S&P Global Ratings

RatingsDirect®

Local Government Debt 2021: COVID Aftershocks Push German And Austrian LRGs Into Heavy Borrowing, But Not Swiss Peers

March 25, 2021

This report does not constitute a rating action.

PRIMARY CREDIT ANALYST

Thomas F Fischinger
Frankfurt
+ 49 693 399 9243
thomas.fischinger@spglobal.com

SECONDARY CONTACTS

Michelle Bozem
Frankfurt
(49) 69-33-999-104
michelle.bozem@spglobal.com

Felix Ejgel
London
+ 44 20 7176 6780
felix.ejgel@spglobal.com

Michael Stroschein
Frankfurt
+ 49 693 399 9251
michael.stroschein@spglobal.com

Key Takeaways

- The pandemic continues to push up borrowing needs for German states and municipalities and, combined with tax shortfalls, will lead to nearly €800 billion of debt by year-end 2022.
- Tax shortfalls and ongoing tax reform will result in low revenue in Austria, exacerbating weak economic prospects for 2021 following the third lockdown period, with local and regional governments' total debt increasing by €2.9 billion.
- A less pronounced economic decline and a more flexible tax system will allow Swiss cantons and municipalities to borrow only CHF16 billion in 2021, including a net borrowing requirement of CHF2 billion.

COVID-19 has pushed German and Austrian states and municipalities to increase borrowing, but S&P Global Ratings expects only a minor debt increase for Swiss cantons and municipalities. Deficits resulting from tax shortfalls will remain high in Germany, leading to nearly €800 billion (US$964.3 billion) debt accumulation by year-end 2022. We expect German local and regional governments (LRGs) to cover about one-half of their gross funding needs by issuing bonds, and to cover the rest with promissory notes and bank borrowing.

Similarly, we expect significant funding needs for Austrian states and municipalities, as the combined effect of tax shortfalls and a tax reform leads to low revenue also in 2021. Given lower economic forecasts for 2021 following the third lockdown period, Austrian LRGs will increase their debt by €2.9 billion (US$3.5 billion), slightly less than in 2020. The federal debt management office OeBFA continues to provide cost-attractive funding for Austrian states, but individual LRGs will tap public bond market issuance only opportunistically.

Swiss Cantons and municipalities enjoy a more flexible tax system and the pandemic provoked a less pronounced economic decline. Absent one-off effects like pension fund increases, we believe that Swiss cantons and municipalities will likely borrow only Swiss franc (CHF) 16 billion (US$17.4 billion) in 2021, including a net borrowing requirement of CHF2 billion. Although this is the first sectorwide net borrowing requirement in years, we do not expect that the overall positive debt dynamics will change.

Table 1

Local And Regional Government Gross Borrowing And Bond Issuance By Country

(Bil.€)	2017	2018	2019	2020e	2021e	2022e
Germany*	126.3	102.9	128.4	175.6	151.7	134.8
Thereof: German LRG bond issuance	52.3	49.4	60.2	112.1	70.9	51.7
Switzerland (Bil. CHF)	14.4	12.3	20.1	20.3	15.9	13.1
Thereof: Swiss LRG bond issuance	4.6	3.6	5.0	6.0	6.1	6.1
Austria§	6.5	5.1	4.6	8.2	6.9	5.6
Thereof: Austrian LRG bond issuance	0.6	0.3	0.0	0.9	0.1	0.1

e--Estimate *Including state-guaranteed winding-up agencies for former public sector banks and other guaranteed financing vehicles. LRG--Local and regional government. CHF-Swiss Franc. §Including state-guaranteed financing vehicles. Source: S&P Global Ratings.

Germany

German states wave the debt brake rule in 2021

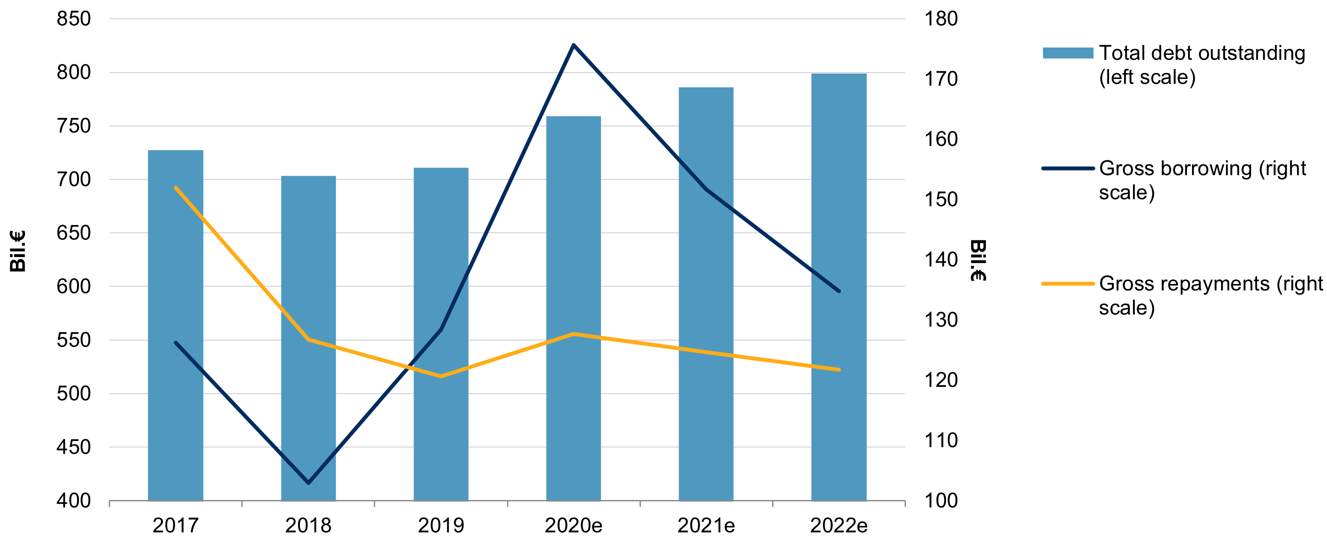
German states will lose nearly €100 billion in tax revenue over the next five years compared with what had been forecast before the pandemic. We believe that it will take at least until 2022 for their tax revenue to reach the nominal levels achieved in 2019, since the recovery of tax revenue will lag the economic rebound. The tax shortfalls in 2020 and also those estimated for 2021 will be more than twice the surplus German states achieved in 2019, exerting significant pressure on all states' finances. In addition, some states have announced large expenditure programs, which will raise deficits even further in excess of the revenue shortfalls. Some states' financial headroom (liquid assets available minus previously accumulated debt) and individual credit profiles deteriorated in 2020, which resulted in two downgrades and two negative outlooks assigned in 2020.

Most German states have paused the constitutional requirement for balanced accounts--the debt brake--for 2021, because budgetary deficits will require significant net new borrowing. The federal and states' constitutions allow for a deviation from the debt break rule in times of natural catastrophe, but we do not believe that they can use this excuse in the years after the pandemic.

We estimate that the annual gross borrowing requirement of German LRGs (states, state-sponsored wind-up agencies for former public-sector banks and other state-guaranteed financing vehicles, and municipalities) will amount to €151 billion in 2021 and €135 billion in 2022. This includes our estimate of a net borrowing requirement of €27 billion in 2021 and €13 billion in 2022. Consequently, we anticipate that the German LRGs' total amount of outstanding debt will increase to €785 billion by 2021 and about €800 billion in 2022, up from the low of €702 billion achieved in 2018 thanks to deleveraging. Our analysis incorporates debt borrowed from private sector lenders, but does not include debts granted from the central government to the states or between states.

Chart 1

German LRG Debt: Net New Borrowing In 2021 And 2022



LRG-Local and regional governments, including state-guaranteed winding-up agencies for former public sector banks and other guaranteed financing vehicles. e-Estimate. Source: S&P Global Ratings.

The projected debt increase, essentially owing to the temporary change in fiscal policies employed in Germany following the outbreak of the pandemic, contrasts significantly with our expectation last year of continued deleveraging (see "Local Government Debt 2020: Debt Reduction In Germany, A Swiss Pension Fund Recapitalization, And Small Net Borrowings In Austria," published March 2, 2020).

In 2020, German states' expenditure surpassed revenue by €39 billion, gobbling up the €13 billion surplus of 2019. We expect that municipalities will report deficits for 2020, as well, but significantly smaller ones than states, thanks to additional transfers received from higher-tier governments. According to preliminary data for 2020 recently published by the German Federal Ministry of Finance, all states posted deficits after capital accounts, varying from only €24 million in Saarland (or 0.5% of Saarland's operating revenue) to €11.6 billion in North Rhine-Westphalia (NRW; equivalent to 12.7% of the state's operating revenue).

Putting aside the states' size, in our view, the varying funding needs reflect the different approaches taken by the state governments. Some announced significant economic support programs, continuing also in 2021. Although we expect Germany's economy will rebound in 2021 as the pandemic abates, with real GDP growth at 3.7% in 2021 and 3.2% in 2022 (see "Sovereign Risk Indicators," published Dec. 14, 2020), we do not believe that tax revenue will rebound accordingly, leaving German states with a considerable deficit to be covered with net new borrowing. However, they will need to dramatically decrease deficits after 2021, because the debt break rule will will kick in again.

All German states share the burden of the national recession and face the same fate with tax shortfalls, similar to the central government. This is because Germany's system of interstate revenue equalization transfers spreads the revenue shortfalls across all states. However, the starting point for each state is different in terms of budgetary performance and debt, given past consolidation efforts, and consequently each state's financial room for maneuver vastly differs. They had varying success in consolidating their budgets prior to the pandemic. Baden-Wuerttemberg (AA+/Stable/A-1+), for instance, swiftly increased its borrowing and offered an extensive support package of €5 billion for the local economy, which has increased budgetary pressures way beyond tax shortfalls. Similarly, Saxony-Anhalt (AA/Stable/A-1+) had less room for additional expenditure, since the previously accumulated bad-weather funds were already earmarked before the pandemic, and so it deviated from its policy of net debt repayments and started to accumulate debt in 2020. We forecast this debt accumulation will continue for several years.

German states will dominate subsovereign debt issuance again, also in a global comparison

Based on our forecast deficits, we believe that the distribution of outstanding debt between the regional and the local level in Germany will continue to follow the traditional 80:20 split in the years to come. We estimate that the states will have raised debt of about €640 billion as of year-end 2021, and the 12,000 municipalities in Germany will have raised about €145 billion. The shorter average maturity of outstanding debt at the municipal level ensures that gross borrowing volumes will be slightly more evenly distributed across German government hierarchy levels than outstanding debt amounts. Taking this into account, we predict that the German state level will be responsible for €95.8 billion of new borrowing in 2021, while municipalities will contribute €33 billion.

With an outstanding amount of debt of more than €160 billion forecast for 2022, NRW clearly remains Germany's largest subnational government debtor. Even without considering the debt of any auxiliary budgets like Erste Abwicklungsanstalt (EAA, the wind-down agency for former WestLB) or Bau- und Liegenschaftsbetrieb NRW (the state's real estate holding and management vehicle), NRW actually owes more than all German municipalities combined. Already by virtue of having to refinance its portfolio's maturities, NRW is practically guaranteed to again have the largest gross borrowing needs of all German LRGs in 2021 and 2022 by a large margin.

Table 2

Rated German States' Adjusted Gross Borrowing

2021 estimates

	Adjusted gross borrowing (bil. €)	Ratings*
Baden-Wuerttemberg (State of)	5.5	AA+/Stable/A-1+
Bavaria (State of)	4.1	AAA/Stable/A-1+
Hesse (State of)	7.8	AA+/Negative/A-1+
North Rhine-Westphalia (State of)	20.4	AA/Stable/A-1+
Saxony (State of)	3.8	AAA/Negative/A-1+
Saxony-Anhalt (State of)	4.7	AA/Stable/A-1+

*As of March 15, 2021. Source: S&P Global Ratings

Although not very significant for the states, we estimate that about one-quarter (about €30 billion) of municipal debt still consists of loans that finance previously accumulated operating deficits (Kassenkredite). These loans were originally only intended as short-dated, liquidity-bridging instruments that were supposed to be quickly repaid, but they have developed a quasi-permanent character for the more fiscally challenged municipalities, which need to roll them over at maturity. With some states, including Hesse via its promotional bank Wirtschafts- und Infrastrukturbank Hessen (WIBank), have orchestrated programs to assume and refinance such loans from their local municipalities, we understand that the outstanding volume is now slowly declining. The remaining volume of Kassenkredite is, however, heavily concentrated at about 30 cities in the states of NRW, Rhineland-Palatinate, and Saarland, and in our view documents the ongoing fiscal pressure at these municipalities.

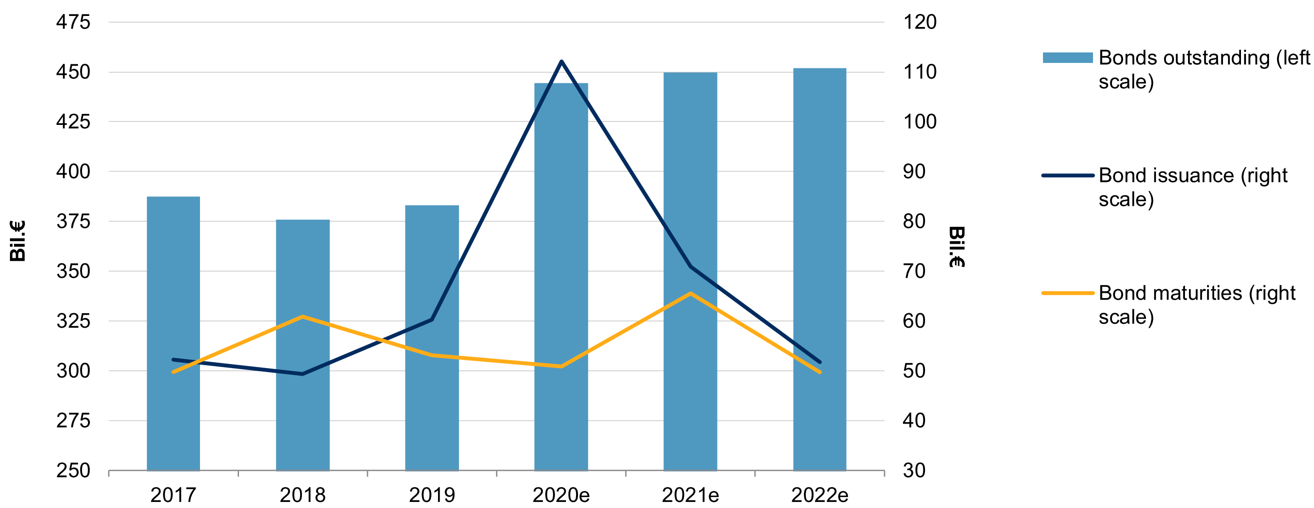
We do not incorporate the possibility of a transfer of the debt to the federal government into our projections, because we think it unlikely that these measures will be implemented before the elections for federal parliament in the third quarter of 2021.

Bonds issued by German states are one of the largest subsovereign debt markets globally

We anticipate German states will be among the largest subsovereign borrowers globally. We forecast German states will issue bonds worth about €60 billion in 2021 and €52 billion in 2022, with the rest covered by loans and private placements. In total, German states account for about 16% of the global subsovereign debt issuance. Actual bond issuance volumes are difficult to forecast accurately, however, since the states will make their ultimate borrowing decisions based on the various alternative instruments' relative attractiveness at the time of issuance. Furthermore, we believe that potential changes in the many ECB bond-buying programs will influence states' choice of debt instruments, and therefore the relative share of bond issuance might increase in 2021.

Chart 2

German LRG Bond Market Activity: Declining Gross Borrowing Needs After The Pandemic



LRG-Local and regional governments, including state-guaranteed winding-up agencies for former public sector banks and other guaranteed financing vehicles. e-estimates Sources: Bloomberg, S&P Global Ratings.

It is usually the German states that issue bonds, with municipal issuance playing just a minimal role. For 2020, we count 159 individual bond issues by German states (up from 107 in 2019), and only one bond issuance by a city. Issuance sizes ranged from just €10 million by NRW to €3 billion by Bavaria. In 2020 we again saw two instances of multiple German states, without participation of the federal government, issuing joint bonds with no mutual guarantee. Both issues were for €1 billion each, maturing in 2027 and 2030.

NRW was the largest borrower in 2020, issuing about €28 billion in 21 separate bonds. Bremen borrowed €16.8 billion in 19 bonds and Lower Saxony issued 11 bonds for €10.1 billion. We do not expect major changes to this ranking, given German states' maturity profiles and debt issuance plans. In 2020, Bavaria issued bonds for the first time since 2014 and Saxony issued for the first time since 2011. Rather small, but highly indebted Bremen issued a very large volume of bonds, with 81% of its bond issuance in 2020 already falling due in 2021. We factor the assumed annual roll-over of these transactions into our forecast because we consider it supports our prediction of gross borrowing and redemption volumes.

With the exception of two bonds issued by Bochum and Munich, German municipalities exclusively used loans in 2020. We consider it possible that German cities might reconsider their financing options in 2021-2022 and issue more bonds, given that the sector is likely to be in deficit, but we do not think they will issue to the same extent as the states. With 18 issues altogether and a total volume of only €3.3 billion outstanding as of year-end 2020, municipalities continue to represent only a small portion of the German subnational government bond debt. S&P Global Ratings does not currently rate any German municipality.

Austria

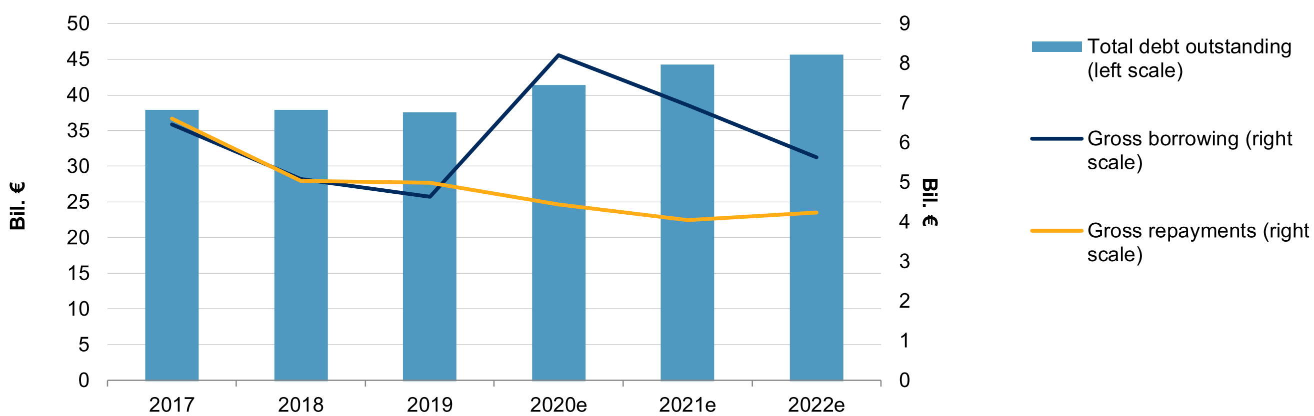
Delayed economic rebound, tax reform, and pandemic-related expenditure pressure states

Austrian states' quickly rising debt burden triggered three outlook revisions to negative in 2020 (Lower Austria, Upper Austria, and Tyrol). We anticipate that gross borrowing by Austrian states and municipalities will amount to about €6.9 billion in 2021 and €5.6 billion in 2022. Despite achieving balanced accounts before the pandemic, we believe the sector will likely have to resort to net new borrowing also in 2021. This owes to sluggish tax revenue and the continuation of various expenditure programs to fight the spread of COVID-19. Debt repayments are stable at about €4 billion in both 2021 and 2022. The further accumulation of debt by states and municipalities of €44 billion by 2021 and €45.5 billion by 2022 will hinge on further support measures from the central government, such as the recent support package for municipalities, which we cannot exclude being extended as the pandemic continues to evolve in Austria. In addition, the upcoming negotiations for the regular review of the intergovernmental tax-sharing system might additionally weigh on the states' willingness to improve their fiscal performance.

In our calculations, we consolidate debt owed by financing vehicles for government real estate and hospital infrastructure with the core budgets' financial liabilities.

Chart 3

Austrian LRG Debt: Substantial Funding Needs By Austrian States In 2021 And 2022



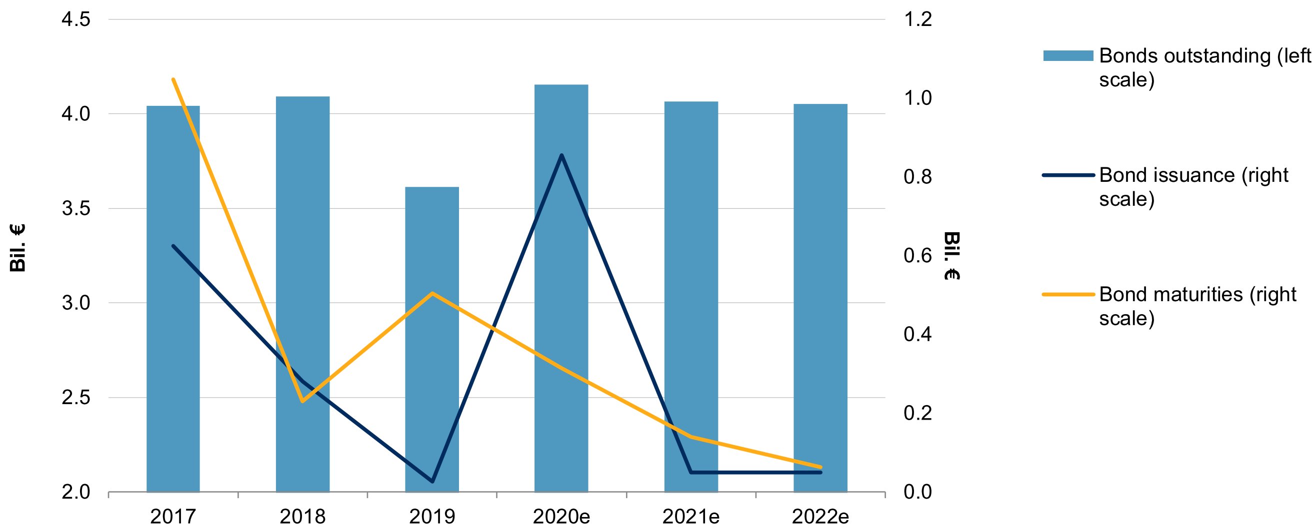
LRG-Local and regional government, including states-guaranteed financing vehicles. e-Estimates. Source: S&P Global Ratings.

The federal treasury fund the largest part of the states' deficits

Austria' nine states, including the city state of Vienna, are responsible for most of the country's LRG borrowing needs and debt outstanding. State transfers cover operating deficits at the municipal level, which limits debt intake by municipalities for investment needs. Currently, the states owe about 75% of the total subnational government debt, which equates to €31.3 billion in absolute terms.

Chart 4

Austrian LRG Bond Market Activity: As The Treasury Takes Over, Bond Volumes Will Continue To Decline



LRG-Local and regional government, including states-guaranteed financing vehicles. e--Estimates. Sources: Bloomberg, S&P Global Ratings.

The states are sharing the same mix of tax revenue with the central government, which exposes them to the economic downturn in Austria following lockdown measures to fight the pandemic. COVID-19 hit Austria significantly in the fourth quarter of 2020 and first quarter of 2021, implying that Austria's economy will recover later than in the other European countries, with subdued tax revenue, the lack of which will trickle down to the states. Various measures implemented at the federal level to ease the burden for taxpayers--including a tax reform with lowering tax rates and moratoria on tax payments--decrease the amount of tax revenue paid out to the state level considerably. The states have to shoulder 21% and municipalities another 11% of the total cost under the current Austrian tax-revenue-sharing formula.

Many states have implemented support packages for their local economies, which will weigh on their budgetary performance over the next two years. We expect deficits at €2.2 billion in 2021, slightly higher than 2020, and reduced deficits of about €1 billion in 2022. Similar to previous years, and reflecting their comparatively weaker recent fiscal performance, we assume that Lower Austria, Styria, and Vienna will remain the largest borrowers among the Austrian states.

Table 3

Rated Austrian States' Adjusted Gross Borrowing

2021 estimates

	Adjusted gross borrowing (mil. €)	Ratings*
Burgenland (State of)	85	AA/Stable/A-1+
Lower Austria (State of)	1275	AA/Negative/A-1+
Styria (State of)	841	AA/Stable/A-1+
Tyrol (State of)	277	AA+/Negative/A-1+
Upper Austria (State of)	374	AA+/Negative/A-1+
Vorarlberg (State of)	139	AA+/Stable/A-1+

*Ratings as of March 15, 2021. Source: S&P Global Ratings

We believe that Austrian municipalities will be better able to deal with the budgetary effects of the pandemic in 2021 and 2022 than the states will, because discretionary capital expenditure plays a relatively larger role for them and, in our view, affords them more flexibility to react to a weaker revenue situation. In addition, support measures from the federal government, such as additional transfers of €1 billion in 2020 and €1.5 billion in 2021, should grant municipalities greater resilience to the loss in shared taxes. Some Austrian states have also announced support measures for their municipalities. Municipalities' gross borrowing activities will therefore largely be limited to refinancing maturing debt of slightly above €1.4 billion per year in 2021 and 2022.

Despite increased funding needs, bond issuance will remain limited

We do not expect any meaningful issuance activity from Austria's LRGs in the public bond market. Even though Austrian municipalities' individual funding needs are usually too small to justify such a transaction, we attribute the lack of public bond issuance from the Austrian states to their ability to access attractively priced funding from OeBFA, Austria's debt management office. In principle, OeBFA stands ready to refinance states' maturing debt and fund their planned deficits. Given these funds are provided with no surcharge to the federal government's own funding levels, they offer a clear pricing advantage. Seven of nine Austrian states will likely finance their deficits nearly exclusively with the federal treasury; only Tyrol and Vorarlberg use bank loans as their dominant external financing source.

Switzerland

Fiscal surpluses are likely to be history, but there are no significant deficits in sight

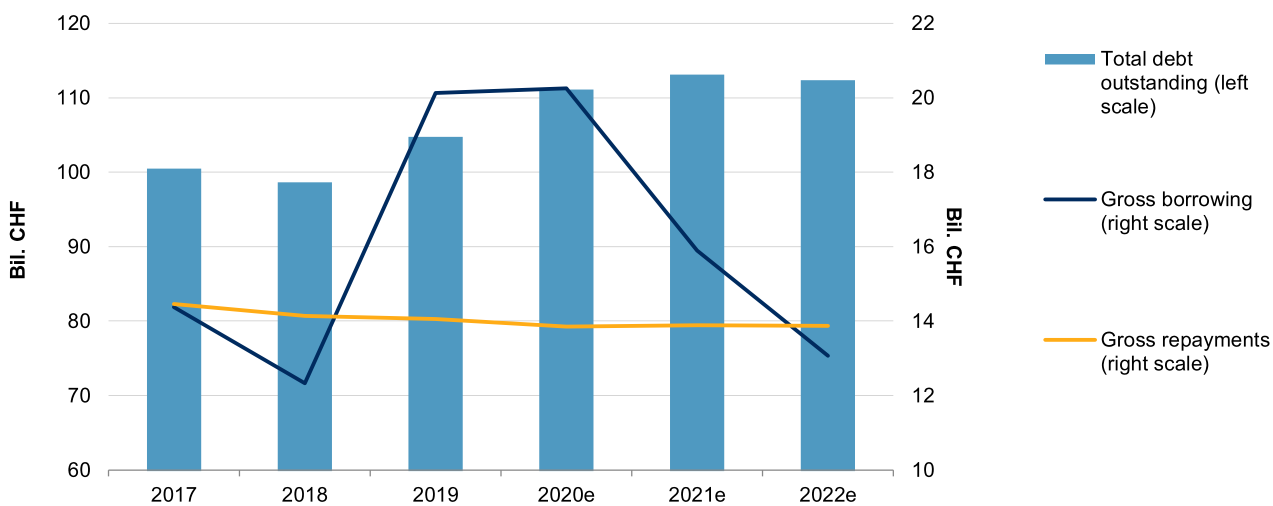
We expect Swiss cantons' and municipalities' issuance volume to be fairly constant over the next two years. With maturities estimated to remain fairly constant at about CHF13.8 billion in 2021 and 2022, subnational government debt should remain stable at about CHF112 billion, in line with our prediction that Swiss cantons and municipalities need to borrow a total of CHF16 billion in 2021, and CHF13 billion in 2022. Although our analysis generally incorporates debt of noncommercial, auxiliary budgets, it notably excludes borrowing activities of cantonal hospitals.

Swiss cantons and municipalities have a general track record of achieving surpluses after capital accounts, leaving the subnational governments well prepared for potential shortfalls in taxes following the COVID-19-induced economic contraction in 2020. So far we note that the 2020 anti-coronavirus lockdowns have led to a significantly less pronounced economic contraction in Switzerland than in Germany and Austria, which should also lead to less pronounced shortfalls in tax revenue. In addition, the Swiss tax system allows its LRGs to adapt the tax code to achieve additional revenue if needed, which should additionally offset the effects of the pandemic.

In 2020, gross borrowing by Swiss cantons and municipalities was tilted by a one-off transfer of the Canton of Geneva to its pension fund. The canton raised CHF5.3 billion in debt to fund the recapitalization, spoiling the whole sector's deleveraging. Nonetheless, absent any further one-off transactions over the next two years, which we are currently not aware of, we think Swiss cantons are well positioned to weather the economic effects of the pandemic.

Chart 5

Swiss LRG Debt: Minor Deficit Expected In 2021



LRG-Local and regional government. e-Estimates. CHF--Swiss franc. Source: S&P Global Ratings.

The effect of Canton of Geneva's recapitalization on the whole sector's debt and borrowing masks what we otherwise consider a fairly supportive economic environment for Swiss cantons and municipalities. We understand from issuers that tax collections were less affected in 2020 than we previously expected after the outbreak of the pandemic. Unlike Austrian and German states, Swiss LRGs did not engage in large expenditure programs, which contributes to our expectation of a sound budgetary performance. We note that the corporate tax reform (tax reform and AHV financing; "TRAF") also reduces corporate tax revenue, which continues to limit tax revenue raising potential for Swiss cantons. However, given the increased payouts by the Swiss National Bank (SNB) (see "Bulletin: Swiss National Bank’s Higher Payout To Government Offers Budgetary Relief," Feb. 3, 2021), we do not expect that this should overly burden Swiss Cantons, at least for 2021. Under the renewed agreement from January 2021, which governs the SNB's profit distributions over the next six years, the maximum distribution to cantons increased to CHF4 billion per year, provided certain thresholds for SNB's net profits are met. This is equivalent to an additional 5% of their annual revenue, making it a welcome relief to budgetary pressures, at least for 2021, and granting a chance for increased payouts in the years thereafter.

We therefore estimate that Swiss LRGs will as a whole manage to post balanced accounts after capital expenditure, with a small deficit of CHF2 billion in 2021 and a small surplus of CHF8 million in 2022.

The funding of Swiss LRGs is usually equally divided between municipalities and cantons. Given the large responsibilities of municipalities, and also considerable differences in population and budget size between larger municipalities like Zurich, Bern, Geneva, and Lausanne compared with smaller cantons like Nidwalden, Appenzell Innerrhoden, and Appenzell Ausserrhoden, we do not believe that the number of issuers will change considerably over the next two years. In total, the Swiss subnational sector accounts for 51% of the Swiss public sector debt.

Table 4

Rated Swiss Cantons' And Cities' Adjusted Gross Borrowing

2021 estimates

	Adjusted gross borrowing (bil. CHF)	Ratings*
Aargau (Canton of)	0.4	AA+/Stable/A-1+
Basel-City (Canton of)	0.5	AAA/Stable/A-1+
Basel-Country (Canton of)	0.2	AA+/Stable/A-1+
Geneva (Republic and Canton of)	1.1	AA-/Stable/--
Solothurn (Canton of)	0.2	AA+/Stable/A-1+
St. Gallen (Canton of)	N/A	AA+/Stable/A-1+
Vaud (Canton of)	0.3	AAA/Stable/--
Zurich (Canton of)	2.1	AAA/Stable/--
Geneva (City of)	0.1	AA-/Stable/--
Lausanne (City of)	0.3	A+/Stable/--
Zurich (City of)	0.8	AA+/Stable/A-1+

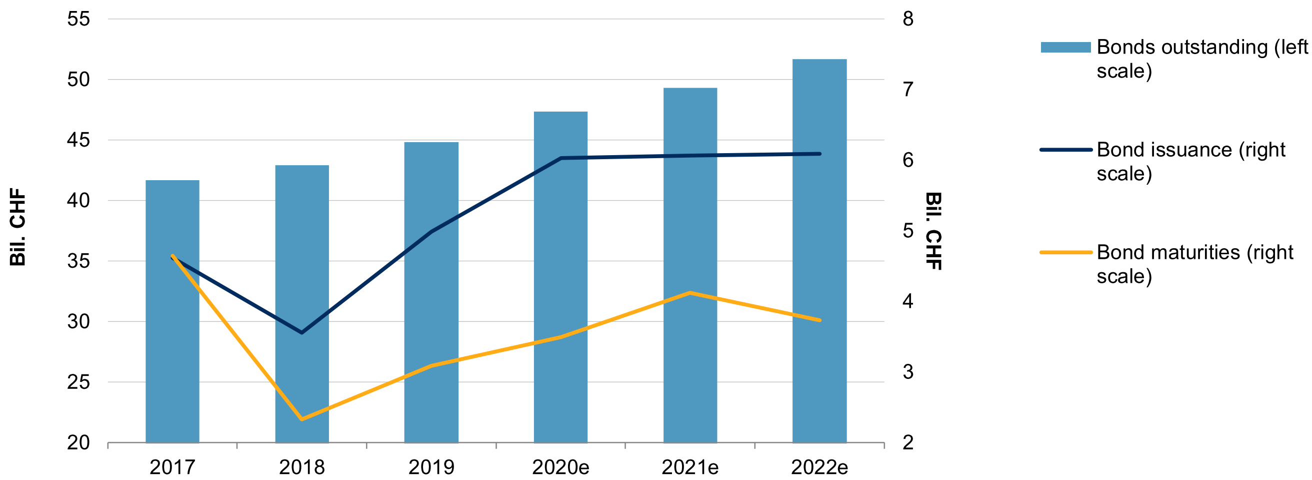
*Ratings as of March 15, 2021. CHF--Swiss franc. N/A--Not applicable. Source: S&P Global Ratings

The local capital market will likely absorb all issuances in 2021 and 2022

The Swiss capital market is dominated by a few large cantonal issuers and a relatively large number of small municipal issuers, which clearly separates the Swiss capital market from those of Austria and Germany. Absent any one-off issuances like Canton of Geneva's pension fund recapitalization in 2020 we expect the total issuance at about CHF16 billion, down from about CHF20 billion in 2019 and 2020. With currently identifiable bond maturities of CHF6 billion in both 2021 and 2022, we believe that those cantonal and municipal bonds exclusively denominated in Swiss francs will be bought by domestic investors. We note that investor's appetite for subsovereign paper remains high, given the ultra-low-interest-rate environment in Switzerland.

Chart 6

Swiss LRG Bond Market Activity: Constant Issuance Activities



CHF--Swiss franc. LRG-Local and regional government. e-Estimate. Sources: Bloomberg, S&P Global Ratings.

Related Research

- Local Government Debt 2021: The Pandemic Takes More Of The Shine Off Large Developed Regions' Credit Quality, March 25, 2021
- Local Government Debt 2021: China's Dominance Overshadows Borrowing Capacity In Other Emerging Markets, March 25, 2021
- Local Government Debt 2021: COVID Aftershocks Push German And Austrian LRGs Into Heavy Borrowing, But Not Swiss Peers, March 25, 2021
- Local Government Debt 2021: Infrastructure Needs Will Boost Borrowing In Developed Markets, March 25, 2021
- Local Government Debt 2021: Global Borrowing To Hit $2.25 Trillion, March 25, 2021
- Local Government Debt 2021: French LRG Debt Could Surpass €155 Billion Within A Year, March 25, 2021
- Institutional Framework Assessment: Swiss Cantons, Jan. 14, 2021
- Institutional Framework Assessment: Austrian States, Oct. 13, 2020
- Bulletin: Swiss National Bank's Higher Payout To Government Offers Budgetary Relief, Feb. 3, 2021
- Credit Conditions Europe: Ill-Prepared For Winter, Sept. 29, 2020
- Sovereign Risk Indicators, Dec. 14, 2020. An interactive version is available at http://www.spratings.com/sri

- Local And Regional Governments Outlook 2021: Gradual Recovery Will Test Rating Resilience, Dec. 10, 2020
- Credit FAQ: How Will A €100 Billion Revenue Loss Affect German States?, Nov. 10, 2020