THE IMPACT OF THE COVID-19 PANDEMIC ON SUBNATIONAL FINANCES

Emergency Governance for Cities and Regions
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UCLG United Cities and Local Governments | metropolis | LSE Cities | LSE The London School of Economics and Political Science

INTRODUCING ANALYTICS NOTE #03

This Analytics Note focuses on the impacts of the COVID-19 pandemic on municipal finances. The information comes from a survey of finance departments of city and regional governments conducted from 5 November to 7 December 2020. **The sample encompasses 33 territories from 22 countries across all continents**, with stronger representation of cities/regions from Europe (36%), Asia (21%), and Africa (15%). The average population of these administrative territories is 1.4 million, but populations range from fewer than 50,000 inhabitants to over 7.4 million.

The survey findings were complemented by a review of secondary sources and primary data collected by other initiatives and international organisations (hyperlinks to the original sources are provided in the text).

This publication is the third in the series of Analytics Notes by the Emergency Governance Initiative (EGI). It follows Analytics Note #02 which centred on the priorities and demands of cities and regions for international information exchange linked to emergency governance. Based on survey research, it was noted that the primary information gap was in relation to resources and finance. This Analytics Note was developed to address this gap.

The data-driven Analytics Notes are published alongside Policy Briefs which outline forward-looking proposals, reform agendas, governance innovations and critical perspectives. **Policy Brief #03, to be launched later this month, builds and expands on the findings outlined in this note.**

ACKNOWLEDGEMENTS

The EGI team would like to thank the dozens of local and regional government officials that took time out of their busy schedules to respond to the 'Municipal Finances and the Pandemic' survey, despite the short notice and the pressures of the emergency response. The level of engagement is testament to the fact that subnational governments regard information sharing and collaboration as key in developing appropriate responses to this emergency.

Main findings

- The top financial challenges for cities and regional governments during the COVID-19 emergency are related to **the health of local and national economies.**
- The emergency has amplified long-standing problems concerning subnational finances such as **insufficient budgets**, but it has also brought other challenges to the fore such as **revenue volatility**, **new demands for services and investments**, and the short to medium term consequences of **reallocating capital investments to finance operational responses.**
- The financial challenges of subnational governments have been **exacerbated in some countries by restrictive regulatory environments.**
- More **financially independent subnational governments may have suffered higher income losses** because intergovernmental transfers were among the least affected sources of revenue.
- Challenges amplified or brought about by the pandemic are expected to be **even more serious after the health emergency has passed.**
- Local governments have significant responsibility for financing **policy sectors which are either inelastic in their demand or tend to have even higher demand during an emergency.**
- As in the case of the 2008 Global Financial Crisis, the COVID-19 **recovery packages will indicate the extent to which nation states value cities and regions.**

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Other highlights from the survey

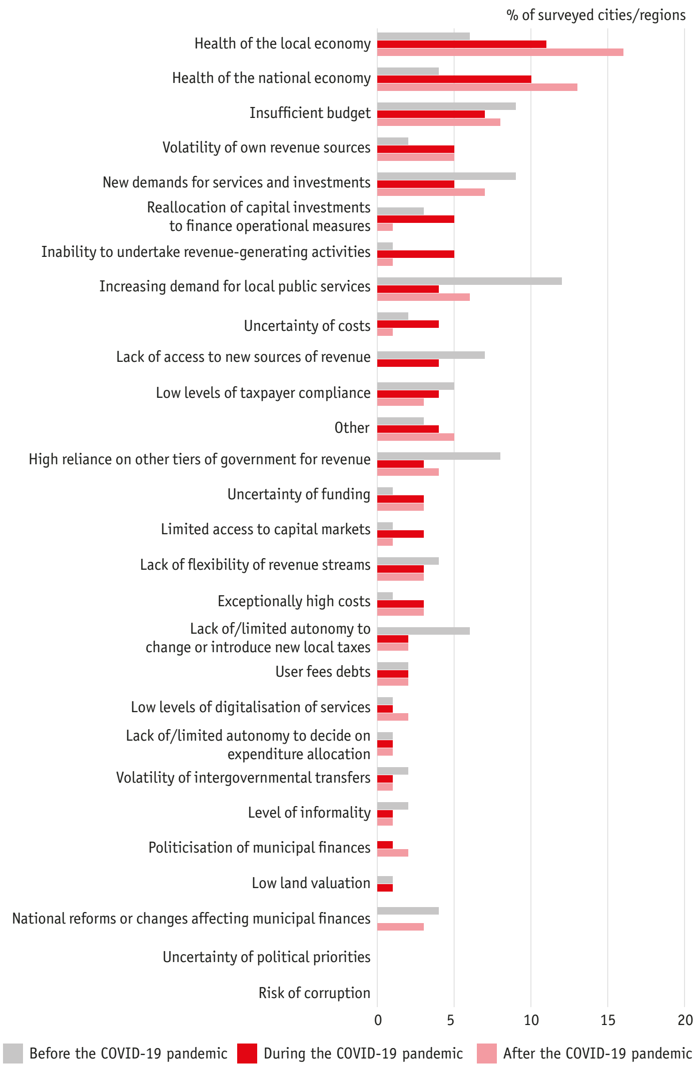
– On average, the cities and regions in the survey sample reported a **5% increase in expenditure and around a 10% decrease in revenue**.

– The **source of revenue associated with higher income losses was from tariffs and fees** (-22% on average), followed by revenue from rent or sale of assets (-18% on average). **Intergovernmental fiscal transfers were less affected** (-8% on average).

– **21% of the cities/regions in the sample borrowed money to tackle the emergency.** A majority (58%) chose not to, despite being able to had they wished, but the remaining 21% did not borrow due to legal constraints (15%) or lack of access to financial institutions (6%).

– Nearly **2/3 of subnational governments had to pause key capital investments** but only 1/3 expect them to be permanently cancelled.

Figure 1: Top finance problems for city and regional governments (before, during and expected after the COVID-19 pandemic)



1. OLD PROBLEMS AND NEW PROBLEMS

1.1 PROBLEMS OF MUNICIPAL FINANCE AMPLIFIED BY THE COVID-19 CRISIS

Before the pandemic, aside from the sharp increase in demand for local public services and investments in recent years, most of the top finance problems for subnational governments were linked to inadequate access to revenue and capital (see Figure 1). According to the survey, in addition to insufficient budgets, cities and regions in the sample have been grappling with an over reliance on central governments, lack of access to new sources of revenue, limited autonomy to change/introduce taxes, and low levels of taxpayer compliance.

The COVID-19 emergency has led to a shift in the relative significance of financial challenges. Contextual factors, such as the **health of local and national economies,** became key concerns since they amplify the problems associated with revenue generation. However, in addition to being just insufficient, subnational governments' budgets have become more volatile as a result of this crisis. There have also been new demands placed upon cities/regions and since they have been less able to generate revenue, **subnational governments have had to reallocate capital investments to finance operational responses**. This will have serious consequences for the financial sustainability of cities and regions in the short to medium term. In fact, the survey respondents expect the **challenges amplified by the pandemic to be even more serious after the health emergency has passed.**

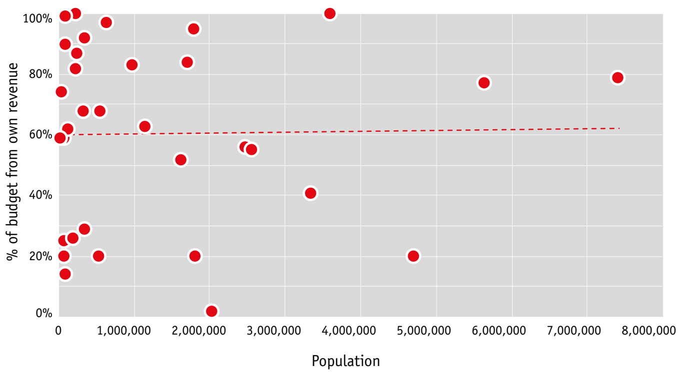
1.2 THE 'SCISSOR EFFECT'

The COVID-19 emergency imposes a particularly significant strain on subnational finances because it has led to a **simultaneous increase in expenditure** (e.g. new equipment, health and social services, cleaning and hygiene) **and a decrease in revenue** (e.g. reduced property transactions and parking fees).

On average, the cities and regions in the survey sample reported a 10% decrease in revenue and around a 5% increase in expenditure. In line with this finding, sharp drops in revenues and increases in expenditures have been reported globally. Rio de Janeiro's revenue declined to 2010 levels, in large part due to a drop in municipal services' taxes. In New Zealand, the city of Auckland projects a loss of NZ$450 million (about 320 million USD) in the current financial year. Analysis by UN-Habitat, UN ECA, UCLG Africa, UNCDF and Shelter Afrique estimated that local governments in Africa could **lose up to two thirds of their financial resources as a result of the pandemic.** In a survey of 300 cities and regions in Europe conducted by the European Committee of the Regions and the OECD, 90% of respondents expected a decrease in their revenue as a result of the pandemic and 85% anticipated an increase in expenditures. Tax revenues were expected to be the most impacted revenue source, whilst expenditures in the areas of social services, social benefits and support to SMEs were expected to rise the most. A CEMR survey of 21 local and regional governments' national associations reported similar findings. Furthermore, most respondents in the CEMR survey reported that they were not receiving enough financial support from national governments to cover their increased costs.

The financial challenges of subnational governments have been exacerbated in some countries by restrictive regulatory environments. For example, in the US, states are required by law to balance their budgets. However, between March and August 2020, state tax collections were on average 6.4% lower than the same period in 2019.

Figure 2: Subnational governments' financial independence



2. MULTILEVEL RESPONSES

2.1 DISTRIBUTION OF RESPONSIBILITIES AND RESOURCES

In recent decades, calls for greater decentralisation around the world have been met increasingly with effective transfer of responsibilities to subnational governments. However, an increase in the budgets of cities and regions has not, in many cases, been proportional to the additional responsibilities and challenges they have assumed. The autonomy subnational governments are given to design appropriate emergency response measures, for example, is often dependent on the share of their budget raised locally. This can vary substantially from city to city, and even within the same country. In addition, **although more populated territories often enjoy higher levels of financial independence, this is not always the case**, as the survey results in Figure 2 show.

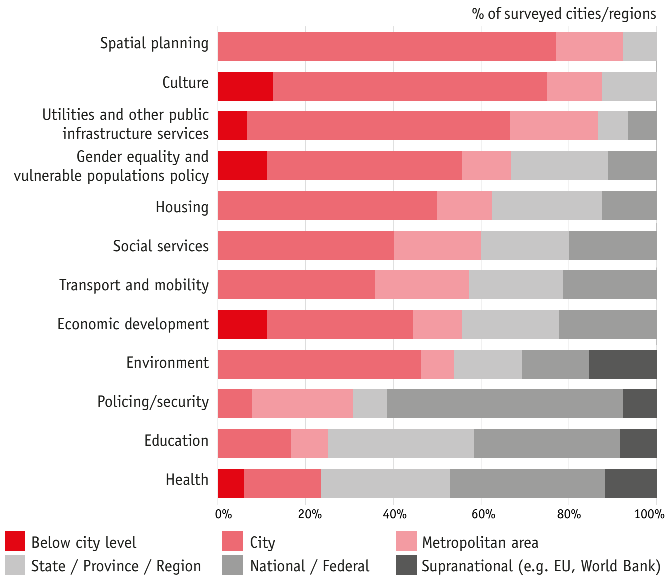
Still, the cities and regions in our survey report a significant level of fiscal autonomy, with an average of 60% of their budget being locally generated.[1] Paradoxically, given that this revenue is likely to come from local and shared taxes (e.g. property), tariffs and fees (e.g. parking), and sale of assets (e.g. land), **more financially independent subnational governments may have suffered higher losses of income.** Our respondents reported that **intergovernmental transfers were among the least affected sources of revenue** since the COVID-19 outbreak (8% less, on average), so cities and regions that rely more heavily on central government suffered less budget instability.

As shown in Figure 3, typically, **local governments have significant responsibility for financing policy sectors which are either inelastic in their demand** (e.g. public infrastructure services – although cleaning costs soared) **or tend to have higher demand during an emergency** (e.g. housing and social services). Conversely, two key sectors in the response to the COVID-19 emergency – health (e.g. mass testing) and policing and security (e.g. enforcing physical distancing) - have primarily been a provincial, state and/or national spending responsibility rather than a local one.

The way in which resources are being shared amongst the various levels of government in response to the emergency is also extremely diverse. After the outbreak of the virus in Hubei, the central government of China allocated CNY 35 billion (about 5.4 billion USD) in general grants to the province. These funds were spent at the discretion of the provincial government, following general policy guidance. Many other central governments have increased grant payments to subnational governments (e.g. Austria, Brazil, Colombia, Estonia, Italy, Japan, Korea, Latvia, Norway, Slovenia, South Africa, Spain and the US). Some of these have been proportional to the decrease in revenue or the increase in expenditure.

However, the CEMR survey conducted in May 2020 presented a less optimistic overview of intergovernmental transfers. Out of 17 European countries, only three (Estonia, Scotland and Germany) said that financial help from national government was still operational and positively perceived by local and regional governments. Most said that financial help had been provided but was insufficient, and cities and regions from three other countries (Iceland, Turkey and Bulgaria) said that they had not yet received any additional financial help from their national governments.

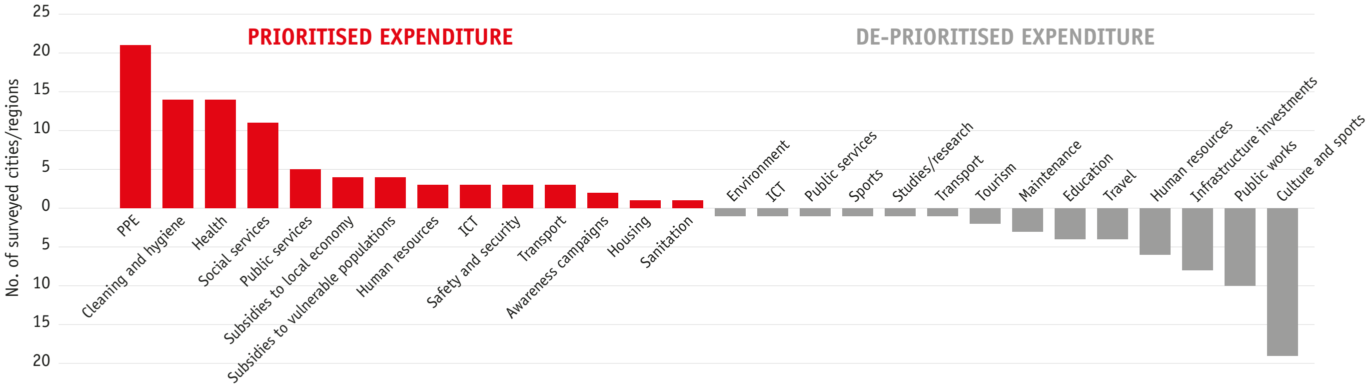
Figure 3: Responsibility for financing different policy sectors across tiers of government



[1] It should be noted that this 60% average is not typical. At the global level, grants and subsidies usually represent the primary source of revenue (51%, on average) for subnational governments. There are, however, large differences between federal and unitary countries (subnational governments' own revenue is, on average, higher in federal countries than in unitary countries) and between high- and low-income countries (cities and regions from low-income countries are more dependent on intergovernmental transfers).

2.2 PRIORITISING AND DE-PRIORITISING BUDGET LINES

Figure 4: Expenditure priorities during the emergency and areas that were defunded as a result



With the arrival of the pandemic, city and regional governments have had to make difficult spending decisions. Some issues have had to be prioritised and, consequently, others have had to be deferred during the emergency response. Figure 4 illustrates how cities and regions have had to take on new expenses such as the purchase of Personal Protective Equipment (PPE), subsidies to local hospitals and other health facilities, disinfection of public spaces, and other social welfare services. Indeed, despite the 'traditional' allocation of spending responsibilities (shown in Figure 3), **during the emergency local governments have had to complement the efforts undertaken by national governments and take on health-related expenditure**.

Furthermore, local governments have had to increase the budgets of their social and public services and support local businesses that were unable to trade due to the pandemic. To do this, cities and regions have had to defund policy sectors which tend to be highly reliant on local-level budgets.

The **repercussions for culture, infrastructure development and maintenance, and housing – but also other crucial areas such as interventions to promote gender equality and empower vulnerable populations – are expected to be high**. Figure 5 shows that most of the subnational governments surveyed have had to postpone important investments to focus on their emergency response, although only about 31% of them currently expect them to be cancelled altogether.

2.3 LESSONS FROM THE GLOBAL FINANCIAL CRISIS

The national economic recovery packages that will follow once infection rates begin to subside will give an indication of the positioning of city and regional governments, not only in the recovery, but also in the configuration of post-pandemic governance. Will subnational governments benefit from these packages to fund their operations and investments? Will the budgeting process adhere to decentralisation ideals and help bridge the 'scissor effect' to support the continuity of essential services provided by local authorities? Although it is too soon to tell in terms of the COVID-19 crisis, lessons can be drawn from the 2007-08 Global Financial Crisis.

As with the current emergency, subnational government revenue was also significantly reduced during the Global Financial Crisis. But while some countries enacted reforms that encouraged decentralisation as part of the response (e.g. Iceland, Greece, France, Italy) others moved towards (re)centralisation (e.g. Montenegro, Spain). Although it is a highly complex and contested issue, recent evidence suggests that higher levels of decentralisation have a positive effect on fiscal performance.

Regardless of the extent to which subnational governments are involved in the recovery, finances are likely to remain strained for some time to come and cities and regions will be required to innovate. However, in a previous EGI survey (July 2020), finance emerged as one of the sectors in which the least innovation was taking place in response to the emergency. Although rare, there are emerging examples of local governments innovating to manage the financial pressures. For instance, Buenos Aires passed an Economic and Financial Emergency law to enable the city to access and direct financial resources to the emergency response.

The EGI Policy Brief #03 will explore some of the solutions that could be developed at both the subnational and national level to enable a more flexible and effective response to complex emergencies.

Figure 5: Postponement of capital investments (e.g. in infrastructure, housing, environment) to focus on emergency response

% of surveyed cities/regions