# The Impact of the COVID-19 Crisis on Subnational Governments in Emerging Markets: The Outlook One Year On

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# BACKGROUND

Subnational governments in emerging market cities have undoubtedly felt the brunt of the COVID-19 crisis. Cities have been at the forefront of the pandemic, given both the impact it has had on their budgets and their citizens, and their central role in managing it. In our October 2020 note, we shared thoughts on what the crisis could mean for cities. More than a year after the crisis first hit, we now project gradual recovery for subnational governments in the second half of 2021 and 2022. This should support investment and lending activity by development finance institutions (DFIs) to help address infrastructure needs globally.

## COVID-19'S IMPACT ON SUB-NATIONAL GOVERNMENTS

### THE PANDEMIC SIGNIFICANTLY HURT BUDGETARY PERFORMANCE AND ADDED TO DEBT

As detailed in our October 2020 note, subnational governments have been significantly hit by the pandemic globally, with revenue contraction and rising operating expenditure leading to higher fiscal deficits.

**Declining city revenues:** Most subnational governments experienced a decline in revenues due to recession and crisis response measures, such as lockdowns and emergency tax relief. These affected both central government transfers and own-source revenues such as taxes and fees. Evidence coming from selected developing market cities shows that in some cases, own-source revenues were significantly impacted by the pandemic.

In South Africa, subnational governments' operating receipts declined by up to 30 percent in the 2019/20 fiscal year (July 2019 to June 2020) relative to what had been projected in the annual budget. This was affected by a sharp decline in property taxes and service charges that collectively account for about 80 percent of receipts. In Lagos State, Nigeria, internally generated revenue or own source revenue fell by 17 percent in the second quarter of fiscal 2020 (April-June 2020), compared with the same quarter in 2019. However, year-on-year internally generated revenues were higher, reflecting revenue recovery in the last two quarters of the year. Similar trends were evident in some cities in Turkey, Ukraine, and India, including in Kerala state.

Central government transfers were equally affected by the pandemic, mostly declining in line with falling central government revenues. The latest World Bank estimates show that GDP contracted by 3.5 percent in 2020 with important implications for central government revenues, which shrank year-on-year by 3.6 percent of GDP in emerging markets in 2020.

With higher levels of indebtedness (reaching 97.3 percent of GDP in 2020 globally), central governments are facing fiscal pressures that could lead to reduced transfers to local governments. For example, the South African government has revised downward certain transfers to local governments such as compensation account transfers, municipal infrastructure grants and integrated urban development grants which were cut in the country's latest budget review.

The World Bank has projected that these factors would result in a decline in revenue to local authorities of 15–25 percent in 2021. That said, the pandemic's impact on subnational governments' revenues varied widely depending on country-specific factors such as the degree of fiscal decentralization, subnational governments' fiscal position pre-pandemic, and the degree of policy response and fiscal support from central government.

**Increasing pressure on fiscal balances:** The fall in revenues, combined with growing operating expenditures in 2020, increased fiscal pressure on subnational governments. Most of them in low-and middle-income countries entered the crisis with a low degree of fiscal autonomy since they depend on central government support, itself significantly constrained due to the pandemic.

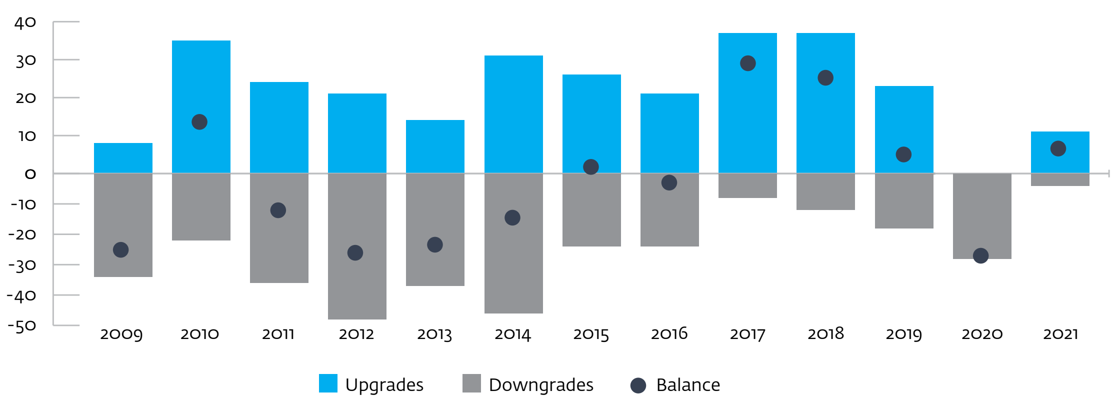
In Brazil, the federal government in 2020 announced a package of measures for states and municipalities amounting to BRR 127.3 billion (equivalent to $23 billion) to face the impact of COVID-19, including direct transfers and debt relief. Subnational governments in Indonesia, on the other hand, relied on budget restructuring to optimize budget utilization, and increasing reliance on new funding schemes such as public-private-partnerships (PPPs), in response to an overall decline in revenues.

## CREDIT IMPACT AND RESPONSE

### SUBNATIONAL GOVERNMENTS WITH A BORROWING HISTORY IN MIDDLE-INCOME COUNTRIES PROVED TO BE REMARKABLY RESILIENT IN TERMS OF CREDITWORTHINESS

Despite some pressure on debt and financial performance, most subnational governments in middle income countries have shown resilience in terms of credit quality, as well as in comparison to low income countries that almost exclusively rely on central government transfers. According to a report published by Fitch Ratings in March 2021, 20 percent of the subnational sector was on negative outlook/watch in Q1 2021 compared to slightly less than 10 percent in March 2020. However, credit downgrades in 2020 were only marginally higher than observed in 2019. S&P Global Ratings lowered 28 subnational ratings in 2020 globally, out of which two-thirds were in Latin America, compared to slightly less than 20 downgrades in 2019. The current economic rebound has started to prompt upward rating movements , with S&P Global Ratings making 11 upgrades since the beginning of calendar year 2021 (as of end of June 2021), compared with four downgrades.

NON-US SUBNATIONAL RATING MOVEMENTS BETWEEN 2009 AND 2021 YTD




*Source:* S&P Global Ratings

IFC's portfolio of subnational investments maintained its weighted average credit quality throughout the COVID-19 crisis. Some of our partner cities decided to delay or postpone investments, which resulted in healthier liquidity positions compared to our pre-pandemic projections. In addition, our portfolio saw benefits from further diversification with higher rated entities, which offset the credit deterioration seen in some countries.

We also observed higher tax revenues and better 2020 accounting estimates than anticipated at the beginning of the crisis for several subnational entities (such as in Turkey and Ukraine) following the easing of restrictions in countries after strict lockdowns. While debt ratios have deteriorated for some subnational governments over the past 15 months in comparison to pre-pandemic levels, this deterioration among IFC's clients was mainly due to either revenue contraction (such as in Argentina) or local currency depreciation (such as for the Turkish municipalities) rather than substantial additional borrowing.

Finally, we have observed that in some middle-income countries some pandemic-related costs have been re-allocated to central governments from the subnational level. In Ukraine, for example, healthcare and social expenditure have been reallocated to the state from cities. This is releasing some pressure on subnational budgets due to a reshuffling of responsibilities and cost allocations.

### INVESTMENT EXPENDITURE CUTS, OR DEFERRALS, HAVE BEEN TYPICAL WAYS FOR SUBNATIONAL GOVERNMENTS TO OFFSET THE NEGATIVE IMPACT OF THE PANDEMIC—ALTHOUGH THIS HAS BEEN GEOGRAPHICALLY UNEVEN

Subnational governments' investment expenditures have been revised downward or deferred since the pandemic started. In our previous commentary, we expected subnational governments in selected developing countries to cut their investment expenditure by 20-70 percent. New evidence shows that subnational governments' capital expenditure cuts were uneven. In fact, investments remained at high levels for the largest subnational government borrowers, namely China and India. IFC is supporting continued investments by subnational governments in India, Morocco, Nigeria, South Africa, Turkey and Ukraine. In Morocco, a new IFC investment concluded in late 2020 for the Fes-Meknes region to (i) finance its capital expenditure program for rural roads, supporting underprivileged local communities in remote rural areas, and (ii) in the context of responding to the pandemic, provide support to fund related expenditures for the purchase of disinfection and sterilization equipment and products.

## LOOKING AHEAD

### WE EXPECT A GRADUAL RECOVERY, WHICH SHOULD SUPPORT NEW INVESTMENT PROGRAMMES AND DFI ACTIVITY IN EMERGING MARKETS

Based on projections in the latest World Economic Outlook released in April 2021, we anticipate gradual recovery for subnational governments in emerging markets, although at different speeds compared with advanced economies. We expect own-source revenues to bounce back, driving up investment expenditure in almost all regions. This will be especially evident in Asia, where subnational governments in China and India have shown strong borrowing trends supported by higher levels of fiscal decentralization. As economies reopen we expect industrial and commercial public services - especially public transportation - to renew with activity growth. According to S&P Global Ratings, borrowing needs will remain elevated and subnational government debt will remain high over the next two years to finance large infrastructure needs. That said, a resurgence of infections driven by the coronavirus variants, delays in vaccination access and reduced fiscal support from central governments makes this recovery more challenging in developing markets.

As shown in IFC's October 2020 note, many subnational governments in developing countries are maintaining relatively large borrowing capacities, which leaves space for more investment to address large infrastructure needs. S&P Global Ratings' March 2021 publication says that most subnational governments in emerging markets show moderate debt levels by international standards, at below 60 percent of revenue. This is consistent with data from IFC's subnationals portfolio, where most subnational governments maintain debt levels below this threshold, for example in Ukraine, South Africa, and Colombia.

The role of DFI and government debt in financing infrastructure will be reinforced in the near-term for at least two reasons. First, private creditors will likely reduce their exposure in emerging markets, considering the prospect of rising inflation, higher interest rates and rising debt burdens for sovereigns. Second, in contrast with developed markets, where bonds are the main source of funding for subnationals, access to capital markets by subnational governments is projected to remain limited for most low- and middle-income countries. There are exceptions including Argentina, China, India and Russia (which are borrowing mainly for debt restructuring purposes). In this context, more DFI debt is expected to flow to emerging markets in the medium term. At the same time there are likely to be new initiatives to develop access to capital markets for subnational governments, to promote access to local currency funding, especially in countries with significant foreign exchange risk (Nigeria and Turkey for example) and to increase the use of public private partnerships in financing public infrastructure.

## SHIFTING PRIORITIES AND WAY FORWARD

COVID-19 has increased the incentive to tackle pressing infrastructure needs and secure urban resilience. As subnational governments make critical decisions to adjust their operating and capital expenditures in 2021, clear strategies and prioritization will be required. The World Bank Group can support national governments in creating an enabling environment for prudent fiscal decentralization and enhanced financial autonomy for cities. IFC can also help cities improve creditworthiness, enhance their capacity to borrow and act as an anchor investor. Subnational governments will require additional financial resources and need to attract and unlock private sector capital to finance green and urban infrastructure. The resurgence of the pandemic in Asia and elsewhere, unpredictability of virus variants as well as uneven access to vaccines, has underscored the need to continue pandemic-related support to emerging market subnational governments.

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