Sub-sovereign Outlook 2022

Regional and local governments are aligning the return to ordinary budgeting with the winding down of central government support and the economic recovery

Sovereign and Public Sector, Scope Ratings GmbH, 25 January 2022

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Executive summary

Scope's 2022 Sub-sovereign Outlook is the first edition of an annual publication containing our latest views on the sector-wide credit outlook and most important themes to watch over the coming year for regional and municipal government finances in Europe. We have significantly expanded our sub-sovereign credit rating coverage since 2017 to about thirty entities across the main European jurisdictions. In addition to publicly available ratings, sub-sovereign credit ratings are mostly accessible via Scope's subscription platform ScopeOne. For an overview of subscriber-exclusive framework studies and freely available research, see this overview.

Our methodological approach is "framework-driven", meaning we acknowledge the importance of interdependence between the institutional frameworks under which sub-sovereigns operates and individual credit profiles, affecting their fiscal strength, liquidity profiles and debt management. Our ratings emphasise the importance of the institutional framework, as we start from an indicative rating distance from the respective sovereign rating, within which sub-sovereigns are positioned according to their individual credit strength.

The overall credit quality of European sub-sovereigns is broadly expected to stabilize in 2022, underpinned by considerable central government support provided during the Covid-19 crisis and the ongoing economic recovery. Supportive factors also include mature institutional frameworks, a revenue base which is less sensitive to economic activity and accommodative financing conditions.

Our key themes for 2022 are:

Institutional frameworks shield sub-sovereigns from Covid-19, but the structural effects of the crisis challenge the return to ordinary budgeting. European sovereigns have broadly centralised the costs of the Covid-19 pandemic through additional transfers to sub-sovereigns to compensate for tax shortfalls and elevated pandemic-related spending, reducing their recourse to debt. Now, as the economic recovery strengthens, sub-sovereign fiscal policy is set to return to ordinary budgeting. As the acute emergency fades and crisis-related support transfers are withdrawn, budgets will still be burdened by structural spending effects left by the crisis, reintroduced limits on debt-financing and diverging revenue recoveries.

Sub-sovereign capital market activity: a growing role of ESG bonds. Sub-sovereigns' funding activity on the capital markets varies greatly across European countries. Non-issuance or rare issuance by sub-sovereigns in certain countries mostly reflects the consequences of the sovereign debt crisis of the past decade, which led to a higher degree of dependence on redirected sovereign funds. Sub-sovereigns' funding activity has hugely benefitted during this pandemic from central banks' very accommodative monetary policy stance and more supportive frameworks under which they operate. The market for ESG-linked debt is growing in importance for sub-sovereign issuers, offering regional and local governments access to a growing and more diversified investor base.

Sub-sovereign investment: EU recovery funds could reduce economic divergence and investment gaps. The Covid-19 crisis marked a change of paradigm in Europe's fiscal response to economic shocks, favouring emphasis on additional public investment - in contrast with fiscal austerity favoured in the past - to avoid the further build-up of significant investment backlogs. Sub-sovereigns play a central role in public investment and will bear significant responsibilities in the implementation of the Next Generation EU (NGEU) programme. The quality of institutional governance and limited administrative capacities remain important obstacles in the effective use of the funds to promote greater EU economic convergence.

Our country views for 2022 for the main European economies are:

Germany (AAA/Sta)	Länder credit risk remains well-anchored by a strong institutional framework. As the Covid-19 crisis ebbs, the Länder face economic recoveries at different speeds and varying debt-brake provisions. Divergent approaches to accounting for pandemic-related financial flows and reserves worsens transparency. Continue to the chapter.
France (AA/Sta)	Covid-19 had a mixed impact across different levels of government in France due to differing budget structures, responsibilities and degree of state support. Budgetary performance is set to improve medium term as the economy recovers while the long-term outlook will be marked by local tax reform and central government consolidation strategies. Continue to the chapter
Italy (BBB+/Sta)	Regions will receive extra resources for healthcare after the pandemic, while legislation to gradually cancel a major regional tax has been recently approved. These developments point to even higher future transfer-dependency in regional finances, which contrasts with political projects aimed at increasing regions' fiscal autonomy. Continue to the chapter
Spain (A-/Sta)	Autonomous communities are set to receive less from the regional financing system and extraordinary transfers this year than in 2020-21, while facing structural spending increases, including personnel costs. Discussions on the reform of the financing system have gained momentum. Continue to the chapter

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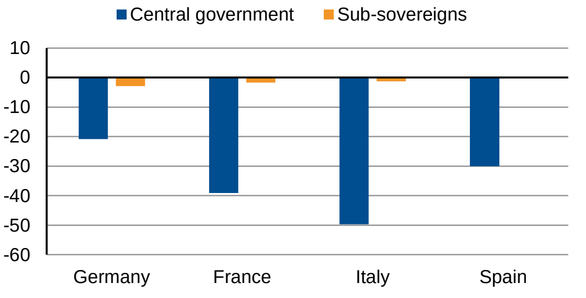
Key themes for 2022

Institutional frameworks shield sub-sovereigns from Covid-19, but the structural effects of the crisis challenge the return to ordinary budgeting

Our approach to sub-sovereign ratings is "framework-driven", meaning we acknowledge the importance of the relationship between sub-sovereigns and their respective sovereign as a key rating driver. We emphasise that institutional frameworks have varying effects on a sub-sovereign's individual credit profiles, thereby affecting their fiscal strength, liquidity practices and debt management. We also recognise that the ultimate recourse of a sub-sovereign to honour its obligations during financial stress scenarios is not its own balance sheet but rather the willingness and ability of the sovereign to provide additional resources.

The Covid-19 shock demonstrated the relevance of such an approach. Central governments in the EU stepped in and shielded sub-sovereigns' balance sheets from the impact of the crisis, mostly via extraordinary budgetary transfers and/or funding support. **Figure 1** shows 2020 fiscal balances at the central and sub-sovereign government level in the EU Big-4 economies. Clearly, the fiscal effects of the crisis were mostly centralised by sovereigns, shielding sub-sovereigns' budgets and limiting their recourse to additional debt.

Figure 1. Fiscal balance by government sector, % of government sector revenue, 2020



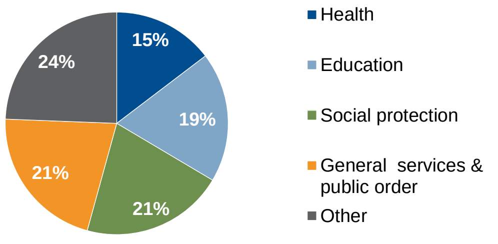
Source: Eurostat, Scope Ratings GmbH

We expect sub-sovereigns to be generally less affected by the Covid-19 crisis than their respective sovereigns, with varying degrees across countries and levels of government. This echoes government policies following the global financial crisis, which led to extensive reforms of the institutional frameworks in the countries which were hit the hardest from the crisis. Institutional frameworks under which sub-sovereigns operate typically cushion immediate economic effects of shocks, with the central government usually undertaking the role of automatic stabilisers, with responsibilities in the most cyclical government revenue and expenditure items. In addition, material transfer-dependency and mature equalisation systems weaken the link between sub-sovereign budgets and the economic performance of the territory in which a sub-sovereign is located.

Despite high uncertainty on how the Covid-19 pandemic and its effects on the economy will evolve, 2022 will see a recovery in subnational finances, as the economic recovery translates into higher own revenues. At the same time, however, central governments will start withdrawing the additional transfers to sub-sovereigns allocated during the crisis, triggering a return to ordinary budgeting. Here, key issues for this year include: i) which structural effects the crisis has left on sub-sovereign spending; and ii) how the pace of scaling back extraordinary budgetary support via central government transfers will align with sub-sovereigns' own revenue recovery.

Sub-sovereign expenditure tends in general to show a non-cyclical structure, with large shares of spending in areas such as healthcare, education, social protection and public order (**Figure 2**). While this favours central government support in times of crisis, it can also lead to the inability to meaningfully adjust current spending, should revenue recover slower-than-expected.

Figure 2. EU aggregate state and local government tiers expenditure by function, 2019



Source: Eurostat, Scope Ratings GmbH

Moreover, generous extraordinary support is likely to have incentivised some distortion in fiscal discipline, with sub-sovereigns tempted to increase spending structurally during the crisis, relying on temporary additional revenue streams, with adverse medium-term consequences. A part of the structural increase is likely to come from augmented personnel costs in strategic areas affected in the crisis, such as education and especially healthcare. Therefore, while the support during the crisis has effectively shielded sub-sovereigns' creditworthiness, we expect medium-term effects on their fiscal performance in form of elevated spending needs.

This poses moreover challenges in the context of the re-introduction of fiscal rules, after the temporary relaxation of frameworks during the pandemic, to allow for a more flexible policy response to the emergency. Consistent with the activation of the escape clause in the Stability and Growth Pact rules governing general government finances at the EU level, many countries introduced provisions to allow for a supportive fiscal policy at the sub-sovereign level. This was particularly efficient during the pandemic, with regions and municipalities being the closest government level to households and firms. These ranged from an outright suspension of debt limits and targets (Germany, Spain), to the introduction of some flexibility in budget rules to facilitate the allocation of resources towards emergency spending or investment (Italy).

As the economy recovers, sub-sovereign fiscal rules are set to be reintroduced, even if, possibly, with some revisions. Sub-sovereigns may find themselves in the need of adhering to rigid rules, while facing structural, pandemic-induced changes to their finances. Here, we also note that central governments are likely to require regional and local governments to contribute to consolidating general government finances, as was the case in certain countries after the sovereign debt crisis. This further underpins the interdependence between sovereign and sub-sovereign credit profiles.

Institutional frameworks have played a key role in implementing an effective response to the crisis. At the same time, we can expect the Covid-19 pandemic related economic transformations also shape the future of intergovernmental relations and subnational finances. While in the short term - with varying degrees across frameworks and jurisdiction - economic factors are cushioned in their effects on sub-sovereign credit profiles through central government transfers and revenue redistribution mechanisms, structural economic trends ultimately affect the comprehensiveness and sustainability of these redistribution mechanisms, or equalisation systems.

The Covid-19 pandemic led to a very significant economic contraction, but with a rapid recovery; however, such recovery is set to be uneven across sectors and territories, carrying structural changes in the economies with impact on regional divergencies between, but also within, countries.

In Europe, the crisis erupted in Northern Italy, affecting initially comparatively more those regions that are also the wealthiest, imposing prolonged containment measures. However, industrial or manufacturing lockdown - inflicted shocks are typically being followed by robust recoveries. The more lasting effects are reflected on other sectors including tourism and hospitality, which have a predominantly high importance in economically weaker regions. This is the case in the South of Italy and Spain, two countries where regional economic discrepancies are very large. A continuous growth in divergence creates pressures on equalisation systems, with wealthier regions less willing to support economically weaker ones. This could further be exacerbated by long-term adverse demographic trends.

Changes to the institutional frameworks to adapt to the post-crisis period may be necessary in Italy and Spain. While the urgency of the pandemic has led to these tensions to subside temporarily, the topics are coming back under debate.

Sub-sovereign capital market activity: a growing role of ESG bonds

Capital market activity in the sub-sovereign sector varies across European countries, including across the Big-4 economies. The effects of the global financial and sovereign debt crises limit market access for regional and local governments of the countries most adversely affected to this day, such as Italy and Spain.

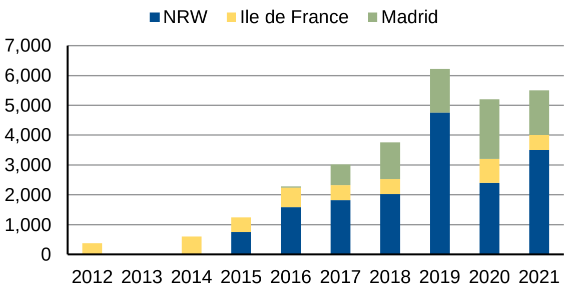
In the biggest European subnational capital market, i.e. the market for German Länder debt, the crisis has led to record-high levels of net issuance, amid uninterrupted market access at very favourable funding costs. Net issuance amounted to EUR 67bn in 2020, slowing to EUR 5bn last year, after years of net redemptions in previous years, in anticipation of the debt brake becoming binding in 2020. However, the flexibility in debt brake laws has allowed the central government and the Länder to respond to the crisis with sizeable fiscal support. In France, bigger sub-sovereigns remain the leading drivers of local and regional government bond issuance, while the ramp-up of Agence France Locale, a local government funding agency founded in 2013, has helped share market access among smaller entities.

In Italy, sub-sovereigns still rely mostly on sovereign on-lending, via the state-owned national developed bank Cassa Depositi e Prestiti (BBB+/Stable), together with bank loans, while sub-sovereign bond issuance is still frozen. In Spain, conversely, stronger regions are increasingly returning to the capital markets, gradually reducing their reliance on central government on-lending, which has characterised most Spanish regions' funding practices since the sovereign debt crisis.

A very accommodative monetary policy stance, including the ECB's asset purchase programmes, and supportive frameworks strongly supported the return of sub-sovereign bond issuance during the Covid-19 crisis given favourable market conditions resulting in the low interest rate environment.

The increasing focus on ESG bond issuance is becoming a key aspect in sub-sovereign capital market activity, driven by shifting priorities at the national government level and increased ambition to tackle climate change and boost infrastructure projects, many of which are funded by subnational governments. However, an explicit integration of ESG factors has not been a priority so far also in view of either available sovereign on-lending or higher funding costs compared with central government debt securities. A better credit quality relative to corporate bonds ensures high investor demand on classic debt securities, further disincentivizing sub-sovereigns from ESG-related bond issuances. **Figure 3** shows issuance of sustainability, green and social bonds across pioneer selected regions over the past ten years.

Figure 3. ESG bond issuance, selected EU regions
EUR m



Securities under Bloomberg's sustainability, social, green instrument indicators.

Source: Bloomberg, Scope Ratings GmbH

ESG bonds distinguish themselves from standard debt securities in that their use of proceeds is earmarked for environmental projects (green bonds), social projects (social bonds) or a mix of both (sustainability bonds). So far sub-sovereigns have mostly issued sustainability bonds, potentially linked to more flexibility in allocating proceeds.

Given their mandates, sub-sovereign spending is naturally focused on infrastructure development, healthcare and environmental protection, which are inherently ESG-related factors. This facilitates the eligibility of a material share of their investment spending to be funded via ESG-labelled debt. Issuance of ESG bonds can provide access to a growing investor base focused on sustainability, giving regional and local governments the opportunity to diversify their investor base towards buy-and-hold investors and improve debt profiles via, for instance, extending their average debt maturity. Also, robust demand for ESG bonds tends to ensure favourable funding conditions, with very low spreads from respective sovereigns yields.

These favourable factors are especially beneficial to regional and local issuers that seek to expand their presence in the markets after periods of limited activity. However, the elevated costs and additional requirements related to prove compliance with sustainability aspects, also limit a more widespread adoption of ESG funding. This is well reflected in the role ESG bonds played for Spanish regions in their return to autonomous funding after years of reliance on sovereign on-lending (see dedicated section below). Conversely, this facilitating role is more limited in the case of German Länder, which were able to maintain a strong market presence also during the past crises and which rely on a very broad and stable investor base.

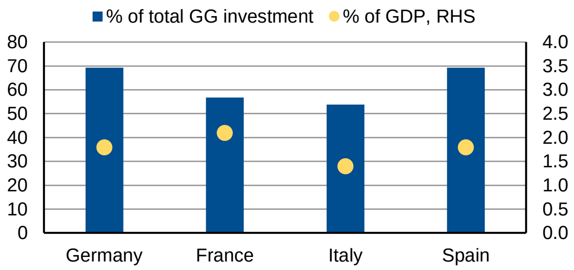
Indeed, it will take some years for the ESG bond market to mature given that sub-sovereigns face several challenges, including the lack of common standards and reporting costs, as well as insufficient data in particular for environmental factors. In addition, smaller issuers may lack the necessary resources needed for fulfilling disclosure requirements.

Frameworks for defining eligibility and conditionality of ESG financial instruments are evolving, with a lack of universally accepted definitions and sometimes competing market- and legal-based standards. This has so far resulted in a divergence of sustainability and green bond frameworks, with each sub-sovereign developing its own format, coupled with second-party opinions from diverse specialised providers, weighing on comparability and transparency. Industry associations' guidelines such as the ICMA principles should support further standardisation. The ongoing development of the EU taxonomy will also contribute to standardisation and maturity of this market.

Sub-sovereign investment: EU recovery funds could reduce economic divergence and investment backlogs

The EUR 800bn NGEU funds, via the Recovery and Resilience and the React-EU facilities, will allow for a significant increase in public investment spending in the next five years. NGEU funds come on top of funds for investment provided in the multiannual financial framework, which, for 2021-27, will amount to over EUR 1.2trn, including almost EUR 400bn allocated to Cohesion Policy.

Figure 4. Sub-sovereign investment, 2020



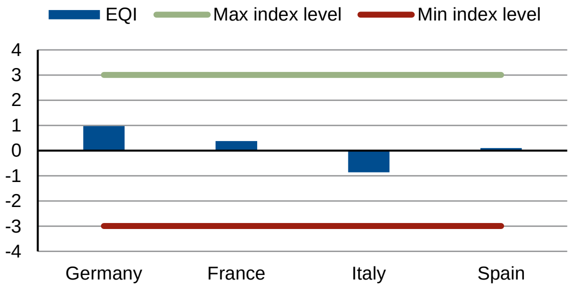
Source: Eurostat, Scope Ratings GmbH

In this context, sub-sovereign governments will play a key role in implementation, with traditionally high spending shares for public investment, see **Figure 4**. Even before the pandemic, a debate around boosting infrastructure spending was warranted in response to long-term challenges and a backlog accumulated after the years of austerity following the sovereign debt crisis.

NGEU funds are asymmetrically distributed towards countries with economies structurally weaker and most affected by the pandemic crisis, such as Italy and Spain, and thus represent a unique opportunity in driving economic convergence. At the same time, sub-sovereigns located in weaker economic regions also display relatively weaker administrative capacities and governance quality.

Figure 5 shows country averages of the quality of governance at the regional level, as captured by the 2021 EQI index, which is based on surveys where respondents are asked about perceptions and experiences with public sector corruption, along with the extent to which citizens believe various public sector services are impartially allocated and of good quality.

Figure 5. Quality of governance index, regional averages, 2021



Source: EQI, Scope Ratings GmbH

In the context of NGEU, a centralisation of planning capacity and ad-hoc governance frameworks have been created in many countries to ensure robust oversight and effectiveness of implementation. These include the involvement of regional and local governments in an effort to coordinate responsibilities of different jurisdictions and to ensure an effective mobilisation of funds.

While increasing oversight and control systems may contribute to improving rigorousness in the investment processes, we still expect regional and local administrations to face significant challenges in turning unprecedented amounts of European funding into growth-enhancing projects. These include fatigue in attracting skilled personnel and bureaucratic impediments in project implementation.

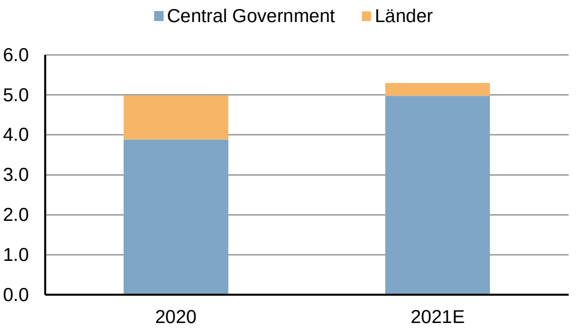
Country views for 2022

German Länder creditworthiness shielded via central government, medium-term pressures persist

Since the first Covid-19 case emerged in Germany in January 2020, the federal and Länder governments reacted forcefully to fight the public health and economic impact of the pandemic. To allow for extraordinary recourse to debt-funded stimulus in the context of the country's debt brake laws – which only became binding for the Länder in 2020 - the authorities used emergency exemption clauses for the years 2020-22. From 2023, re-instated debt brakes will cap the structural deficit at the central government level at 0.35% of GDP and at 0% for Länder governments.

The German fiscal response was sizeable, including in a European comparison, leading to a central government and Länder aggregate deficit of around EUR 170bn in 2020 (or 5% of GDP) and an estimated EUR 180bn in 2021, or 5.3% of GDP (**Figure 6**).

Figure 6. Central government and Länder government deficit
% of GDP

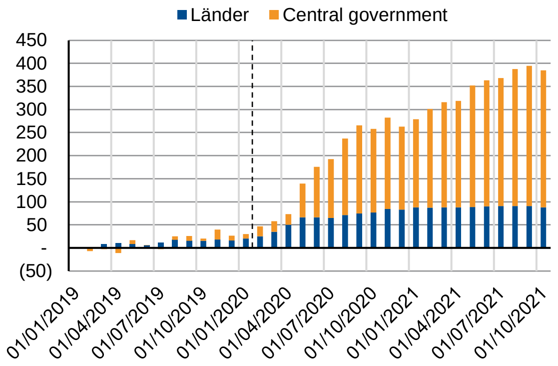


Source: Federal Ministry of Finance, Scope Ratings GmbH

The central government has shielded subnational finances during this crisis, carrying the costliest measures, such as a short-time work scheme, grants to affected businesses, and a value added tax cut in the second half of 2020 to stimulate demand, along with direct fiscal support to the Länder, such as a permanent increase in the central government's share of the cost of accommodation for job seekers. It is in this context, and in view of the very mature and predictable links between the two layers of government, that we continue to view the German federal framework as the most supportive in Europe, leading to a very close link between the creditworthiness of each individual Land with that of the central government.

To fund significant deficits, both the central and Länder governments increased net debt issuance, in the context of very low net issuance in the previous years due to debt brake provisions (**Figure 7**).

Figure 7. Cumulative net debt issuance
EUR bn, Gross capital market issuance net of redemptions



N.B. Data until October 2021. Source: Bloomberg Finance L.P., Bundesrepublik Deutschland Finanzagentur GmbH, Scope Ratings GmbH

Looking ahead, Länder finances and their budgetary flexibility still face medium-run challenges. First, the Covid-19 crisis will have a lasting impact on projected tax revenues. Previously, we conservatively estimated tax shortfalls for the Länder to amount to EUR 100bn over the period from 2020 to 2025. However, latest data by the Federal Ministry of Finance shows a much stronger than expected recovery in 2021, with aggregate tax revenues in Germany from January to November standing 13.4% higher than in the same period last year, pointing to an earlier-than-expected return to pre-crisis tax levels.

Second, despite strong institutional links, and in particular the mature tax sharing system, we still view the crisis as having impacted the Länder to varying degrees. For example, real GDP declined by as much as 7% in Bremen in 2020, vs a more moderate 3.2% in Brandenburg, and structural factors will cause post-pandemic economic recoveries to be multi-speed. The ifo institute estimated varying trend growth rates for the Länder, ranging from negative 0.2% in Saarland to 1.1% in Bavaria and Berlin.

Finally, we observe significant heterogeneity in the Länders' budgetary response to the crisis. In accordance with 16 different regional debt brake laws, the Länder exercise a large degree of autonomy on how to respond to the crisis. This has led to very different outcomes, in terms of size and type of the fiscal response, accounting practices, and in the start and length of pandemic debt redemption. Very short debt redemption periods, starting in the delicate recovery phase, overly harm budgetary flexibility in the short-term. In addition, diverging accounting practices on pandemic related financial flows and budgetary reserves weakens transparency in the system and core budget comparability.

Research
German Federal government shields Länder from pandemic debt burden supporting creditworthiness – 9 November 2021
Germany's federal fiscal framework: closer Länder-central government ties underpin credit quality – 17 February 2021
Ratings
Free State of Bavaria (AAA/Stable): Rating action release; Rating report – April 2021
Land of Berlin (AAA/Stable): Rating action release; Rating report– June 2021

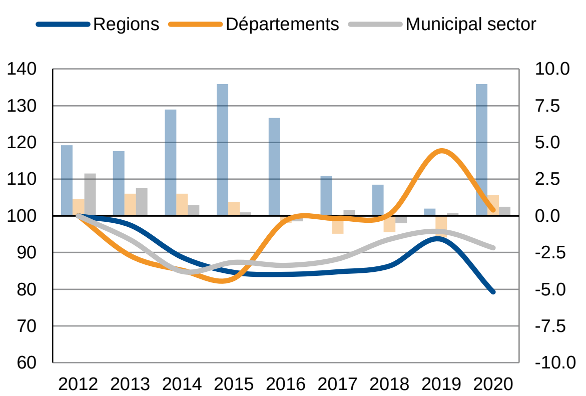
French local authorities: varying Covid-19 hit and shifting budget structures

The heterogeneous impact of Covid-19 on French public finances

Local and regional governments intervened jointly with the state to support their communities and economies during the pandemic as recession reduced revenues. Overall, local and regional finances weathered the Covid-19 pandemic well in 2020 though the crisis interrupted years of improvements in budgetary performance for all subnational levels of government.

Operating margins did not fall below their 2018 levels for France's *départements* and the municipal sector (**Figure 8**). Regions recorded the weakest operating performance in years due to rapidly rising exceptional spending given their responsibilities in terms of economic development. This was partly offset by increased capital revenue via state investment subsidies. All tiers of government increased their net debt issuance though this was more substantial for regions whose net debt movement reached previous highs, reflecting weaker budgetary performance and rising investment given increased support for the private sector amid the economic crisis.

Figure 8. Subnational operating performance (LHS) and net debt movements (RHS)
2012 = 100 (LHS); % of operating revenue (RHS)



Note: The lines refer to operating margins; the columns refer to net debt movements.
Source: DGFiP, Scope Ratings GmbH

Still, local and regional government finances displayed remarkable resilience during 2020 compared with the state despite a 8% contraction in GDP. In absolute terms, the 2020 increase in general government debt (+EUR 274bn) was mostly driven by rising indebtedness of the central government and social security bodies (+EUR 254bn). Debt increases for regions (+EUR 3bn), *départements* (+EUR 1bn) and the municipal sector (+EUR 2bn) were moderate in comparison. Similarly, the increase in the general government deficit (+EUR 135bn) reflects much wider deficits at the central government level (+EUR 131bn) than the subnational one (+EUR 3bn).

The wide differences in the magnitude of the fiscal shock between sovereign and sub-sovereign government tiers reflects the role the central government played as the primary shock absorber. This reflects several reinforcing factors: i) local and regional revenues are generally less cyclical than those of the central government; ii) local and regional authorities benefit from higher expenditure flexibility than the central government given that investment is a major component of French subnational governments' expenditures; and iii) operating expenditure increased less than anticipated thanks to effective cost control and a reduced public service offering.

In addition, local and regional authorities benefitted from crucial systemic support thanks to increased state transfers designed to limit the impact of the crisis on their finances. The French state implemented several support mechanisms totaling EUR 2.6bn or 1% of total subnational government revenue (**Figure 9**). Measures included advances on transfer duty receipts and for public transport bodies, an increase in the investment subsidy and a revenue loss compensation scheme. State support played a very important role in bolstering finances of the municipal sector and *départements*, especially for the hardest hit entities though it was less significant for regions.

Figure 9. French State support schemes for subnational governments
EUR m

Support scheme	Total allocated	Total disbursed
Revenue loss compensation scheme	246	266
For the municipal sector	*200*	*200*
Exceptional investment subsidy	950	9
Exceptional mask purchase transfer	135	129
Advances	1,250	307
Total State support	**2,581**	**711**

Source: Cour des Comptes

Medium- and long-term trends for local and regional finances

The medium-term outlook: French subnational public finances will see continued domino effects from the Covid-19 crisis as affected tax proceeds are recorded with one- or two-years delay. These will be offset by positive revenue dynamics given France's expected rapid economic recovery following the relaxation of pandemic-related restrictions.

The 2022 draft budget expects a strong rebound in revenue from local taxes (+3.7% in 2021, +4.5% in 2022), thanks to the strong economic recovery. Subnational operating expenditure should also grow, albeit at a slower pace (+2.2% in 2021, +2.4% in 2022), with a gradual return to pre-crisis activity levels. We therefore expect a broad-based operational recovery in subnational public finances which should support the expected jump in investment spending (+12.3% in 2021, +3.4% in 2022) as part of the recovery plan and limit recourse to additional debt to fund investment.

Municipalities will benefit from a higher revaluation of castral values in 2022 than in previous years due to accelerating inflation, which will increase their property tax revenue. A strong dynamic in the volume of real estate transactions is expected to have driven an increase of around 17% in property transfer tax proceeds (EUR 1bn) in 2021, thus providing a boost to *départements'* operating revenue. This increase will compensate for the decline in corporate contributions based on value added (CVAE) receipts due to Covid-19 (which is budgeted with a one- to two-year lag). The economic rebound will also lead to lower demand for welfare benefits and should contain the growth in current spending. The recovery in domestic demand supported regions' revenue in 2021 through increased VAT income. This should continue in 2022 and will have a positive impact on regions' and *départements'* budgetary performance, following the structural change in their revenue structure, as discussed below.

Longer-term trends: The impact of reforms on local taxation and subnational budget structures, as well as France's post-crisis consolidation strategy remain important issues.

French local and regional authorities saw their tax base significantly restructured following the 2018 local tax reform and the 2020 *France Relance* recovery plan. The gradual suppression of the residency tax, which represents more than a third of municipalities' operating revenue, should be completed by 2023. The transfer of the share of the property tax previously allocated to *départements* will compensate municipalities for the lost revenue from 2021 onwards. These will in turn receive a portion of the VAT. The same mechanism will compensate regions for the CVAE eliminated as part of the government's 2020 recovery plan. These changes have significant impacts on the budget structure of each tier of local government:

Municipalities will continue to benefit from a relatively non-cyclical tax base but the reform will further concentrate their fiscal base. Over half of municipal tax revenues will be raised from property owners, weighing on the revenue flexibility of the municipal sector.

The change to *départements'* budget is significant as it impacts almost three-quarters of their operating revenue. This transfer increases their exposure to the business cycle and reduces their rate-setting power which is exacerbated by the importance of social spending in operating expenses (58% in 2020). This raises the fear of a 'scissor effect' for *départements*, a situation in which an economic downturn would cause a fall in revenue and a sharp increase in spending while economic booms will have the opposite effect.

Population ageing represents a significant long-term pressure on social spending in the form of long-term care subsidies (*Allocation personnalisée d'autonomie*, APA). The recently implemented unemployment insurance reform, which tightens eligibility for the jobless, could also lead to an increase in claims for the *départements'* basic welfare benefits (*Revenu de solidarité active*, RSA). These significant headwinds have led to ongoing parliamentary discussions around additional transfers of competencies to the state.

The replacement of the CVAE by a portion of the VAT represents a significant medium-term gain for regions, which would have been faced with a fall in revenue in 2021 and 2022 due to the lag in the payment of the CVAE. This change should increase revenue predictability but could have a negative impact on regions' incentives for local economic development, as it further de-links their revenue base from the economic activity in their territory.

Regions will also benefit from additional state transfers in the coming years to support investment due to their role in the implementation of the government's recovery plan, though the final budgetary impact of this involvement is still unclear.

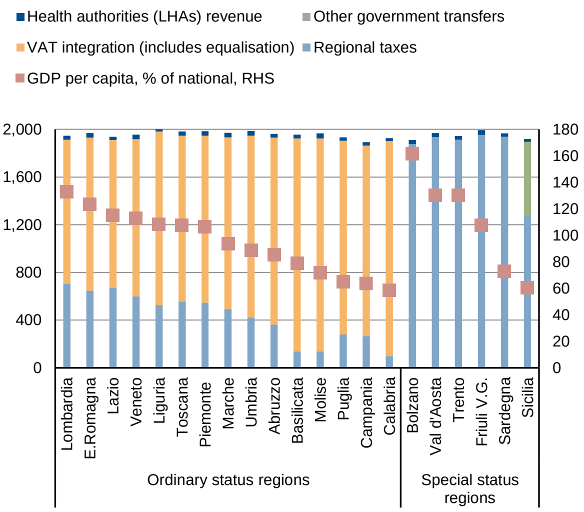
A critical factor for the long-term trajectory of local and regional finances will relate to the post-crisis fiscal consolidation strategy adopted by the central government. In the wake of the global financial crisis, local governments bore the bulk of the consolidation effort and suffered from a fall in state transfers (-25.4% over 2011-17). A repeat of the previous consolidation strategies would have negative consequences for the necessary investment to be undertaken by sub-sovereigns. There is therefore a risk that further pressure is applied on local governments to reduce spending, through strict caps on expenditure growth or additional cuts to their resources.

Research
France: municipal finances resilient to Covid-19 shock but regional disparities persist – 28 May 2020
France's residency tax reform poses fiscal risks at the local and national level – 13 June 2019

Italian regions: healthcare spending dynamics and budget performance

Italian regions are largely responsible for healthcare provision with healthcare accounting for 80% of their operating expenditure. This limits the regions' budgetary flexibility, as large proportions of revenue and expenditure are earmarked for healthcare transfers. In the context of wider economic discrepancies across Italian regions, the need to ensure minimum standards of healthcare and provide equal per capita healthcare financing, requires a significant redistribution of financial resources. Economically stronger regions finance a large part of their needs with their own taxes, but weaker regions rely more on central-government transfers and equalisation flows (**Figure 10**).

Figure 10. Healthcare financing resources, 2021
EUR per capita, refers to the "fondo indistinto" component

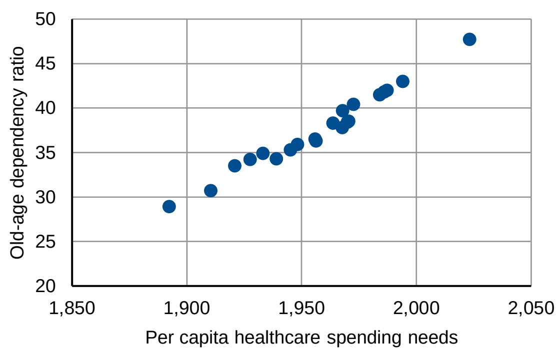


Source: Riparti 2021, Camera dei Deputati, Scope Ratings GmbH

As demonstrated by the Covid-19 crisis, the regions' responsibilities for healthcare also led to substantial support from the central government, which protects regions' finances, at least in the short term. The central government stepped in with additional healthcare resources for about EUR 9.5bn. The national healthcare fund has been raised from EUR 114bn in 2019, to EUR 118bn in 2020 and about EUR 121.5bn last year.

In the long-term, however, regional finances are set to come under strain from ageing dynamics, as per capita healthcare funding needs, which are relatively similar across regions, depend significantly on demographic factors (**Figure 11**).

Figure 11. Per capita healthcare needs (EUR) and old-age dependency ratio (%), by region



Italian regions are set to face adverse ageing developments in the years to come. Italy has already the most adverse demographics in the euro area (as captured via the old-age dependency ratio), with moreover, ageing dynamics set to worsen more rapidly than for euro area peers in the next decades. The old-age dependency ratio is projected at 67% by 2050, from 39% today. This will significantly increase healthcare costs. Regions may find themselves facing significant pressures on their budgets, with limited flexibility to react and the need to rely more on central government financing. As healthcare costs are set to structurally increase, the share that regions can cover with own taxes is set to shrink, absent a significant restructuring of the financing framework. Read more in our dedicated research report.

Regional and municipal finances in 2022

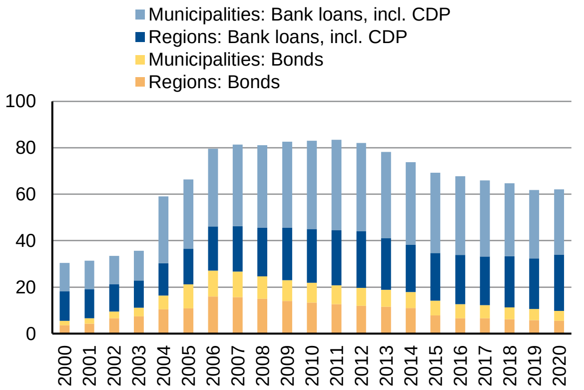
Budgetary performance to be supported by economic expansion. Extraordinary budgetary transfers to support general functions of regions and municipalities are set to fade out, with the 2022 general government budget envisioning central government support only for local transport. Regions will however receive larger resources allocated to healthcare after the pandemic, with EUR 6bn further increase in the national healthcare fund over 2022-24. The improving economic outlook for the Italian economy and the sizeable allocation of EU funds anchor expectation of gradual recovery in regional and local governments' own revenue.

Still, governance quality and a clear turnaround from low EU funds absorption will be necessary. This is also because regional and local governments will directly manage about 35% of the Italian Recovery and Resilience Plan funds, according estimates from the UPB (the fiscal watchdog on Italy's public finances). Assuming that 75% of the funds will be allocated to new projects, this would result in an increase of the annual investment expenditure by regional and local governments by more than 40% compared with pre-crisis levels.

We also note that the framework law for a comprehensive fiscal reform adopted by the government in October of last year introduces key changes for the regional and municipal tax systems, which will be endorsed with implementation decrees over the next 18 months. These include the abolition of IRAP (the regional tax on value of production) and modification in the supplement to IRPEF (the tax on personal income) for regions and municipalities. As these are the most important regional taxes and fundamental in the funding of healthcare spending, alternative funding sources will have to be identified. The IRPEF supplement is also the second most important municipal tax in terms of share in operating revenue, after the property tax IMU.

Debt dynamics. Very strict borrowing and budget balance rules for Italian regional and local governments after the euro area sovereign debt crisis are reflected in overall contained and decreasing debt levels for the sub-sovereign sector (**Figure 12**). Also, direct access to financial markets is limited with the importance of bond financing clearly downsized since 2011-12. Bank lending and sovereign on-lending via state-owned development bank Cassa Depositi e Prestiti (BBB+/Stable) are set to remain the most important source of financing for Italian sub-sovereign.

Figure 12. Italian sub-sovereigns' debt, by instrument, EUR bn



Source: Banda d'Italia, Scope Ratings GmbH

Fiscal federalism reform is set to remain on hold. Significant redistributive fiscal flows across wealthier and poorer regions, together with the need to maintain a strict control on general government debt levels, result in slow progress on the enhancement of regional fiscal autonomy. The fiscal federalism reform of 2009, aimed at enhancing fiscal responsibilities and overcome transfer-based regional finance, has been postponed multiple times in the last decade.

Similarly, negotiations around the devolution plans ("*autonomia differenziata*") from three regions - all net contributors to the equalisation system, namely Lombardy, Veneto and Emilia Romagna - to increase their responsibilities and control on taxes generated in their territories, have also slowed down. More recently, the completion of the fiscal federalism reform has been included in the national recovery and resilience plan reform agenda. If eventually further fiscal autonomy is granted to Italian regions, alternative redistribution mechanisms to ensure the provision of fundamental services, in particular healthcare, will have to be constructed given the large economic disparities across regions.

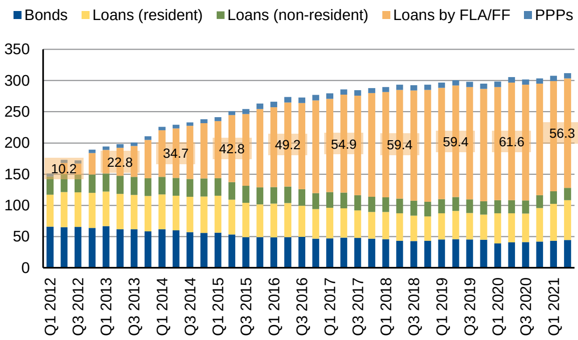
Research
Scope's institutional framework studies on Italian and Spanish regions available on subscription – 15 April 2021
Italy: healthcare spending pressures from Covid-19, demographics challenge regions' fiscal framework – 25 January 2021
Italian regions' autonomy plans weigh on predictability of the country's fiscal framework – 29 April 2019
Ratings
City of Milan (BBB+/Stable): Rating action release – September 2021; Rating report – December 2020
Region of Lombardy – on subscription

Spanish regions: increasing funding autonomy via ESG bonds

After the euro area debt crisis in 2010-12, sovereign on-lending became the predominant funding source for Spanish regions, substituting to a large extent direct market issuance, as the crisis hampered regions' market access. Since 2012, the central government has centralised funding and de facto bailed out regions in financial distress.

In 2020 an important turnaround in this trend started. For the first time the aggregate regional sector share of debt via the government facility has decreased, from 61.1% in 2019, to 58.9% in 2020, then to 56.3% in the first half of 2021. The amount of debt via the facility has also decreased in absolute terms, from EUR 180.2bn in 2019 to EUR 175.7bn in H1 2021 (**Figure 13**).

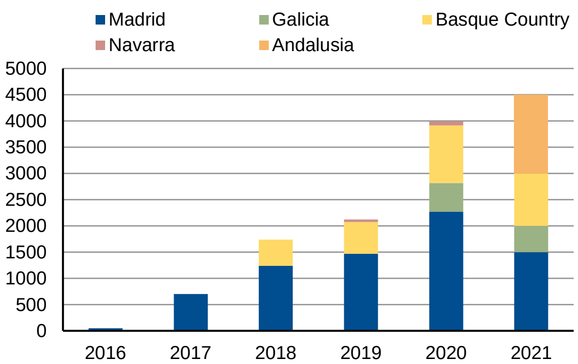
Figure 13. Spanish regions' debt, by instrument
EUR bn, displayed data labels refer to share in total debt



Source: Bank of Spain, Scope Ratings GmbH

In recent years, regions meeting fiscal targets have gradually returned to capital markets to substitute part of the debt owed to the central government. A handful of pioneering Spanish regions have successfully placed sustainability and green bonds. The trend accelerated in 2020-21 (**Figure 14**).

Figure 14. ESG bond issuance, EUR m
Based on Bloomberg social, green, sustainability indicators



Source: Bloomberg, Scope Ratings GmbH

Sustainability and green bonds can improve regions' debt profiles through: i) locking-in low funding costs whilst reducing their reliance on borrowing from central government; ii) diversifying their investor base; and iii) extending their average debt maturity.

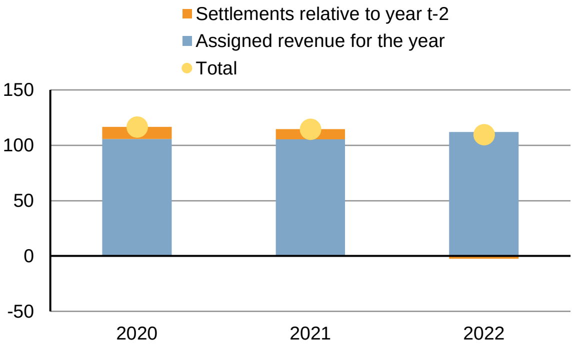
The growing market awareness of ESG credentials, a strong political focus in the EU on measures to mitigate the economic and social impact of climate change and the coronavirus pandemic, and the long-term declining trend of interest rates all represent an opportunity for Spanish regions to tap into growing investor demand for ESG-linked bonds and attract new sources of long-term capital. Read more in our dedicated research report.

Regional finances in 2022

Budgetary performance to be impacted by structurally elevated spending. Resources from the regional financing system (counting for about 80% of regions' operating revenue) are set to decline from 2021 onwards. Looking ahead and adjusting for settlements related to 2020 tax advances and lower extraordinary transfers, regional budgetary results will depend on their ability to control spending, after the extraordinary costs related to the pandemic subside.

However, a large part of spending increases is set to remain structural, at the minimum the portion related to personnel, counting for about 40% of regions' operating expenditure. Sizeable EU funds allocated to regions under the Resilience and Recovery Facility and the React-EU program, of about EUR 11bn, represent a key opportunity to finance substantial capital expenditure, and thereby supporting the economic recovery, without burdening regional finances. Still, they also represent a challenge, given Spain's weak record of EU fund absorption[1]. Some delays in funds allocated for 2021 have already materialised.

Figure 15. Regional financing system revenue
EUR bn



Source: Ministry of Finance, Scope Ratings GmbH

Capital market activity to expand. Spanish regions have increased their issuance in financial markets, even during the Covid-19 crisis. We expect, however, this development to be uneven across regions, with those highly indebted and more reliant on the central government being less able shorter term to shift towards autonomous external funding.

Overall funding needs will remain close to current levels, given that authorisation to regional debt issuance requires balanced accounts, while the allocation of proceeds is exclusively foreseen to investment spending. This means that regions' autonomous issuance would mostly replace existing debt. ESG bonds are likely to be a key tool for regions to regain funding autonomy. Still, additional incentives are necessary until Spanish regions' green and sustainability bonds reach market maturity, for example via a new 'sector standard' for environmental or social reporting.

Regional financing system under reform pressure. Discussion around the reform of the regional financing framework, which was supposed to be implemented back in 2014, has accelerated in recent months. The government presented in December 2021 first proposals to update the calculation of the "adjusted-population", a key criterion behind resource redistribution among regions.

However, negotiations are set to be complex and time consuming, given strongly opposed interests among regional groups. On the one hand, Valencia together with Andalusia and Murcia demand immediate higher resources. On the other hand, Galicia and other regions particularly affected by adverse demographics aim to preserve some of the main aspects of the current system, which focuses on structural population variables to allocate funds. Madrid opposes proposals that would force the region to converge its tax rates to those of peers, while Catalonia's medium-term priorities remain oriented towards the achievement of additional autonomy, including in its financing position.

Research
ESG financing: Spanish regions' shift to ESG-linked bonds supports financial autonomy, debt profiles – 8 Sept 2021
Scope's institutional framework studies on Italian and Spanish regions available on subscription – 15 April 2021
Spain's evolving fiscal framework: implications for the sovereign and its regions – 17 January 2018
Ratings
Autonomous Community of Andalusia – on subscription
Autonomous Community of Catalonia – on subscription
Autonomous Community of Galicia – on subscription
Autonomous Community of Madrid – on subscription
Autonomous Community of Valencia – on subscription

[1] Funcas, "What the absorption of structural funds says about the EU recovery plan", Miguel Carrión Álvarez, November 2020

Annex I: Scope's sub-sovereign coverage and 2022 calendar dates

Sub-Sovereign	Rating	Calendar review date
Germany		
Baden-Wurttemberg	AAA/Stable	21-January 2022 | 8-July 2022 | 9-December 2022
Bavaria	AAA/Stable	8-April 2022 | 23-September 2022
Berlin	AAA/Stable	21-January 2022 | 17-June 2022 | 9-December 2022
Brandenburg	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Bremen	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Hamburg	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Hessen	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Lower Saxony	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Mecklenburg-Western Pommerania	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
North Rhine-Westphalia	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Rhineland-Palatinate	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Saarland	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Saxony	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Sayony-Anhalt	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Schleswig-Holstein	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Thuringia	On subscription	21-January 2022 | 8-July 2022 | 9-December 2022
Andalusia	On subscription	10-June 2022 | 25-November 2022
Catalonia	On subscription	10-June 2022 | 25-November 2022
Galicia	On subscription	10-June 2022 | 25-November 2022
Madrid	On subscription	10-June 2022 | 25-November 2022
Valencia	On subscription	10-June 2022 | 25-November 2022
City of Milan	BBB+/Stable	25-February 2022 | 12-August 2022
Region of Lombardy	On subscription	4-March 2022 | 19-August 2022
Canton of Geneva	On subscription	1-April 2022 | 23-September 2022
Canton of Zurich	On subscription	1-April 2022 | 23-September 2022
Canton of Balsel Country	On subscription	1-April 2022 | 23-September 2022

Annex II: Scope's sub-sovereign research

German Federal government shields Länder from pandemic debt burden supporting creditworthiness	9 Nov 2021
ESG financing: Spanish regions' shift to ESG-linked bonds supports financial autonomy, debt profiles	8 Sep 2021
Scope's institutional framework studies on Italian and Spanish regions available on subscription	15 Apr 2021
Germany's federal fiscal framework: closer Länder-central government ties underpin credit quality	17 Feb 2021
Italy: healthcare spending pressures from Covid-19, demographics challenge regions' fiscal framework	25 Jan 2021
France: municipal finances resilient to Covid-19 shock but regional disparities persist	28 May 2020
European sub-sovereigns mostly able to weather Covid-19 shock, but face medium-term challenges	7 May 2020
France's residency tax reform poses fiscal risks at the local and national level	13 Jun 2019
Italian regions' autonomy plans weigh on predictability of the country's fiscal framework	29 Apr 2019
Spain set to reinvigorate reform of federal financing	17 Jan 2018
Credit quality of German Länder driven by institutional framework, says Scope	17 Jul 2017

Annex III: How we rate sub-sovereigns – in brief

Our approach to assigning sub-sovereign ratings comprises two analytical pillars:

1) Institutional framework:

- We analyse the institutional and fiscal links between the sovereign and sub-sovereign government layers.
- This results in an indicative downward **rating range** from the sovereign rating, within which sub-sovereigns are rated, based on their individual credit characteristics.

Institutional framework assessment					
Category	Weight		**Assessment:** Integration	Score	Weighted score
Institutionalised support	25%	Transfer & bailout regime	**High**	100	25
	15%	Borrowing limits	**Medium**	50	8
	10%	Funding support	**High**	100	10
Fiscal interlinkage	20%	Tax authority	**Low**	0	0
	15%	Fiscal equalisation	**High**	100	15
Political coherence	10%	Distribution of powers	**Medium**	50	5
	5%	Common policymaking	**Medium**	50	3
			Integration with the sovereign	**Σ**	**65**

Integration score	0-10	10-20	20-30	30-40	40-50	50-60	60-70	70-80	80-90	90-100
Indicative notch range from the Sovereign	0-10	0-9	0-8	0-7	0-6	0-5	0-4	0-3	0-2	0-1

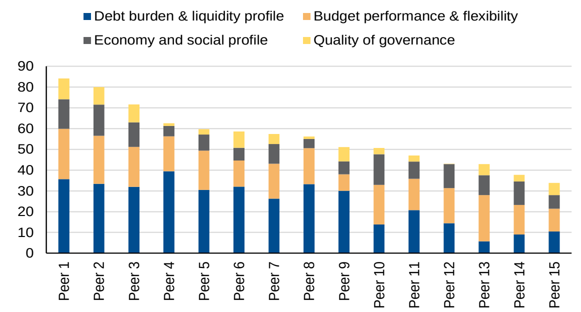
Rationale:

- Track record of central government support under stress scenarios, including via funding facilities or budgetary transfers, for example, during the financial crisis and the Covid-19 crisis;
- Revenue redistribution and vertical transfers in sub-sovereign budgets inherently link their creditworthiness with the sovereign's and often weaken their dependence on their own economic base;
- The central government possesses legal rights over sub-sovereigns' finances and budgetary practices.

2) Individual credit profile

We assess individual credit metrics across **four risk categories**: debt burden & liquidity profile, budget performance & flexibility, economy & social profile and quality of governance.

Quantitatively, via a relative benchmarking model across 15 ratios:



Qualitatively, to evaluate risks that cannot be fully captured by quantitative variables:

Qualitative assessment					
Category	Weight	Qualitative Scorecard	Risk		
			Low	Medium	High
Debt burden & liquidity profile	*40%*	Debt profile			
		Contingent liabilities			
		Funding and liquidity			
Budget performance & flexibility	*30%*	Budget management			
		Expenditure flexibility			
		Revenue flexibility			
Economy & social profile	*20%*	Growth & diversification			
		Labour & demographics			
Quality of Governance	*10%*	Recent events & policy risk			
		Transparency & accountability			

We combine the quantitative and qualitative assessments into **individual credit profile scores**, ranging from 1 (weakest) to 100 (strongest).

Rationale:

By comparing issuers with national peers, we account for the fact that fiscal, economic and debt metrics need to be viewed in the context of the respective framework, as mandates, budgetary rules and accounting standards vary significantly across countries and jurisdictions.

3) Mapping:

Finally, we map the institutional framework assessment and the individual credit profile for an indicative rating.

			2) Individual credit profile						
			Strong			Medium		Weak	
			≥ 75	≥ 65	≥ 55	**≥ 45**	≥ 35	≥ 25	< 25
			Indicative maximum notch adjustment from sovereign rating:						
1) Institutional framework		0 - 1	0	0	0	-1	-1	-1	-1
	Full	0 - 2	-1	-1	-1	-1	-1	-2	-2
		0 - 3	-1	-1	-1	-2	-2	-2	-3
		0 - 4	-1	-1	-2	**-2**	-3	-3	-4
	Medium	0 - 5	-1	-2	-2	-3	-3	-4	-5
		0 - 6	-2	-2	-3	-3	-4	-5	-6
		0 - 7	-2	-2	-3	-4	-5	-5	-7
		0 - 8	-2	-3	-4	-4	-5	-6	-8
	Low	0 - 9	-2	-3	-4	-5	-6	-7	-9
		0 - 10	-3	-4	-5	-6	-7	-8	-10

Issuer
Region ABC
Country
XYZ-land
Sovereign rating
A+/Stable
Indicative rating adjustment
-2
Additional considerations
-
Final rating
A-

This is not a mechanical approach: we allow for additional considerations, such as exceptional circumstances or long-term ESG risks. Find out more in our sub-sovereign rating methodology.

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