COVID-19 Will Test The Financial Flexibility Of LRGs In Germany, Switzerland, And Austria

April 27, 2020

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Key Takeaways

- The temporary halt in economic activity caused by the COVID-19 pandemic will mean a significant drop in tax revenue, alongside higher spending on health care and on transfers to affected enterprises and individuals.
- Although federal governments will assume most of this burden in Germany, Austria, and Switzerland, we expect some local and regional governments (LRGs) to offer supplementary aid packages.
- Subnational governments in the region will fund these packages through a significant increase in debt issuance, causing deficits after capital accounts to spike in 2020.
- Despite a pronounced deterioration in budgetary performances in 2020, we would currently expect very limited negative rating actions related to COVID-19 on German, Austrian or Swiss LRGs.

S&P Global Ratings expects COVID-19 to lead to recessions across the region. In Germany, the impending recession is forecast to cause a 6% drop in the country's GDP in 2020. Both Austria and Switzerland could see GDP contract by 6.5%. These changes will eat into tax revenue for LRGs. Given that the effect of the pandemic is evolving quickly, it is difficult to predict the amount of the tax shortfall.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

German States Will Borrow To Support COVID-19 Measures

At the moment, we estimate that German states' 2020 tax revenues could be about 7%-12% lower than in 2019. For comparison, during the 2008 financial crisis, when German real GDP shrank by

5.7%, state tax revenue dropped by 7.6% year on year.

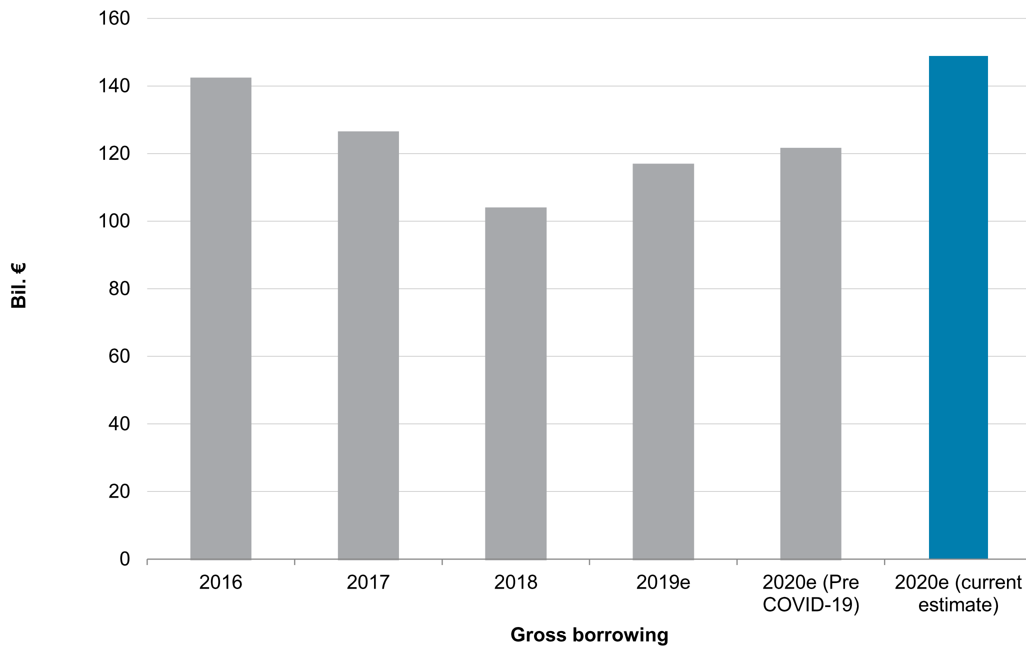
Even as their revenue declines, German states are implementing support packages in an attempt to shelter their local economies from the pandemic's fallout (see table 1). We also expect German states will maintain their capital expenditure. Given this backdrop of falling revenue and rising expenditure, many states will see a sharp deterioration in their budgetary performance in 2020. Most will revert to debt financing to cover their budget deficits. This will increase their borrowing needs.

Fiscal Measures By German States To Bridge The Economic Fallout Of the COVID-19 Pandemic

	Baden-Württemberg	Bavaria	Hesse	North-Rhine Westphalia	Saxony-Anhalt	Saxony
Cash measures:						
General						Support package of €6.75 billion announced; details yet to be disclosed
Nonreimbursable subsidies and other COVID-19-related expenditures	€0.5 billion, further expenditure pending	€10 billion (including buffer for tax shortfall), further €10 billion pending	€2 billion	€9.5 billion	€375 million (of which €83.5 million not yet allocated)	
Equity participation fund	Setup in progress	Setup in progress	N/A	Available	N/A	
Municipalities support	€100 million	N/A	N/A	N/A	€125 million	
Non-cash measures:						
State guarantees for credit lines	€1 billion	€38 billion, partially pending	€5 billion	€16 billion	€1.9 billion	
Tax holiday	Available	Available	Available	Available	Available	

Across all German states and municipalities, we therefore expect additional, crisis-induced borrowing of €25 billion-€30 billion in 2020, a significant increase compared with our previous assumptions (compare chart 1 with "Local Government Debt 2020: Debt Reduction In Germany, A Swiss Pension Fund Recapitalization, And Small Net Borrowings In Austria," published on March 2, 2020). Our calculation takes into account that some states, such as Bavaria, have cash cushions that they could tap, before resorting to debt.

German LRGs: Expected 2020 Borrowing Significantly Up Over Previous Expectation, And Substantially Higher Than Annual Borrowing Of Previous Years



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

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Levels of debt and support will both vary

Not all German states will increase borrowing to the same extent so debt levels will not rise uniformly. Germany's system of interstate revenue equalization transfers will ultimately spread the revenue shortfalls across all the states, but it is the financially stronger states--such as Bavaria, Baden-Wuerttemberg or Hesse--that have announced comprehensive support packages. They are using their greater fiscal flexibility to offer significantly larger packages. Less fiscally flexible states, such as Saxony-Anhalt, are showing more restraint and offering more limited support. That said, a direct comparison of the size of the assistance packages may be misleading. Some states have included loan guarantees that will, at least initially, not require funds from the budget, and some state legislatures have approved larger amounts as a precaution against greater-than-expected needs.

Although debt levels in most states will reach higher levels than we previously expected, we forecast GDP growth to rebound with 4.3% in the second half of 2020, and consequently budgetary performance to recover as of 2021. We therefore expect rating actions to remain limited across the German LRG sector.

Swiss Cantons And Cities Will Borrow To Offset Declining Tax Revenue

If Switzerland's GDP contracts by 6.5%, as currently forecast, we estimate that the pandemic could cause tax revenue for Swiss LRGs to drop by an average 6%-8% year on year in 2020. Switzerland's tax collection mechanics involve an advance tax payment in the current year, and two further installments in following years, once the tax bills get finalized. Therefore, some of the revenue losses will be delayed, extending well into next year. This will offset the effect of a strong rebound in Swiss economic growth in 2021, when we expect GDP to grow by 6.3%.

Individual cantons and cities may see noticeable differences, depending on their economic structure and the resilience of their tax base to the economic shock. We do not expect the Swiss national fiscal equalization scheme to level such differences within the year, as it is far less extensive than the German or Austrian schemes. The Swiss scheme employs a lookback period of four to six years to calculate relative equalization entitlements.

Pandemic-related health care expenditure will weigh on Swiss cantons

Swiss cantons pay 55% of the invoiced cost of in-patient health care treatment for their residents. We would also expect them to foot the general bill for increasing capacity at hospitals and implementing public health measures.

The supplementary assistance packages for local enterprises, offered by a few cantons and cities in addition to the federal program, tend to be of much smaller size than, for example, in Germany, mostly consist of guarantees for bank credit lines, and will hence not immediately increase operating expenditure levels markedly.

The Swiss national government has funded most of the cost of liquidity assistance for enterprises and individuals by means of a Swiss franc (CHF) 42 billion package of compensation payments for reduced working hours through the national unemployment fund and loan guarantees for enterprises. This will not affect cantonal or municipal budgets.

Overall, we expect the COVID-19 pandemic to generate additional borrowing needs of up to CHF3 billion for Swiss LRGs in 2020, mainly due to lower tax revenue. We had already included a contribution to the Canton of Geneva's pension fund of more than CHF4 billion in our CHF16 billion forecast for the sector's predicted gross funding needs for this year. So COVID-19 is likely to increase borrowing needs by just under 20%.

That said, most LRGs had balanced budgets before the crisis--only a few were in deficit. We currently consider our Swiss LRG ratings robust enough to absorb the higher 2020 deficits, most of which will be debt-funded.

Austrian States Face A Tax Holiday In 2020

We forecast that the 6.5% contraction in Austria's 2020 GDP will reduce Austrian states' tax revenue by about 7%-12%. Revenues for Austrian LRGs are distributed through the national equalization system, so all states will be affected to about the same extent, regardless of their economic structure.

In addition, Austria's federal government announced a tax holiday, which allows for postponement of tax payments. This will lead to delays in tax collection from 2020 into 2021. Although the tax holiday will weigh on the budgetary performance of many Austrian states, we generally consider that they have sufficient flexibility to weather such a temporary occurrence. Where needed, we

also expect the federal treasury agency to fund potential liquidity needs resulting from budgetary deficits in 2020. Hence, we consider it likely that states would tap capital markets only in rare cases.

We assume that economic activity in Austria will resume in the second half of 2020, which should cause GDP to rebound by 4.0% in 2021, relieving the transient stress on budgets. Moreover, although Austrian states have announced regional support packages with varying notional amounts, we understand that only moderate amounts within these packages will need to be financed from the 2020 budget. Most stimulus for businesses and individuals is coming from measures taken by the federal government. Because of these dynamics, we expect COVID-19 to have a limited rating impact on Austrian states.

Overall, despite the negative impact of the COVID-19 pandemic on German, Austrian, and Swiss LRGs' performances, leading to increases in debt levels, we view the impact as temporary. That said, returning to precrisis levels might take more than a year. Furthermore, we expect that plans to recover the expenses may only be outlined in following years.

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