COVID-19's Impact on Sub-National Governments

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In emerging markets, urban centers feel the brunt of both the health and economic crises, putting subnational governments, or SNGs, front and center in the efforts to contain COVID-19. SNGs in emerging markets face significant challenges brought on by the pandemic, for example, significantly less use of public transit, dramatically lower sales tax revenue due to retail and tourism closures, and limited capacity to mount an effective health response. Low levels of preparedness compound these vulnerabilities.

BACKGROUND

More than half a million SNGs exist globally at the municipal, state, and regional levels. They are funded through government transfers and own-source revenues derived from taxes and fees for urban services. Most lower-income countries rely on central government transfers for a large share of revenues. Restrictions on SNG borrowing exist in most countries in emerging markets, where less than 20 percent of the largest 500 cities have local borrowing capacity. This further limits cities from accessing commercial debt through capital markets or financial institutions.

COVID-19'S IMPACT ON SUB-NATIONAL GOVERNMENTS

The COVID-19 pandemic has caused significant dislocation in SNG revenues, expenditure burdens and priorities, and the capacity to meet these needs. A global recessions whose effects could last well beyond 2020 is expected. The World Bank forecasts a 5.2 percent contraction in global GDP in 2020. With more than 80 percent of global economic output generated in cities, where 55 percent of the world's population lives and 95 percent of COVID-19 cases have been reported, subnational governments are directly impacted by the pandemic and are at the forefront of response measures.

Impact on cities' revenues: SNGs see a reduction of tax and other budget revenues during lockdown and recovery periods. Government revenues in 2020 are projected to be, on average, 2.5 percentage points of GDP lower than in 2019. The shrinking fiscal space will likely affect central government transfers to SNGs. COVID-19 is also affecting cities' own-source revenues. For example:

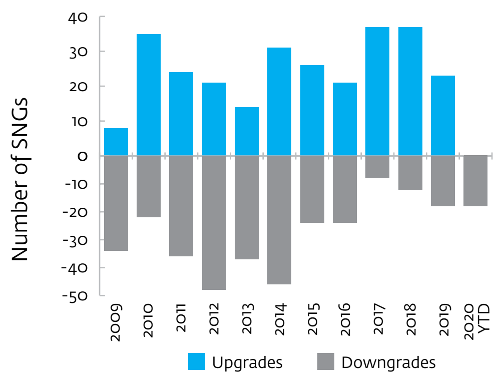
- Revenues from public transport companies, water utilities, and waste utilities are projected to decline in 2020 due to emergency measures implemented to contain the pandemic. For example, urban mass transit revenues will be severely affected by extended lockdowns and lower usage. A recent World Bank and the International Association of Public Transport (UITP) survey of 27 bus operators in India revealed that 81 percent had no ridership following the lockdown in March 2020, while the remainder witnessed a 90 percent reduction, causing significant financial losses.
- COVID-19 will lead to potentially large tax revenue losses for SNGs due to tax deferrals and lower taxable incomes. Cities reliant on elastic sources of revenue (for example, on sales and income taxes), or with a high share of revenues and employment in tourism and commodity exports will be more severely impacted in the short term.
- SNGs also generate revenues from land sales, rental income, royalties, and dividends, all of which will be affected by the pandemic.

The World Bank's global estimates project a 15–25 percent decline in local government revenues in 2020. In Africa, local governments could experience a drop in local finances of 30–65 percent, on average, depending on the severity of the crisis.

Impact on expenditures: COVID-19 has led to emergency expenditures to support the overall economy, healthcare systems, coping measures, social protection, and other actions. Forecasts show that the pandemic will push 71 million people into extreme poverty in 2020, mostly informal workers and women. This situation contributes to widening the social protection financing gap in developing countries. The degree to which SNGs bear these expenses depends on the level of fiscal decentralization. In cities such as Bogota—where health, education, and social inclusion account for 50 percent of operating expenses—the pandemic's impact on SNGs' social expenditures is more pronounced.

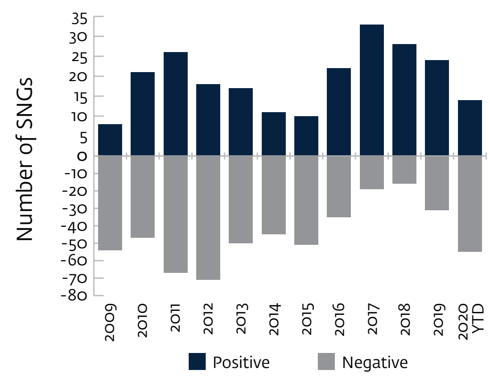
Impact on creditworthiness and borrowing: Pandemic-induced economic and financial shocks continue to trigger both sovereign and SNG rating downgrades globally. Argentina, Colombia, Guatemala, Mexico, Nigeria, and South Africa were downgraded by at least one rating agency since April, with sub-sovereign ratings subsequently adjusted downwards. According to S&P, sub-sovereigns were also downgraded on a standalone basis in more than half of the cases. All the rating downgrades taken on SNG in the first half of the year were downgrades covering lower-raked SNGs. Outlooks deteriorated across the board (Figure 1).

Figure 1(a): SNG Rating Movements 2009–2020 YTD



Source: S&P June 2020

Figure 1(b): SNG Rating Outlooks 2009–2020 YTD



Source: S&P June 2020

Many SNGs in middle-income countries, such as Argentina, Brazil, India, and Turkey, have an active borrowing program and maintain high debt levels. S&P forecasts that the global recession and shrinking fiscal space will force credit-rated SNGs to increase annual borrowing by 10 percent over 2020–21, relative to previous forecasts of a 6 percent growth, pointing to a higher debt burden for SNGs due to the pandemic. Rating agencies expect debt levels to remain sustainable, supported by record-low interest rates on long-term foreign currency debt.

SNGs with low creditworthiness will face credit rating pressures reflecting both COVID-19 impacts and pre-existing vulnerabilities, and are likely to struggle to fund regular Capex. Some SNGs are also struggling to fund short-term liabilities. In South Africa, for example, many municipalities have historically failed to meet their obligations to Eskom, the country's power utility. The pandemic has increased these SNGs revenue pressures. Some previous well-banked SNGa are also facing liquidity constraints in local markets, which is increasing reliance on multilateral banks and fiscal consolidation measures.

RESPONSE TO THE CRISIS

Responses to contain COVID-19 impacts in cities are being implemented at various levels of government: central, regional, and municipal. External support is also being extended to sovereigns and SNGs by development partners.

SNGs are at the front line of COVID-19 containment and mitigation of the socio-economic impacts. Wide-ranging measures have been implemented to contain the virus, such as deploying emergency public service facilities to underserved areas, implementing lockdowns and movement restrictions, and expanding medical care and containment facilities.

For example, Pakistani provincial governments announced fiscal measures broadly consisting of cash grants to low-income households, tax relief, and additional health spending that includes increased compensation to healthcare workers. The Punjab local government announced a tax relief package and a cash grants program collectively valued at 28 billion Pakistani rupees ($168 million). Cape Town rolled out COVID-19 testing booths and spent 70 million South African rand ($4.1 million) to implement a COVID-19 preparedness plan that included retrofitting clinics and setting up overflow facilities. The Mexico City capital government and 13 of its 16 municipalities collaborated to implement a new food voucher program supporting low-income households and micro-businesses.

As existing cashflows are diverted to cover emergency expenditures, SNGs are cutting or delaying non-essential capital and operating expenditures. While operating expenditures are usually dominated by salaries and are much less flexible, the pandemic has caused operating expenditures cuts in areas such as community and economic development, code inspections, and permitting. Cities are also putting some workers on furlough as well as implementing hiring freezes.

The bulk of uncommitted capital expenditures are relatively more flexible, thus face a higher risk of deferral. The Philippines government has reduced its public works and highways budget for 2020 by about 21 percent to fund COVID response programs. In Africa, SNG investment expenditures supported by central government transfers could decline by 26–63 percent, on average, depending on the size of the city and the severity of the crisis. For example, Kenya implemented a 71 percent budget cut on its Big Four projects, under the 2020–21 budget period.

Territorial containment measures have been adopted that depend on effective SNG leadership and planning. To curb a potential resurgence of COVID-19 cases, Mexico adopted a reopening protocol that codes states based on the epidemiological situation, allowing different types of economic activities. Ukraine adopted a similar framework based on four quarantine zones, while in India, the relaxation of travel restrictions was geographically staggered.

SNGs are not shouldering the burden of the pandemic alone—many central governments have already responded to COVID-19 with unprecedented measures. Adopted measures include additional government spending for medical resources, employment support, food distribution, subsidies for small businesses, social protection, and public investment.

In Brazil, which has among the highest number of cases globally, the national government has implemented a series of fiscal measures adding up to 12 percent of GDP. These include income support to vulnerable households, employment support, lower taxes, and import levies on essential medical supplies, liquidity support to businesses and households from public banks.

Ukraine has been implementing several measures to support businesses, including the cancellation of penalties for certain tax legislation violations until the last day of the quarantine and a temporary moratorium on tax audits and inspections. The government has also expanded the subsidized loans program and credit guarantee scheme, extending about 3,000 loans worth 6.8 billion Ukrainian hryvnias ($240 million) as of September 2020.

Some relief may come from international institutions. The IMF announced its readiness to mobilize its $1 trillion lending capacity to help nations implement essential containment measures, shield affected people and firms, reduce stress to the financial system, and implement recovery programs. The World Bank also announced a $14 billion COVID-19-related financing package.

IFC is supporting SNGs through financing and advisory services to help mitigate the crisis:

- *IFC's support to SNGs during the crisis* includes alleviating liquidity and debt pressures, ensuring continuity of essential public services, and adapting public infrastructure to the challenges posed by the COVID-19 outbreak. In Turkey, IFC is providing financing to a municipal water utility for the continuation of essential construction works. In Ukraine, IFC provided support to Zaporizhzhia City to understand public mobility patterns for enhancing the planning of quarantine and reopening measures, among others. In Morocco, IFC is supporting an SNG to meet funding needs related to the purchase of disinfection and sterilization equipment for public spaces.
- *IFC's regular Capex support* is meeting increased demand from SNGs that are adequately served by the market under normal liquidity conditions. For example, IFC is supporting the cities of Ekurhuleni (South Africa) and San Jose (Costa Rica) with long-term financing to implement infrastructure Capex plans.

GOING FORWARD

COVID-19 has increased impetus to address access gaps, meet growing demand, and build resilience. Infrastructure accounts for a significant part of the planned post-COVID economic stimulus in some emerging markets. For example, Bogota, Colombia, approved its District Development Plan in May 2020, aimed at advancing several large-scale public transit projects over the next four years. Indonesia has budgeted nearly 50% annual increase for infrastructure spending in 2021 to catch up on projects neglected during the pandemic.

As SNGs are making hard decisions to adjust their operating and capital expenditures in 2020–21, clear strategies and prioritization are required. Such decisions must be taken in a timely way to maintain financial sustainability, and with clear strategy and priorities in mind to ensure the stable functioning of the public infrastructure, provision of basic public services, and economic recovery conditions.

Cities will need to address structural issues in urban infrastructure and unemployment. These include low SNG fiscal capabilities, large inequalities in access, low urban planning capabilities, and high levels of employment informality. Unemployment will increase in marginalized areas due to the pandemic, increasing inequality. SNGs' recovery efforts should systematically address inequality, improve social protection, deepen planning capabilities, and improve crisis preparedness and response.

SNGs will require additional financial resources. Depending on the severity of economic damage from the pandemic, the recovery process will require government interventions. Volatility and risk aversion in financial markets are likely to remain in the short term. In contrast, in the medium term, a global recession affecting developed countries may result in subdued capital flows to emerging markets. While the specific needs of SNGs during the recovery period are still unfolding, support from development finance institutions will be imperative.

Government policy should focus on preserving the role of the private sector in financing urban infrastructure. Several SNGs in emerging markets are pursuing alternative financing options for larger-scale infrastructure projects to preserve funds for social costs. In Indonesia, where state and regional budgets are expected to prioritize COVID-19 recovery efforts through 2022, the Finance Ministry has urged SNGs to pursue PPPs for infrastructure development.

IFC will continue to provide support to SNGs to implement post-crisis recovery and resilience programs. Beyond financing, IFC is offering advisory support in the forms of client interactive online sessions, including (a) peer-to-peer sharing on best practices to reduce the viral spread and minimizing negative impacts, (b) sharing IFC's experience and lessons from the Ebola outbreak in Guinea, (c) advice on community education and outreach through online and offline channels, led by IFC's Sustainable Infrastructure Advisory, (d) advice on the adjustment of public transport infrastructure to contain the spread of virus outbreaks, and (e) dissemination of relevant information and resources on best practices in communicating effectively with the public during COVID-19.

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