KfW Research
KfW Municipal Panel 2023 – Summary

German municipalities are defying the crises but are already facing new risks

May 2023

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The year 2022 was another one marred by various crises. The impact of the COVID-19 pandemic and the flood in the Ahr Valley were not yet overcome when the war in Ukraine with a growing influx of refugees, disruptions to global supply chains and, most of all, massive energy price increases created new challenges for cities, communities and rural districts. Despite these multiple crises and the negative outlook for municipal finances that was associated with them, the responses returned by the treasuries under the KfW Municipal Panel 2023 indicated stability. Their current financial position and investments are both robust, the perceived investment backlog is growing only moderately and funding opportunities are still adequate despite the interest rate reversal.

Numerous budgetary risks such as high price increases and rising interest rates, however, are severely clouding municipalities' expectations for their future financial position and financing conditions. These uncertainties are putting them at risk of falling behind with the transformative challenges they are facing. It is becoming clear yet again that the fragile budgets of municipalities are making it hard to systematically and vigorously increase public investment.

Despite a surprisingly positive financial position, expectations are now lower than ever

So far, municipalities have managed the current crises surprisingly well in spite of the many budgetary challenges they have faced. According to the cash statistics, the fiscal balance in 2022 was +EUR 2.6 billion. However, this average amount masks wide differences between financially strong and weak municipalities. Specifically, 21% of the municipalities surveyed under the KfW Municipal Panel 2023 rated their financial position as 'good' and 2% as 'very good'. By contrast, 28% described their financial position as 'inadequate'. The mood is thus comparable to that of the previous year. Across the nation, however, municipalities have become more worried about the future. Just 7% expect a 'rather more positive' development of their financial position in the next five years, while 10% expect it to remain 'unchanged'. The vast majority of 57% expect a 'rather negative' and a further 26% even a 'very negative' development.

One explanation for these bleaker expectations is the foreseeable inflation-induced additional expenditure which the municipalities will have to shoulder for materials and equipment as well as staff in the form of higher collective bargaining agreements. Besides, uncertainty remains about how to finance the costs of caring for the refugees, so that considerable financial risks remain for municipal budgets in addition to the business cycle-related uncertainties.

Municipal investments are defying the crises but expenditure growth can hardly keep up with price rises

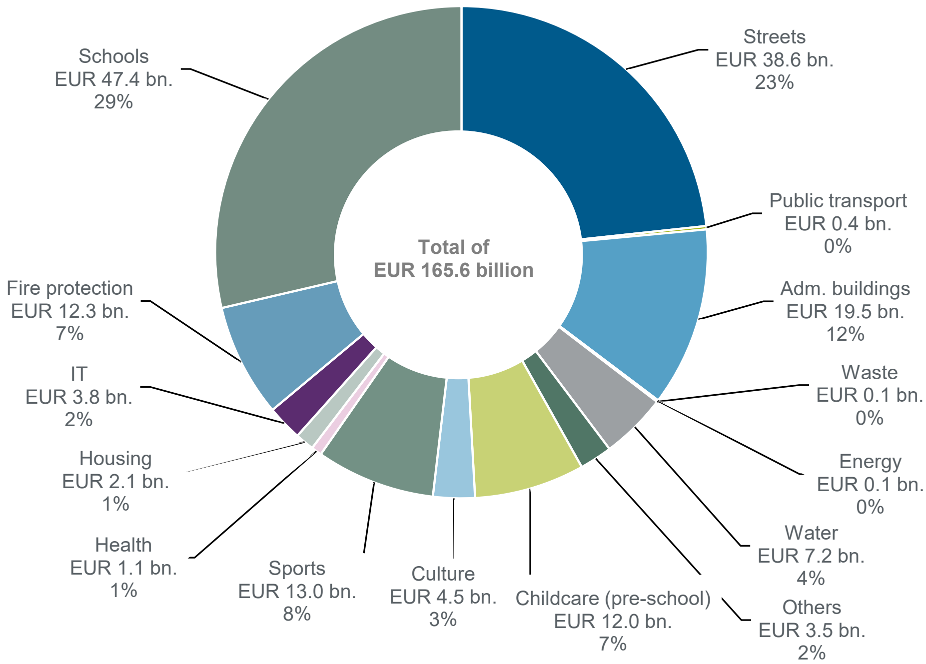
So far, however, these negative expectations have hardly affected investment plans. The investment expenditure of municipalities with more than 2,000 inhabitants is projected to increase by EUR 1.8 billion this year to EUR 43.1 billion. The steady growth in investment expenditure of the past years will therefore continue. However, given the massive increases in construction prices it is doubtful whether this growth will be sufficient to increase investment in the public capital stock in real terms, partly because municipalities have been unable to realise a considerable portion of the planned investments within the scheduled timeframes. School buildings and roads, with EUR 12.1 billion and EUR 10.8 billion respectively, continue to be the largest planned investment items in the municipalities' core budgets.

Investment backlog has grown moderately, structural causes are hampering its reduction

The development of the investment backlog also illustrates how investments have increased. It is true that the estimated perceived nationwide investment backlog has grown by just under EUR 7 billion to around EUR 166 billion in total. But given the price increases and pent-up needs that became evident in the course of the most recent crises, this increase can be seen as rather moderate. The largest backlogs can be identified in school buildings (EUR 47.4 billion), roads (EUR 38.6 billion) and administrative buildings (EUR 19.5 billion).

The investment backlog is primarily due to structural causes. Thus, financially weak municipalities face greater challenges in ensuring the ongoing maintenance of their infrastructure, which is why it more often exhibits serious deficits. Overall, 62% of the financially weak municipalities reported a 'severe' or 'significant' investment backlog, compared with 46% of the financially strong municipalities. The expectations on how the investment backlog will develop over the next five years are distributed almost evenly, with 30% expecting a reduction and 34% an increase.

Municipalities' perceived investment backlogs



Source: KfW Municipal Panel 2023, conducted by Difu from September to December 2022.

For the areas of schools and child day-care centres, 42 and 41%, respectively, expect an improvement, partly because a number of projects were launched in recent years and promotional programmes helped providers meet the additional legal requirements. By contrast, roads are seen as an area with major problems where a relative majority of 45% expect the investment backlog to increase.

Funding is increasingly determined by factors that are beyond the control of the municipalities

The importance of municipalities' own funds, i.e. tax revenue and key allocations, has fallen again in the funding mix. Freely available funds still amount to 38% and purpose-tied allocations account for 10%. Funds from third parties, namely promotional funds and municipal loans, now represent 22 and 25%, respectively. The significance of the individual funding instruments heavily depends on the municipalities' size and, thus, tasks to be completed and funds required. The financial position also has an influence, since own funds play a more important role in financially strong municipalities while financially weak ones are more likely to resort to loans. Financially weak municipalities use promotional funds at a rate that is only 2 percentage points higher. This is plausible because promotional funds are often based on the volume of investment, which is higher in financially strong municipalities. On the other hand, the targeted support of financially weak municipalities, which many promotional programmes address, does not appear to have much leverage.

Rising interest-rates and economic risks lead to growing concerns among treasurers

With a view to the current year, municipalities tend to expect the share of own funds in the funding mix to decrease further, while municipal loans are set to gain in importance and offset the decline. Around 56% of municipalities expect to borrow more this year but treasuries already see a deterioration in borrowing conditions. Although 43% of municipalities rated borrowing conditions 'very good' or 'rather good' at the end of 2022, these ratings show a decline of 18 percentage points on the previous year. The interest rate reversal has also generated lower expectations, with 57% of municipalities now expecting a significant deterioration of financing conditions in the next 12 months, compared with 20% in the previous year. In response to the changed conditions, 62% of municipalities are adopting various measures to deal with the rising interest rates.

Climate change mitigation and adaptation requires adequate funding

In this year's special survey topic, the KfW Municipal Panel addresses climate change mitigation and adaptation measures as probably the largest transformative task municipalities currently face. The responses returned show that around 15% of municipal investments are already directed at climate change mitigation and adaptation. At the same time, municipalities anticipate growing additional climate-relevant investment needs. The survey findings also show how important adequate and reliable funding is for them to be able to fulfil their tasks even in times of crisis, so that temporary crisis phenomena do not force them to delay responding to long-term transformative challenges.

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 representative nationwide survey is conducted by the German Institute for Urban Affairs (Difu) and supported by the leading municipal associations.

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

Publisher's details: KfW Group (eds.), Economics Department, Palmengartenstrasse 5-9, 60325 Frankfurt am Main, Germany, www.kfw.de/research