Local government finances: how cash advances can be limited and budget imbalances avoided

Prior to the coronavirus crisis, local government finances were in good shape overall. Local government budgets recorded large surpluses, albeit with significant differences from municipality to municipality. Sizeable cash advances continued to persist in some federal states. Technically speaking, cash advances are only intended to bridge intra-year, short-term liquidity shortfalls and are supposed to be paid off by no later than the fiscal year-end. Despite this, they sometimes also span multiple years (i.e. periods extending beyond the fiscal year-end) to make up for budget shortfalls. Multi-year cash advances are thus indicative of local government budget imbalances that have not been resolved. However, it was possible in the pre-crisis years to reduce these advances by a total of one-quarter from their peak levels, in no small part thanks to state-run debt relief programmes. Now, as a result of the coronavirus crisis, there is a danger that local governments will increasingly turn to multi-year cash advances again to plug their budget gaps. While central government and state governments have largely shielded them from the financial impact of the crisis over the past year, revenue prospects are still lagging behind their pre-crisis levels over the medium term.

Federal states bear much of the responsibility for keeping their municipalities' finances in order. For one thing, they have to ensure the provision of adequate funding. For another, they are responsible for budgetary surveillance and have extensive powers of intervention.

There appear to be three big starting points for securing stable local government finances. First, a fundamental reform of local government financing to stabilise the currently volatile local government revenue would be a welcome development.

Second, federal states need to ensure that their municipalities' persistently high levels of cash advances are reduced. The spotlight here is on North Rhine-Westphalia and Rhineland-Palatinate, but also Saarland. Debt relief programmes run by federal states, such as the one in Hesse, appear to be sensible approaches to handing financial flexibility back to the local government level in the future. Programmes of this kind need to be accompanied by rules which, going forward, safeguard sound finances and enable location conditions to be of adequate quality.

Third, it is important to prevent structural budget imbalances from materialising in the future. This is conditional on federal states being consistent in their surveillance and addressing unwelcome developments early on. One stipulation could be that municipalities are only permitted to obtain cash advances that would not be repaid by the end of the fiscal year from their home state. The federal state would thus also formally assume liability, underscoring its shared responsibility. Local government financial problems would then be reflected in state government budgets and transparently disclosed to the public in the budgetary accounts. If the necessary borrowing were to also count towards federal states' debt brakes, this would provide them with an added incentive to prevent local government budget imbalances from emerging.

Local government budget rules and cash advances

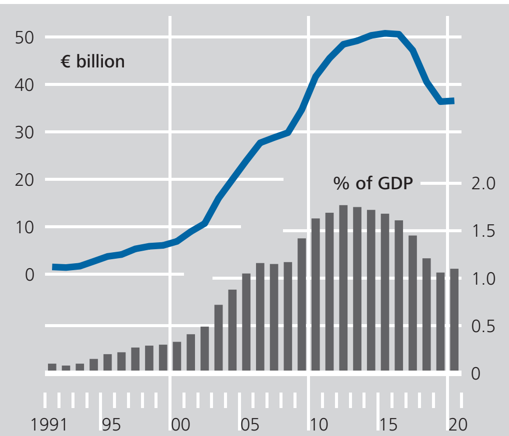
Federal states bear much of the responsibility for keeping municipalities' finances in order

Municipalities can take on debt to fund investment. However, they are subject to relatively strict budget rules in the process. For example, the municipality is required to demonstrate that, looking ahead, it will be able to repay the debt from its current revenue. The federal states set out detailed budget rules to be followed by their municipalities, monitor compliance with these rules and also possess extensive powers of intervention.[1] Where necessary, they can demand that individual municipalities make adjustments before a budget is approved. Additionally, they have to ensure the provision of adequate funding. In this respect, they bear much of the responsibility for keeping their municipalities' finances in order. Regardless, some federal states have allowed local government budgets to slip, resulting in imbalances and even excess balance sheet debt.

Multi-year cash advances are a sign of structural funding gaps

At the central and state government levels, larger deficits are a sign of budget strains. This is less straightforward at the local government level, where deficits resulting from debt-financed investment can actually be a sign of financial strength. By contrast, large volumes of cash advances are a reliable indicator of weakness, as they are only actually intended to bridge intra-year liquidity shortfalls. Multi-year cash advances are those that could not be repaid within one fiscal year, though.[2] They were taken out not to fund investment but rather to plug budget gaps. Large or growing volumes of multi-year cash advances are thus a sign of structural financial problems that have not yet been resolved. Thus, the likelihood of a municipality no longer being able to solve these problems on its own grows. Such instances of protracted financial problems and a potential inability to pay back debt are frequently followed by a lengthy consolidation period, often going hand in hand with low local government investment, making the location less attractive.[3] In order to avert the unwelcome adverse effects of unsound finances, structural funding gaps have to be tackled swiftly and decisively. This is where the home state has a pivotal role to play.

Local government cash advances



Sources: Federal Statistical Office and Bundesbank calculations.
Deutsche Bundesbank

Cash advances in decline for five years, but still sizeable …

Up to the early 1990s, multi-year cash advances were not common at the local government level. They then grew over many years, reaching a peak of around €51 billion at the end of 2015 (see the adjacent chart).[4] They thus made up one-third of debt attributable to local government core budgets and off-budget entities. In the subsequent period up to the end of 2020, cash advances decreased to around €37 billion (1.1% of gross domestic product (GDP)), or one-quarter of aggregate local government debt. They remain a large item in many local government budgets, however.

1 These far-reaching opportunities to exert influence set the relationship between the federal states and their municipalities far apart from the relationship between central government and state governments within the German federal system and between the European Union as a supranational organisation and its largely fiscally autonomous Member States.
2 In this article, "intra-year" and "multi-year" do not refer to a cash advance's term. Instead, they describe whether a cash advance is paid off in the same fiscal year (intra-year cash advance) or whether it is still outstanding at the end of the fiscal year (multi-year cash advance). It is possible for a multi-year cash advance to be due in less than one year. The remainder of this article focuses on municipalities' multi-year cash advances.
3 See Beznoska and Kauder (2020).
4 As a percentage of GDP, cash advances reached their peak in 2012 already (1.8%).

… and concentrated in small number of federal states

The average volume of local government cash advances varies widely across the federal states. Across all non-city states, it stood at around €480 per capita at the end of 2020, ranging from less than €20 in Thuringia to €1,610 in Rhineland-Palatinate. Very high per capita cash advance levels of over €1,000 were also recorded for Saarland (€1,410) and North Rhine-Westphalia (€1,180).

State-run debt relief programmes as a possible solution for high volumes of cash advances

Central government aid and state-run debt relief programmes supported scaling-back of cash advances

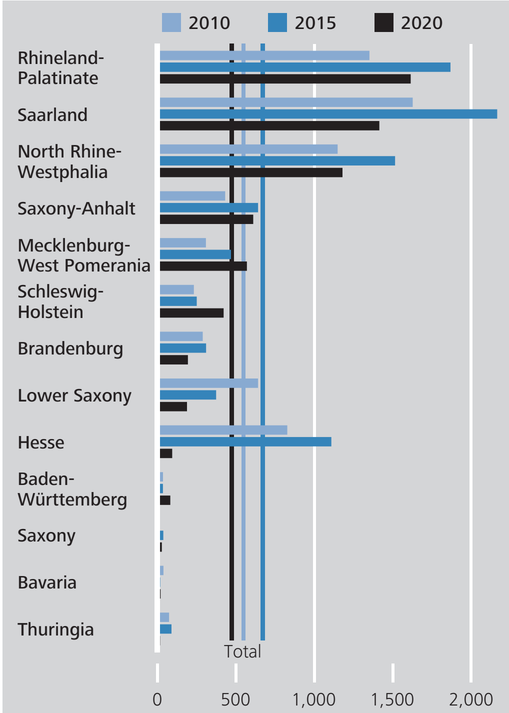
The scaling-back of multi-year cash advances went hand in hand with fiscal surpluses, which were partly attributable to expanded central government aid. This primarily took the form of assuming a larger share of the costs of social benefits and, for example, providing lump-sum funding to cover expenditure related to refugees. On top of this, individual federal states launched debt relief programmes. The first of these were set up over a decade ago already, with varying designs and degrees of success.

State-funded debt relief sensible provided it is appropriately structured

State-run debt relief programmes make sense where municipalities' own concerted efforts are no longer enough to make a significant dent in their large volumes of cash advances. In terms of design, it is crucial to ensure that undesirable incentives to take on further debt are limited. Various parameters come into play here. The federal state has to determine the extent to which it will take on accumulated debt from cash advances or participate in servicing this debt. It is also necessary to define the period of time over which the affected municipalities will contribute to financing. Clear conditions can support consolidation requirements. Examples of such conditions include specifications for non-personal tax multipliers, although requirements relating to personnel management would also be conceivable. Locational disadvantages can be related to budget problems. With that in mind, debt relief programmes need to be consistently integrated into the federal state's general regional policy, e.g. by also using available funding to invest in infrastructure within this framework.

Local government cash advances by federal state

€ per inhabitant



Sources: Federal Statistical Office and Bundesbank calculations.
Deutsche Bundesbank

"Hessenkasse" fund as example case: federal state assumes cash advance debt and tightens budget law at same time

In 2018, Hesse opted to take a comprehensive approach – establishing the "Hessenkasse" fund – by making state government funds available to service debt.[5] Participating municipalities remain involved, however, by paying off half of their cash advances up to an upper limit. Repayments take the form of a fixed annual amount and can be stretched over a period of up to 30 years. At the same time,

5 Specifically, subject to approval by the municipality, cash advances were transferred to the state-owned WIBank (€5 billion). This debt was local government debt not covered on the balance sheet by financial assets. The federal state of Hesse provides state government funds for interest and principal payments via the off-budget "Hessenkasse" fund. Through this set-up, the transferred cash advances no longer count as explicit government debt included in the government finance statistics. However, they still count towards the general government Maastricht debt as they are recorded at the state government level.

Hesse tightened its budget law for all municipalities to prevent a sustained increase in cash advances in the future. Municipalities not supported by the fund were eligible to receive additional investment grants. All in all, an approach of this kind appears sensible. The programme combines debt relief by the federal state with mandatory participation by the affected municipalities and stricter budgetary oversight.[6] This counteracts the undesirable incentive effect of debt relief programmes that cash advances might appear to present less of a burden to municipalities in the future.

No compelling case for assumption of cash advances by central government

There is a less compelling case, however, for central government to assume the debt from local government cash advances.[7] It is the federal states that are ultimately responsible for the accumulation of cash advances. In the past, even relatively financially weak federal states were able to avoid such build-ups.[8] Central government is badly placed to counteract the distorted incentives associated with assuming this debt, and prospective central government aid might well be holding back federal states with particularly high levels of cash advances from coming up with their own comprehensive solutions.

Approaches to stabilising local government finances and preventing a return to rising cash advances

Sound local government finances through steady revenue

If new imbalances are to be prevented and municipalities enabled to perform their tasks without disruption, a solution focusing on legacy debt alone is not enough. The pressure on local government budgets has been eased significantly in structural terms through various forms of central government aid. For example, central government's share in the costs of accommodation for those receiving unemployment benefit II was raised again in 2020, and significantly so. In the same year, the increased share of local business tax revenue that western German municipalities were required to pay to the federal states ceased to apply. Despite all this, local government financing remains highly volatile, which could be remedied by means of a fundamental reform.[9] Should it not be possible to deliver such a reform, the cyclical fluctuations in local government finances could be smoothed out at the state government level. In periods of economic weakness, the federal states would support their municipalities in accordance with the rules. During upswings, the state government budgets would then withhold the corresponding amount of additional revenue. Since federal states' debt brakes are limited to structural new borrowing, they would be compatible with such symmetrical cyclical strains on, and relief for, state government budgets.

Ensure funding commensurate with tasks

In order to support sound local government finances, federal states need to demonstrate that their municipalities receive financing commensurate with the tasks of the latter through their local government financial equalisation schemes. To this end, it would be necessary to determine as transparently as possible, assuming a cost-effective approach, the financing requirements associated with mandatory municipal services. This is already compulsory in some federal states.

6 Saarland took a similar approach: starting in 2020, the state took on repayment of €1 billion, or around half of its municipalities' cash advances, through its "Saarlandpakt" fund. The off-budget fund makes interest and principal payments for the cash advances it has assumed and is financed from the state's core budget. Municipalities are required to pay off their remaining cash advances out of surpluses by the end of 2064.
7 See Deutsche Bundesbank (2019).
8 In 2019, the Federal Government members of the Commission on Equivalent Living Conditions proposed that central government assume the debt from local government cash advances on a one-off basis. However, the proposal was not approved by those federal states with municipalities that already had scarcely any cash advance debt due to strict state-level budgetary oversight.
9 Starting points for such a reform were presented in greater detail in Deutsche Bundesbank (2020). For example, the weight of the highly volatile local business tax in the total tax revenue received at the local government level could be reduced. In return, the weight of more stable sources of revenue, such as municipalities' share of wage tax revenue, could be raised. This would change the distribution of wage tax nationally, but not increase the tax itself. Another possible option is to give municipalities the power to set their own local multipliers on the local government share of general income tax. In addition, local government financial equalisation could be stabilised by not passing temporary tax revenue shortfalls at the state government level through to the local government level.

Effective local government budgetary oversight

Additionally, local government budget rules could also be applied more rigorously. This could also involve the federal state making specific interventions in local government budgets if rules are violated. Effective budgetary oversight of this nature is ultimately also an important factor in maintaining room for manoeuvre in the future.

Issuance of multi-year cash advances via state government budgets to underscore responsibility at federal state level

Another option would be to reform local government budget rules to make them more effective. One stipulation could be that municipalities are only permitted to obtain cash advances that would not be repaid by the end of the fiscal year from their home state. Anchoring borrowing options in this way would underscore the latter's shared responsibility. Up to now, it has been for the most part assumed on the markets that, in the event of default, the federal states are liable for loans taken out by their municipalities. For this reason, multi-year cash advances are made available at comparatively favourable conditions, even when municipalities find themselves in financial difficulties. Given the silent nature of this financing, the problem of cash advances also threatens to stay off the political radar. The proposed change would result in the federal states being directly and solely affected by difficulties in repaying cash advances, which would provide clarity at the state and local government levels as well as for the capital market regarding accountability. Municipalities' planned multi-year cash advances would then be disclosed annually in state government budgets and outturns.[10] Financial problems at the local government level would thus be presented transparently, on an annual basis at fiscal year-end close and, at the latest, in the budgetary accounts.[11]

Counting multi-year cash advances towards debt brakes will oblige federal states to resolve imbalances as quickly as possible

Federal states' debt brakes place severe restrictions on their ability to borrow. As a result, there is an incentive for the federal states to keep local government financial equalisation tight in order to relieve the pressure on their own budgets. This would also be the case if – as outlined above – municipalities were only permitted to obtain multi-year cash advances from their home state. As long as it is formally assumed when lending these funds that the advances are not ultimately transfers, as financial transactions they do not usually count towards the state's debt brake. However, since the use of cash advances over multiple years indicates that the recipient municipality is currently unable to make regular repayments, this classification does not seem appropriate. It would therefore make sense to count multi-year local government cash advances towards federal states' borrowing under their debt brakes. Insofar as local government underfunding is reflected in growing multi-year cash advances, responsibility for this development would then rest with the federal state.[12] The federal states' budgetary oversight keeps them protected from being put under pressure by their municipalities through excessive expenditure.

Transparent reporting by Stability Council

Irrespective of such a reform, it would make sense to flag state-specific strains in local government finances in a transparent manner. This would raise awareness of the problem. For example, in its budget analysis for individual federal states, the Stability Council could highlight local government cash advances in a dedicated population-based indicator.[13] If a certain threshold is exceeded in the previous year, this would sound an alarm in budgetary surveillance. The federal state concerned could then be prompted to adopt specific measures aimed at stabilising local finances.[14]

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10 As a rule, it is unlikely when a federal state is drawing up its budget plan that more than a handful of budgets for the state's numerous municipalities will have already been approved. However, the state-level financial supervisors overseeing local government finances could provide plausible estimates here. If, as time went on, greater local government needs led to additional financing requirements, a supplementary budget would have to be adopted.
11 If the municipalities receive cash advances at standardised terms and the federal states themselves raise capital in the capital market, transaction and interest costs for municipalities could also fall.
12 See Deutsche Bundesbank (2016).
13 See Deutsche Bundesbank (2018).
14 Possible starting points for such measures would then, in turn, be multipliers for non-personal taxes, local government expenditure in relation to appropriate benchmarks as well as the allocation and distribution of funds in the local government financial equalisation scheme.

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