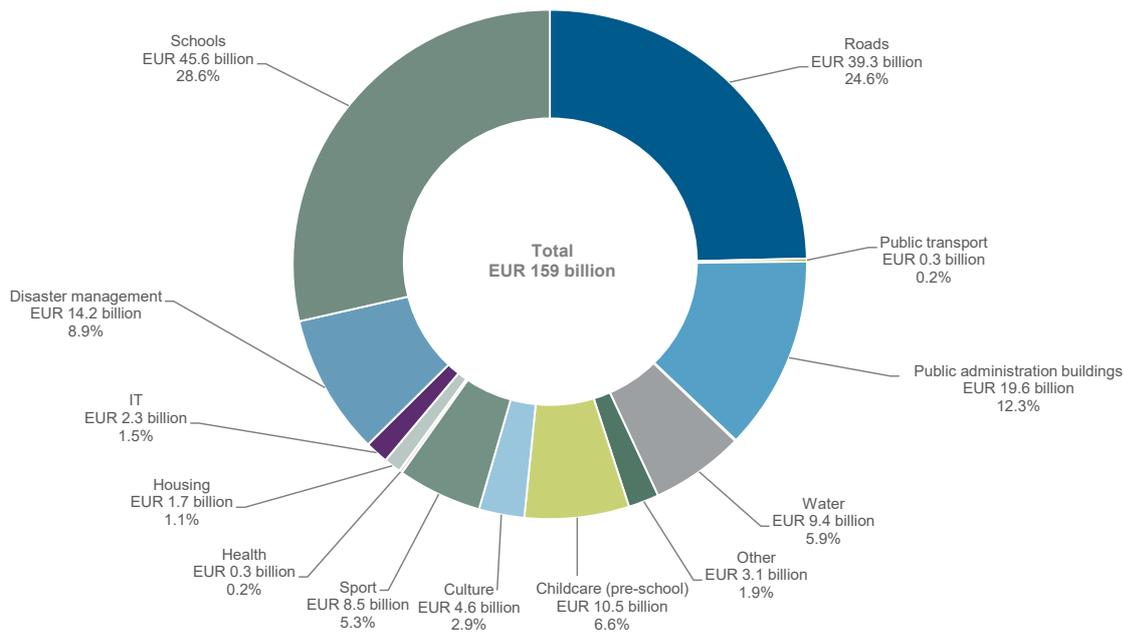
In addition, the survey findings reveal a shift in investment priorities last year. Municipalities see much greater needs in schools, IT and disaster management – areas that came under particular public scrutiny because of the pandemic and natural disasters.

Investment backlog grows by nearly EUR 10 billion

It is intuitively plausible that significantly growing investment needs, high construction prices and only moderately rising investment mean that the perceived investment backlog has grown to EUR 159.4 billion. Schools (28.6%), roads (24.6%) and administrative buildings (12.3%) again account for the largest shares. The strongest growth was recorded in roads (+EUR 5.7 billion), disaster management (+EUR 3.8 billion) and administrative buildings (+EUR 3.3 billion), while minor decreases took place in areas such as arts and culture, IT, schools and sport.

Roads and transport infrastructure in particular are seemingly becoming municipalities' 'problem child' again, since they have also downgraded their assessments of their state of repair and are less able to ensure their ongoing maintenance. Therefore, 48% of the surveyed treasurers expect the investment gap to continue widening, while only 23% can imagine that the investment backlog will ease. Across all investment areas, 28% of municipalities expect the investment backlog to continue growing, while 36% expect no change and another 36% can even imagine a decline.

Municipalities' perceived investment backlog in 2021



Source: KfW Municipal Panel 2022, conducted by Difu from September to December 2021

Investment finance shifts to loans and promotional funds

Whether municipalities can actually tackle their investment needs to the extent necessary is also determined by their financing options. They have made changes to their instrument mix in response to the crisis. In 2021 around one quarter of municipal investment was financed from municipal loans, a sharp rise on previous years. Municipalities' own funds had a share of 36%. These include budget surpluses from the previous year (23%) and freely disposable revenues, that is tax revenues and key allocations, which amounted to 13%. The importance of promotional funds increased again (25%), while purpose-tied investment allocations fell to 11%.

Municipalities expect this development to continue in the form of a larger proportion of loans and promotional funds in investment finance. In particular, the debt incurred is likely to remain in the books for many years as a reminder of the coronavirus crisis, since nearly half the municipalities expect to take more than ten years to be able to repay this debt.

Crisis-resistant municipal finances are a prerequisite for functioning municipalities

Already the Ukraine war is creating administrative and financial strain for German municipalities. The top priority is to accommodate and integrate the refugees. At the same time, many questions raised around security and preparedness of public services will require an investment response from municipalities, for example in the expansion of warning systems and protection of critical infrastructures. Higher energy prices are another element of increased municipal expenditure. These additional needs contrast with municipalities' fragile revenues, which are likely to be further impacted by the economic distortions caused by the war in

Ukraine.

At the same time, the consequences of the coronavirus crisis have not even been fully processed, as shown by the findings of the KfW Municipal Panel 2022. As was the case at the start of the coronavirus crisis, municipalities are again anxious about how well their budgets can be endowed to face these major risks.

Municipalities already have enough on their plates even without these crises. In addition to their permanent duties to provide general public services, they face the transformative challenges of climate action, demographics and digitalisation, which require comprehensive changes to municipal infrastructure and services. Without sufficient planning certainty, the investments needed here are at risk of being axed yet again to save costs. More than half the surveyed municipalities responded that their funding needs to be improved on a sustained basis in order to make municipal finances crisis-resistant. However, such structural strengthening would have to address both the volume and the reliability of finance to ensure even in troubled times that municipalities retain their urgently needed capacity to perform their functions.

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).