European Sub-Sovereign Outlook 2024

Moderate economic growth and prudent budget policies to offset higher spending and lower central government support

Sovereign and Public Sector, Scope Ratings, 5 February 2024

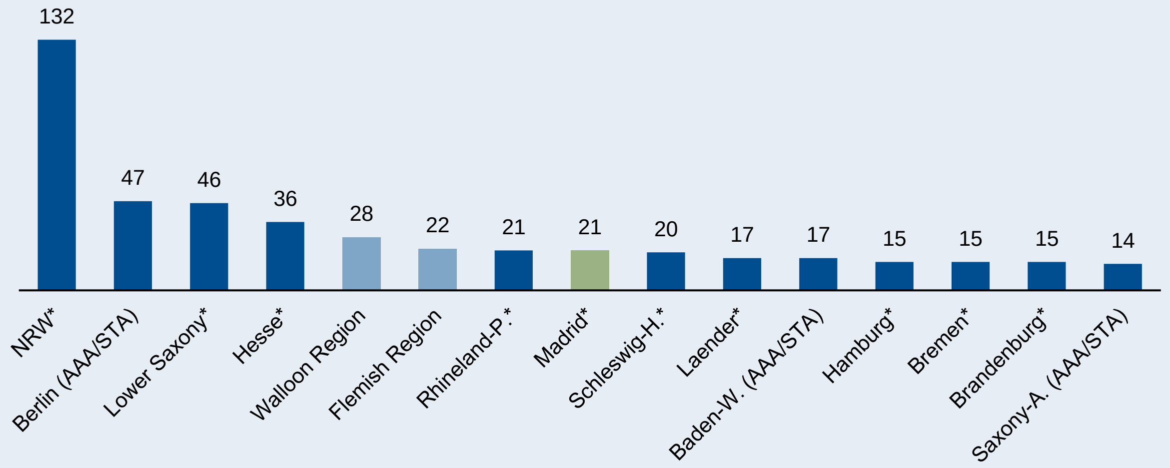
Executive summary

Balanced Outlook for European sub-sovereign issuers in 2024:

- Sub-sovereigns in France (AA/Negative), Germany (AAA/Stable), Italy (BBB+/Stable), Norway (AAA/Stable), Spain (A-/Stable) and Switzerland (AAA/Stable) face broadly balanced risks in 2024.
- Sub-sovereign issuers benefit from resilient institutional frameworks and continued central government support, albeit reduced from the high level during the pandemic and energy shock. Sub-sovereigns will contribute to fiscal consolidation as European fiscal rules are re-activated, notably in Italy and France.
- The expected moderate economic recovery in the euro area (+1.4% average real growth in 2024/25), in Norway (1.2%) and in Switzerland (1.4%) will ensure steady tax receipts which, combined with prudent budgeting, will lead to broadly stable fiscal performance. Sub-sovereign budgets will feel the full impact of inflation on costs, overtaking the initially favourable impact on revenue recorded in 2022.
- Robust debt profiles shield issuers from rising financing costs; the expected cuts in interest rates in the second half of 2024 will provide further support.

Figure 1. Leading sub-sovereign debt issuers in Europe

EUR bn, public debt securities outstanding



** Rated on subscription, accessible on ScopeOne. As of 25 January 2024. Source: Bloomberg Finance L.P., Scope Ratings*

Our key themes for 2024:

- **Post-crisis institutional and fiscal changes**: Central government support is vital for sub-sovereign resilience, but reduced transfers pose challenges. Structural costs, influenced by population growth and investment requirements, highlight a need for increased budgetary autonomy to address long-term fiscal pressures. Possible changes in the Spanish regional framework may involve partial debt absorption, revealing systemic vulnerabilities. In Germany, the recent constitutional court ruling reinforcing the budgetary constraints of the debt-brake will influence Länder fiscal strategies.
- **Coping with structural budget pressures**: Sub-sovereign budgets will stabilise, driven by a moderate economic recovery, steady tax revenue and prudent financial policies. Still, issuers face long-term spending pressures, which vary according to budget structures and spending responsibilities.
- **Sub-sovereign funding: subdued volumes, robust profiles**: Issuance volumes should remain subdued due to sovereign on-lending funding practices, front-loaded issuance in 2020-21, the availability of EU funds, and the re-instatement of fiscal rules in Europe.
- **Rising relevance of environmental and social factors**: European regions face diverse climate and transition risks. Sub-sovereigns play an important role in implementing climate strategies. Demographic dynamics and social factors directly impact revenue allocation, expenditure, and economic outcomes.

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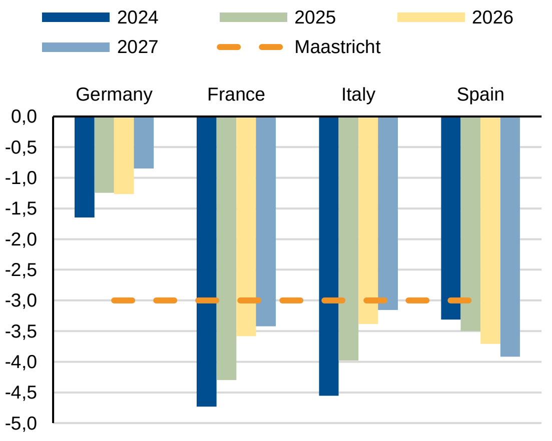
Key themes for 2024

Post-crisis institutional and fiscal changes

Central government support played a crucial role in offsetting the immediate impact of the recent pandemic, energy and cost-of-living crises, enabling sub-sovereigns to support local business and households without taking on more debt. Consequently, sub-sovereign finances have proved relatively resilient in recent years, albeit at the cost of wider central government deficits. Sub-sovereign issuers in France, Germany, Italy, Norway, Spain and Switzerland can expect sustained central government support this year but not at the same level as in the recent past. Central governments across Europe temporarily eased budgetary constraints for sub-sovereigns from 2020 to 2023, but we expect a return to more stringent budgetary and borrowing rules, partly due to the re-activation of European Union fiscal rules.

As direct central government support gradually eases, structural costs are rising given higher interest expenses, investment needs, and rising social and healthcare commitments linked to ageing populations. A risk for sub-sovereign finances is thus structurally lower vertical transfers due to post-crisis central government fiscal consolidation. This risk is pronounced for sub-sovereigns in France and Italy where central governments are running wide deficits and expect sub-sovereign contributions to fiscal consolidation (**Figure 2**).

Figure 2. General government balance, 2024-27
% of GDP



Source: Scope Ratings forecasts

Pressure for consolidation and prolonged crisis-related expenditure in 2024 underscores the need for enhanced budgetary autonomy for sub-sovereigns. However, there is a long-term shift towards greater centralisation. The recent crises have exacerbated this trend, leading to a progressive disconnection of sub-sovereign budgets from the economic performance of their respective territories and a reduction of fiscal autonomy at the sub-sovereign level in Europe.

While institutional frameworks, a key input for our rating considerations, will remain stable in the countries we cover, we identify two important, recent trends in Spain and Germany with regards to institutional governance.

In Spain, the government led by Prime Minister Pedro Sánchez has proposed the central government to partially take on regional-government debt. This would improve debt metrics for those regions that depend on central-government lending, but the associated reduction in interest payments may not bring significant relief. First, Spanish regions already have a low interest burden, averaging 1.7% of operating revenue at YE 2021 compared with almost 7% in 2014. Secondly, the regions that would receive a more substantial debt relief typically also run higher budget deficits, such that a partial transfer of their liabilities to the central government balance sheet offers only limited relief.

In contrast, Madrid carries no debt owed to the central government while other regions carry relatively little debt. The prospect of partial debt forgiveness for select regions could potentially ignite new conflicts, with consequences for political stability. That said, the suggested write-off of a portion of regional debt owed to the central government will serve as a catalyst for overdue reform of Spanish regional financing system.

Among the weaknesses of regional financing, as pointed out for example by the Catalonia and Valencia regions, are structural deficiencies and underfunding which hamper political coordination across levels of government. The central government's provision of extraordinary support only partially alleviates the problem. A potential multi-year reform of the regional financing system might involve additional ad-hoc transfers over the coming years, paving the way for the implementation of systemic changes aimed at enhancing budgetary performance. In these circumstances, some regions might end up with more resources at their disposal if the central government opts for higher recurring transfers.

For the **German Länder**, the federal constitutional court ruling in November 2023 has important implications. Many Länder governments had since 2020 approved credit authorisations under debt-brake emergency safeguard clauses each year for spending over subsequent years via special funds or credit-funded reserves. While no Land retro-actively repurposed funds as the federal government did, some budget acts and associated emergency credit authorisations might stand in conflict with the budgetary principle of applying to a single calendar year, and only the one for which the budget was adopted, according to the court.

So far, there are no rulings by regional constitutional courts on Länder budgets, although proceedings are underway in several cases. Overall, implications of the court ruling might extend to around half of the 16 Länder, with most of them reacting by postponing planned budget acts or passing supplementary budgets with declarations of budgetary emergencies for each year during which the related spending of emergency funds takes place. For some Länder, spending of emergency funds is scheduled to last until 2027/28. These initial responses to the court ruling will not lead to higher borrowing overall. The Länder have aimed rather at minimising the risk of violating budgetary principles in the aftermath of the court ruling.

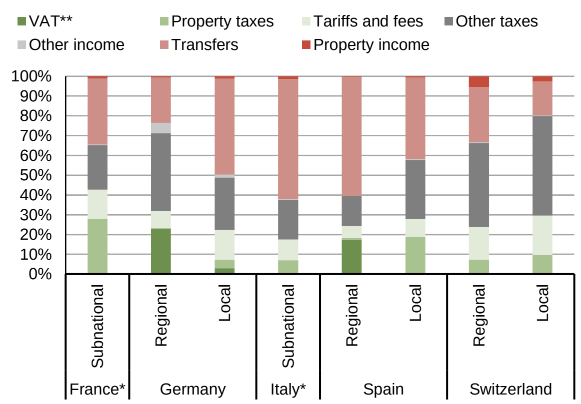
The court's decision has reinforced fiscal rules and budgetary principles for German Länder, while moderately limiting budgetary flexibility and raising uncertainty over important investment at the federal and Länder level. Indirect adverse effects might stem from lower transfers to the Länder from the federal government and the uncertainty around co-financed projects and federal subsidies. Still, Länder governments are likely to stick overall to their capex plans, given the urgency of investing in infrastructure.

Finally, 2024 will see important elections for Länder parliaments in Saxony, Thuringia and Brandenburg, all in eastern Germany. Current polls point to the populist, anti-immigrant Alternative for Germany (AfD) party as the strongest in all three states. If the polls prove correct, putting together coalition governments will be tough. The incumbent political parties will have diminished positions in parliament as they all continue to rule out governing with the AfD.

Coping with structural pressures: sub-sovereign budget dynamics

In 2024, sub-sovereigns in Europe face still-high inflation and the need to align fiscal policies with social pressures and financial constraints amid the gradual withdrawal of central government transfers. The impact will vary across sub-sovereign sectors, depending on their budgetary structures and flexibility to adapt. Moderate economic growth and robust tax revenue, and careful budgetary policies foster budget stability.

Figure 3. Sub-sovereign revenue in selected European countries, 2020
% of total revenue



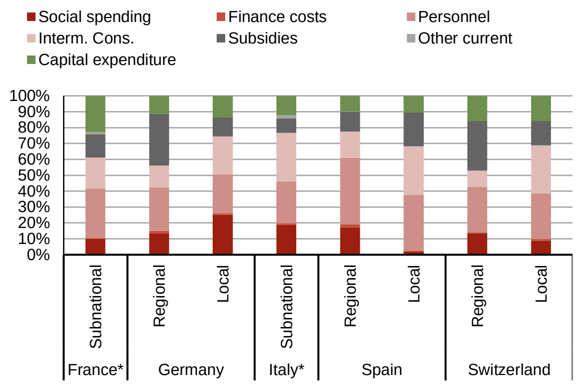
* Unitary country data is available only in aggregate figures.

Source: SNGWOFI, OECD, National sources (statistical office and Ministry of Finance), Scope Ratings

German and Spanish regional governments have benefited from recent dynamism in value-added tax (VAT), given its substantial share in their budgets (18% and 23%, respectively). While Italian regions share VAT proceeds with the central government, Swiss cantons don't receive VAT income but also face more moderate inflationary dynamics. In France, recent fiscal reforms have increased VAT's share for sub-sovereigns to 51% for regions, 21% for *départements*, and 22% for intermunicipal groupings, enhancing their revenue base's dynamism, all the while raising their exposure to economic downturns (**Figure 3**).

The inflationary environment has led to increased spending on goods and services. Personnel costs are rising, particularly with public-sector wage increases in Spain and Germany. Sub-sovereign entities with substantial wage bills, such as French municipalities (comprising 38% of total expenditure) and Spanish regions (constituting 42%), face heightened vulnerabilities (**Figure 4**). The costs of sub-sovereigns' investment plans have risen due to higher input prices and elevated interest rates.

Figure 4. Sub-sovereign expenditure in selected European countries, 2020
% of total expenditure



* Unitary country data is available only in aggregate figures.

Source: SNGWOFI, OECD, National sources, Scope Ratings

Sub-sovereigns' budgetary flexibility varies, with capex a critical lever to adjust to budgetary needs. French sub-sovereigns have notable flexibility, allocating a quarter of total spending to capital projects. Sub-sovereigns play a crucial role in executing public investment initiatives across Europe. Reducing investments is not a viable option for fiscal consolidation at the regional level, whether due to existing investment backlogs or the need to implement NextGenerationEU (NGEU) funded projects. While tax adjustments are another option to support budgetary stability, sub-sovereigns' tax autonomy differs and is generally limited. Only Swiss cantons have discretion over tax revenue. German Länder can influence tax sharing arrangements. Italian and Spanish regions have limited capacity to adjust tax revenue.

Sub-sovereign funding: subdued volumes, robust profiles

Sub-sovereign funding practices vary across jurisdictions (**Figure 5**). German Länder and Swiss cantons independently secure funds by tapping debt capital markets. In contrast, French sub-sovereigns rely on private placements and bank loans, complemented with sovereign on-lending. Spanish regions also rely mostly on sovereign on-lending.

In Italy, regions have not actively issued bonds since the financial crisis, also primarily depending on sovereign on-lending through the national development bank. Despite diverse funding practices, sub-sovereign financing costs are predominantly influenced by their respective sovereign's borrowing costs.

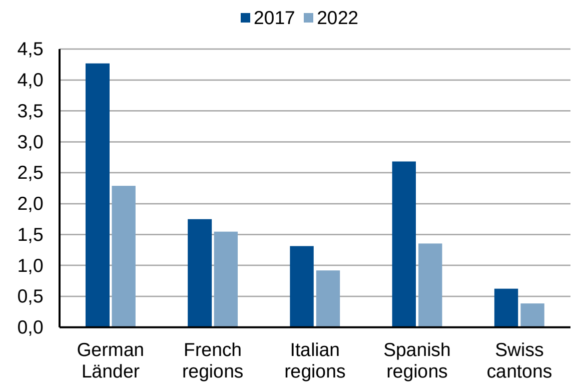
Figure 5. Sub-sovereign funding practices

Germany	France	Italy	Spain	Switzerland	Norway
Full access to autonomous funding on bond capital markets	Access to bond capital markets for larger issuers; ample reliance on bank-based funding	No bond issuances since the financial crisis; funding via bank loans and sovereign on-lending	Only stronger issuers can access bond markets or combine market funding with sovereign on-lending	Full access to autonomous funding on bond capital markets	Full access to autonomous funding on bond capital markets coupled with funding via sovereign on-lending

Usually refers to first-tier sub-sovereigns. Source: Scope Ratings

Sub-sovereign bond issuance will be modest in 2024, limited by high interest rates and the availability of alternative financing given substantial EU funds particularly for Spanish and Italian sub-sovereigns, together with the re-instatement of debt-limiting EU fiscal rules. German Länder and Swiss cantons will control debt issuance tightly.

Figure 6. Interest payments to operating revenue
%



Source: National sources, Scope Ratings

Strong sub-sovereign debt profiles and the modest rise in overall sub-sovereign borrowing will limit the impact of higher interest rates on sub-sovereign debt-servicing costs (**Figure 6**).

Still, highly indebted sub-sovereigns lacking budgetary flexibility and cash buffers will need to find fiscal room to accommodate rising interest payments.

However, amid tighter budgetary rules and increasing spending pressure, sub-sovereigns still need to find fiscal room to accommodate rising interest payments, particularly for highly indebted sub-sovereigns lacking budgetary flexibility and cash buffers.

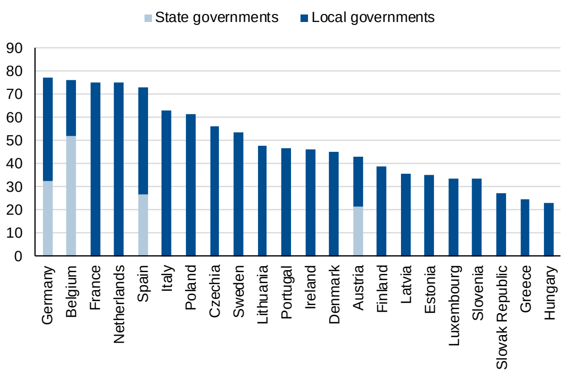
Sub-sovereigns issuing in bond markets may need to deepen and diversify their pools of investors in response to tight financial conditions. The growing relevance of ESG-linked bonds could support the sector's capital market issuance. European sub-sovereigns, including NRW (Germany), Madrid (Spain), Ile de France (France), and Geneva (Switzerland), have been pioneers in issuing ESG-linked debt.

Rising relevance of environmental and social factors

Our approach to rating sub-sovereigns systematically integrates environmental and social factors. European countries' exposure to physical and transition risks varies considerably by region as do their environmental policies. Germany, France, or Belgium (AA-/Negative) are generally less exposed on average to physical climate risk, but in Spain, Italy and the Netherlands (AAA/Stable), certain regions face comparably higher risks to drought, earthquakes and flooding. Transition-related risks are elevated in parts of Eastern Europe – related to a high share of heavy industry and dependence on fossil fuels – as they are in parts of Germany, Italy, Austria (AAA/Negative) and Spain.

National governments formulate overarching climate strategies, but sub-sovereigns are important in implementing them in conjunction with their own climate strategies. European sub-sovereigns are responsible for a large share of spending on climate adaptation and mitigation (**Figure 7**). Main competencies lie in water and waste management, transport, energy, and housing development.

Figure 7. Climate-significant expenditure by sub-sovereign governments
% of general government spending



Source: OECD Subnational Government Climate-Finance Database, Scope Ratings

Social factors generally relate to ageing and migration. Population dynamics within different parts of the same sub-sovereign system usually determine the proportion of intra-government transfers, with a direct impact on revenue allocation. On expenditure, sub-sovereigns face demographic pressure regarding pensions and healthcare. Demographics also affect economic outcomes, such as employment and growth. In addition, sub-sovereign governments are often responsible for regional healthcare, education and security services.

Country views for 2024

We summarise below our views for the sub-sovereign systems we currently cover.

German Länder	Balanced risks	*German Länder: Broadly neutral balance of risks despite spending pressures and economic stagnation*
French local authorities	Downside risks	*French local authorities: revenue growth slows, costs rise persistently*
Spanish regions	Upside risks	*Spanish regions: robust revenue dynamics with gradual market return*
Italian regions and cities	Downside risks	*Italian regions and cities: transfers withdrawal amid cost pressures and limited revenue flexibility*
Swiss Cantons	Balanced risks	*Swiss cantons: resilient fiscal performance despite SNB dividend distribution suspension*
Norwegian cities	Balanced risks	*Norwegian municipalities: borrowing for investments amid spending pressures*

German Länder: Broadly neutral balance of risks despite spending pressures and economic stagnation

The balance of risks to ratings of the German Länder is broadly neutral in 2024, despite economic and budgetary headwinds. This is reflected in Stable Outlooks on AAA-ratings assigned to publicly rated Länder (Bavaria, Baden-Württemberg, Berlin and Saxony-Anhalt). The implications of the federal constitutional court ruling from November 2023 on the Länder vary, with around half of Länder governments affected by the implications of the ruling.

Budgetary Performance and Outlook

Difficult economic and budgetary conditions will persist in Germany this year as activity stagnates. GDP growth will only be around 0.3%, after a 0.3% contraction last year. Growth will vary among Länder economies, with the relative dependence on energy-intensive industries an important driver of under- or over-performance compared with the national average. However, federal financial equalisation smooths out disparities in economic performance and regional taxing power, reducing the impact on sub-sovereign credit profiles.

Tax revenue remains buoyant despite sluggish economic growth, a reflection of record-high employment (supporting personal income tax, 42.5% of which goes to the Länder) and recovering real demand (supporting value added tax, 50.5% of which goes to the Länder). Länder's tax revenue is expected to grow 4.3% in 2024 and 4.9% in 2025, after stabilising in 2023 at very high 2022-levels.

At the same time, a weaker economic performance and labour market are downside risks, which could be reflected in the next round of official tax estimates in May 2024. In addition to steady tax revenue, Germany's sturdy integrated institutional framework and existing budgetary reserves contribute to robust credit profiles.

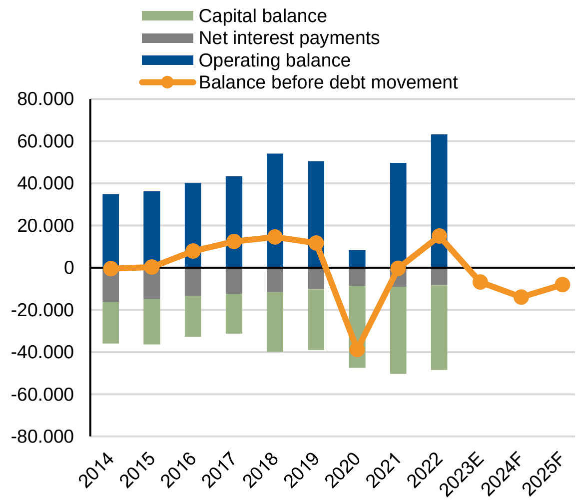
Budgetary pressures mostly stem from rising costs related to operating, interest and capital expenditure. This is coupled with relatively inflexible expenditure structures. Reflecting these budgetary headwinds, we project moderate deficits for the Länder in 2023-2025, after a buoyant 2022 (**Figure 8**).

First, higher operating expenditure in 2024/25 will reflect rising spending on personnel, among others, which accounts for 36% of operating expenditure, on average. In the context of elevated inflation over the past two years, employees of 15 Länder negotiated a wage deal in December 2023, leading to around 11% higher wages on average, with total estimated costs of around EUR 24bn in 2023-25. The pay rise is split over three years, helping cushion the immediate budgetary impact on the Länder's books.

Länder's active and retired civil servants' compensation will increase in line with the pay rise for Länder employees. Other operating expenditure items will also rise broadly in line with inflation, including transfers to municipalities and other administrative expenses.

Capital spending will likely remain elevated. The Länder typically spend around 11% of total revenue on investments. Capital expenditure financed via special budgetary vehicles or via reserves filled with emergency funds under the debt brake will face increased scrutiny, but overall capex will likely be undertaken as planned. Länder governments affected by the implications of the constitutional court ruling reacted quickly by passing amended budgets, although some uncertainty remains, potentially with an impact on future budgetary practices and strategies.

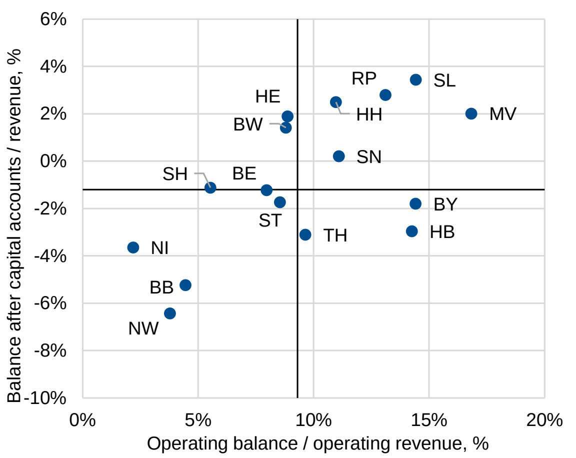
Figure 8. Länder budgetary performance
EUR m



Source: Destatis, Scope Ratings

The Länder's financial performance (**Figure 9**) varies despite fiscal equalisation, while the Länder also approached the fiscal response to the pandemic and energy crises in 2020-22 in different ways.

Figure 9. Individual budget performance
%, average over 2018-2022



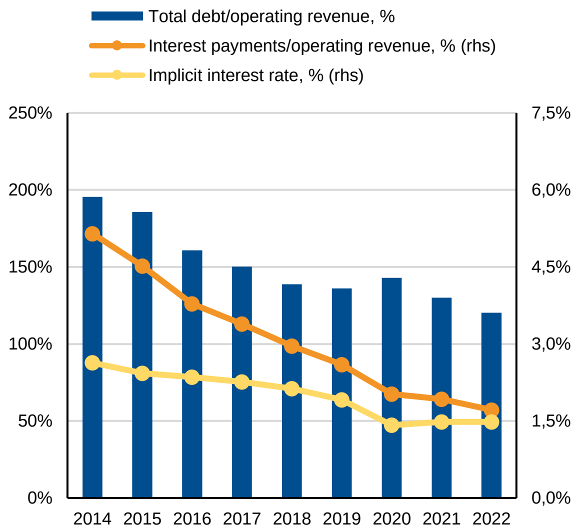
Note: Axes cross at the respective median. Source: Destatis, Scope Ratings

Debt burden and affordability

We project Länder's aggregate debt to remain broadly stable in coming years, as the usage of emergency borrowing declines, not least in the context of the constitutional court ruling. Ample cash reserves of EUR 68bn at YE 2022 continue to limit the need for new borrowing, although not all of these funds are freely available as they are earmarked for specific purposes.

Länder aggregate debt amounted to around EUR 600bn as of September 2023, broadly stable over the previous 12 months. Before 2020, debt had been on a multi-year downward trend, in line with Länder's consolidation efforts in anticipation of debt-brake limitations becoming effective (**Figure 10**).

Figure 10. Debt and interest burden
%



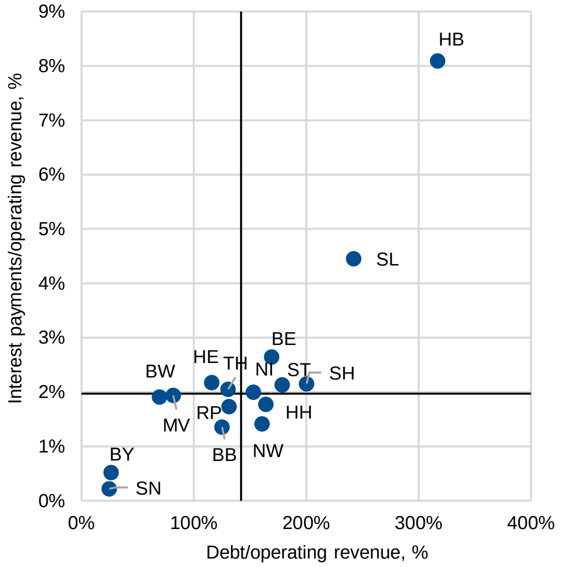
Source: Destatis, Scope Ratings

After a peak in 2020, the debt-to-operating revenue ratio declined to 120% at YE 2022. Due to a declining debt burden and low interest rates before 2022, the Länder benefit from excellent debt affordability. Total interest paid was EUR 8.4bn in 2022, or 1.7% of operating revenue. We expect this to increase only moderately over 2024-25, due to robust debt profiles and the relative attractiveness of Länder-issued debt, helping secure excellent funding conditions.

Länder's individual debt varies, as issuers consolidated their balance sheets in the years to 2020 starting from different legacy positions (reflecting structural budgetary profiles and different funding approaches) and at varying speeds (**Figure 11**).

Bavaria and Saxony have low debt, while Saarland and Bremen have high debt burdens, including by international standards. Both Länder are in consolidation programmes agreed with the federal government and receive dedicated transfers. Bremen is furthermore in discussions with Germany's Stability Council for another round of consolidation.

Figure 11. Individual debt and interest burden
%, YE 2022

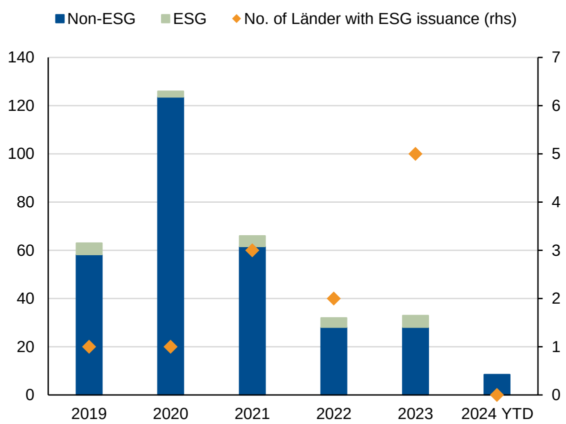


Axes cross at the respective median. Source: Destatis, Scope Ratings

Länder's debt profiles shield them against higher interest rates. They locked-in favourable funding conditions in 2020/21 with low-coupon, long-dated bonds, lowering refinancing needs. In general, exposure to interest-rate and FX risk is minimal.

We expect funding activity to remain relatively low and in line with that in 2022-23 at around EUR 35bn on a gross basis (**Figure 12**). Borrowing needs are lowered by the existence of budgetary reserves, a declining use of debt-brake emergency borrowing and high prevailing interest rates. The Länder have so far issued around EUR 8.5bn this year (as of 30 January), far exceeding the EUR 5.1bn recorded in the same period in 2023, due to benchmark deals by Hesse, Berlin and Lower Saxony of EUR 1bn or higher. Possible reasons for front-loaded issuance include robust investor demand before anticipated rate cuts by the ECB later this year.

Figure 12. Länder gross debt issuance
EUR bn



Note: Publicly listed securities only. Source: Bloomberg Finance L.P., Scope Ratings

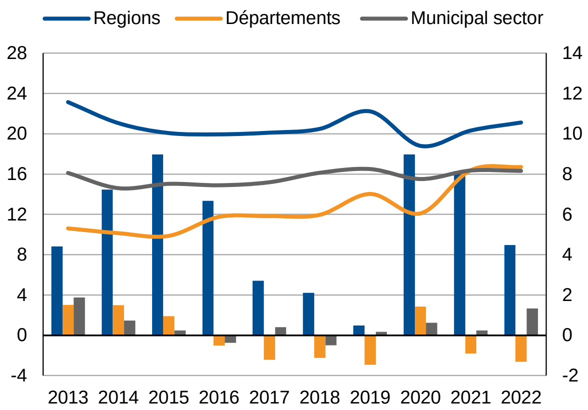
Finally, we expect ESG bond issuance to play an increasingly important role in Länder's funding approaches, after a marked increase in the number of ESG issuers to five in 2023. Last year, Berlin and Saxony-Anhalt joined other Länder that had been issuing green and sustainability-linked bonds for years, such as North Rhine-Westphalia, Baden-Württemberg and Hesse. Still, volumes remain limited, potentially pointing to high administrative costs and a diminishing premium on ESG-linked bonds ("greenium").

French local authorities: revenue growth slows, costs rise persistently

Budgetary Performance and Outlook

The French local and regional government sector's budgetary performance is expected to weaken in 2023-24, amid decelerating revenue growth and persistent cost pressures, after broad resilience in 2022.

Figure 13. Subnational operating performance (LHS) and net debt movements (RHS)
% of operating revenue



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

The outlook varies among the different sub-sovereign tiers. France's *départements* are the most exposed to unfavourable economic conditions, followed by the regions, while the municipal sector has performed well despite the difficult context (**Figure 13**).

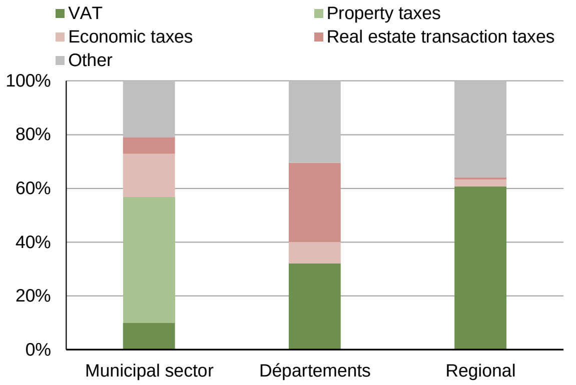
VAT revenue growth decelerated markedly last year, in a context of weak economic growth and private consumption, rising around 0.9% in 2023 and set to increase by only 1.0% in 2024. Regions and the *départements* were most impacted as VAT receipts make up more than 60% and 30% respectively of their tax revenue (**Figure 14**). In addition, the *départements* are particularly exposed to the downturn in the real estate market, due to their high reliance on transaction-related taxes (around 20% of their total operating revenue). Conversely, the municipal sector benefitted from robust property tax receipts last year, due to the combined effects of the revaluation of cadastral values in line with inflation and rate hikes.

VAT receipts will grow modestly in 2024, in line with easing inflation and a slow recovery in private consumption. At the same time, the deceleration of inflation will lead to a lower revaluation of cadastral values, which will in turn provide a smaller revenue boost to the municipal sector via the built-property tax.

On expenditure, persistent cost pressures continued to squeeze local government budgets in 2023 despite the decline in headline inflation. Rising energy costs pushed up current expenditure, despite various central government support mechanisms, partly due to a lag in the extension of energy-supply contracts. The indexation of public-sector wages to consumer prices led to a marked increase in personnel costs, estimated at around 5% of all costs for local and regional authorities in aggregate.

Rising welfare costs pressure departmental budgets, given basic welfare benefits and long-term care subsidies which amount to around 25% of operating expenditure. Public-sector wages and social benefit payments should continue to inflate operating costs this year, due to the lag in inflation adjustments.

Figure 14. Tax revenue structure per sub-sovereign government tier
% of tax revenue



Source: DGCL, Scope Ratings

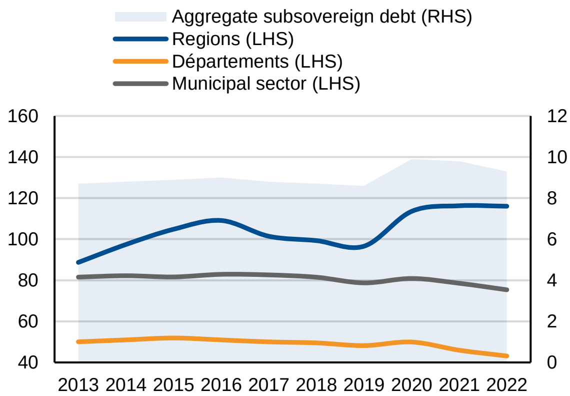
The medium-term outlook for the *départements* remains unfavourable for sub-sovereign governments in France. Prolonged weakness in the real estate market threatens to be a drag on revenue growth, through lower property transfer fees. Our baseline forecasts are for France's labour market to remain robust, but the *départements* are most vulnerable to an adverse scenario where a further slowdown in economic growth leads to a rise in unemployment, putting upward pressure on social spending, which accounts for almost two thirds of operating expenditure. The transfer of the *départements'* share of property tax to municipalities in 2021 has shrunk their fiscal leeway, thus significantly limiting their ability to react to shocks.

French local authorities' investment spending remained robust in 2023 despite the difficult operating environment, growing by around 9% from the previous year. Some of that growth reflected the impact of inflation on investment costs. Looking ahead, we expect local governments to maintain their investment plans despite the still challenging context. They will be in part supported by central government transfers, partly through the "Green Fund" designed to help local authorities address exposure to climate-related risks, with EUR 2.5bn earmarked for 2024, up from EUR 0.5bn last year.

Debt burden and affordability

French local-government debt has held relatively steady in recent years, amounting to 9.3% of GDP at end-2022 (**Figure 15**). This relative stability despite the pandemic and energy crisis underlines the role of the central government in absorbing macroeconomic shocks and supporting local government finances through economic downturns.

Figure 15. Aggregate debt by tier of France's sub sovereign sector
% of operating revenue (LHS), % of GDP (RHS)



Source: DGCL, INSEE, Scope Ratings

Indebtedness varies across French sub-sovereign government tiers. The regional sector stands out for its rising and comparatively elevated borrowing, which amounted to 116% of operating revenue at end-2022, against 75% for the municipal sector and 43% for the *départements*. This largely reflects the regions' leading role in public infrastructure investment. Risks related to higher leverage are nevertheless largely mitigated by region's sound operating margins and low interest costs.

Local and regional governments tapped their liquidity holdings in 2023, which had grown markedly over recent years. As a result, French local authorities' cash position decreased by 9.0% in aggregate last year, while remaining at historically high 19.5% above their end-2019 level. Debt ratios will rise in the 2023-24 period, in line with sustained investment efforts and narrowing operating margins.

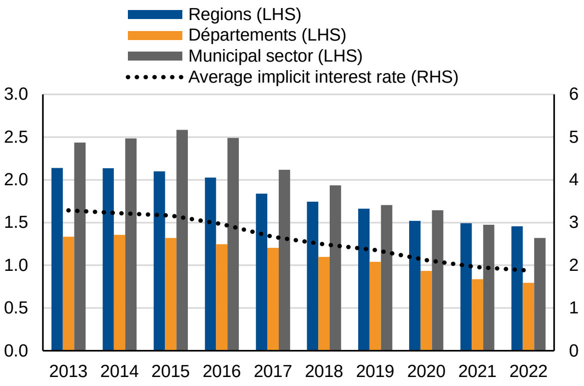
After a period of steady decline, interest payments increased last year because of tighter funding conditions (**Figure 16**) and will continue to do in the coming years.

Beyond the near-term outlook, pressure from central government to reduce its reliance on deficit financing and contain public-sector debt will have consequences for France's sub-sovereigns.

The 2023-27 public finance programming bill, signed into law last December, sets out ambitious targets for the consolidation of local authorities' finances, including a headline target of reducing the aggregate debt of local authorities to 7.6% of GDP by 2027, a 1.7pps decrease from 2022.

The focus of the programme is on containing expenditure growth, in contrast with the post-global financial crisis period, where local governments faced a sharp fall in state transfers, declining 25.4% in the period 2011-17.

Figure 16. Interest payments by tier of France's sub-sovereign sector
% of total expenditure (LHS), % (RHS)



Source: DGCL, Scope Ratings

Specifically, the bill aims for a 0.5% annual reduction in real operating expenditures over 2024-27. Although the practical details of this strategy have yet to be determined, it will be a decisive factor in the financial trajectory of local authorities.

Spanish regions: robust revenue dynamics with gradual market return

Budgetary Performance and Outlook

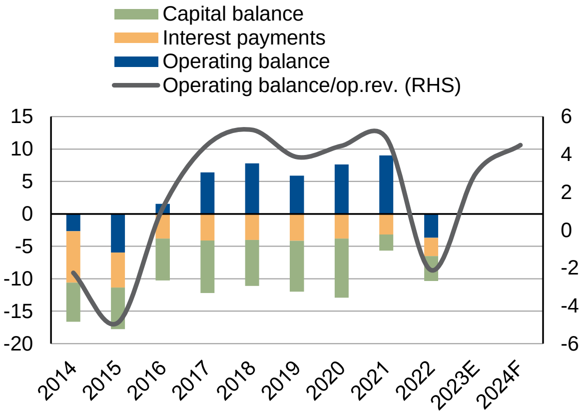
Spanish regions will improve budgetary performance in 2024 on increased revenue allocated by the central government through the so-called ordinary regime of the regional financing system which covers 15 of the regions. In the so-called 'foral regime', which covers the Basque Country and Navarra, the autonomous communities are responsible for their own taxes and do not receive central government transfers.

Growth in the regions' expenditure should slow too. More contained spending will reflect the re-imposition of EU fiscal rules, lower inflation, and cost-efficiency measures undertaken by the regions.

Despite weak revenue in 2022, attributed to the phasing out of pandemic-related extraordinary transfers, the central government forgave negative settlements for the regions through the regional financing system. In 2023, revenue rose in Spain's common status regions due to the central government advancing funds. Revenue growth should continue through 2024 as Spain's relatively resilient economy bolsters tax receipts and favours a strong labour market.

Spain's regions also face large investment spending in the years ahead, but much of the financing will be through EU funds, a significant portion of which is earmarked for implementation via Spain's regions. Increased EU funding will also bolster sub-sovereign liquidity, favour generally balanced regional budgets and diminish dependence on debt.

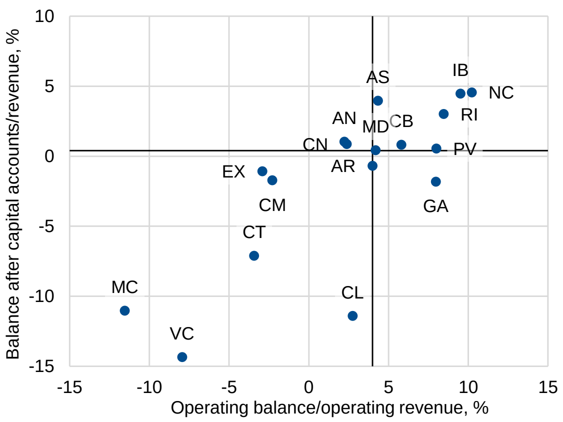
Figure 17. Aggregate budgetary performance
% of total revenue, % of operating revenue (rhs)



Source: Ministerio de Hacienda, Scope Ratings

Budgetary performance will still vary significantly, due to the criteria used in resource distribution within Spain's regional financing system which makes up about 75% of the regions' operating revenue. Some regions, notably Valencia, Murcia, and Catalonia, have negative operating margins and run substantial capital-account deficits (**Figure 18**). In these financially weaker regions, substantial deficits are expected to persist in coming years. Some improvement in operating deficits is likely due to these region's larger revenue share in the financing system in 2023-25.

Figure 18. Budget performance, by region
weighted average over 2020-2022



Axes cross at the respective median. Source: Ministerio de Hacienda, Scope Ratings

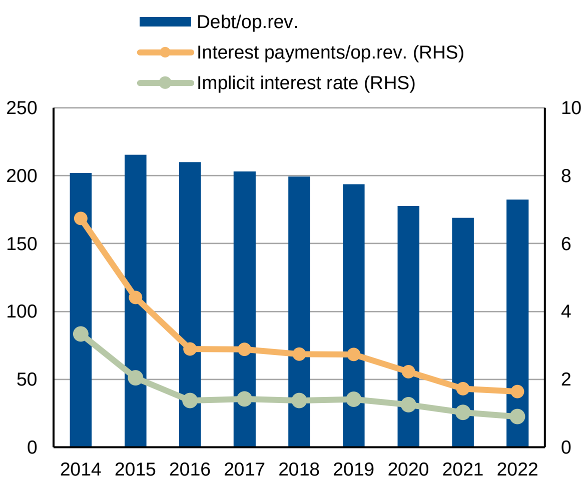
In contrast, regions like the Balearic Islands, Cantabria and La Rioja have stronger finances, maintaining operating margins consistently above 10% of operating revenue, which bolsters self-finance capabilities. Basque's and Navarra's financial fiscal performance is among the strongest, but they are also more vulnerable to individual shocks due to the direct link between their finances and the local economy, as they do not benefit from the revenue equalisation mechanisms of the ordinary regime.

The re-imposition of EU fiscal rules in 2024 should further ensure the controlled growth of operating spending, despite cost pressures from high interest rates, weighing on regions' budgetary room for manoeuvre given their rigid expenditure commitments. In alignment with the Spanish regional framework, the 2024 budget target for Spanish regions has shifted from a balanced budget to a 0.1% deficit. This adjustment, complemented by a projected 14.9% increase in resources from the financing system compared to 2023, enhances the regions' fiscal flexibility to address higher structural spending in areas such as health and education. Looking ahead to 2025-26, the sector will aim to broadly balance its accounts. The regions' (and cities') extra fiscal flexibility is also needed due to efforts from the national government to reduce the general government deficit to 2.7% of GDP in 2024, compared with 3% in the 2024 Stability Plan.

Debt burden and affordability

Spanish regions' total debt accounted for 182% of operating revenue in 2022 (**Figure 19**), rising from 2021, and thus reversing a declining trend since 2015. Debt-to-revenue increased due to the phasing out of pandemic-related transfers in 2022 but should decline this year as regions benefit from the substantial increase in revenue from the financing system compared with last year and access to EU funds to meet investment needs.

Figure 19. Sector debt and interest burden
%

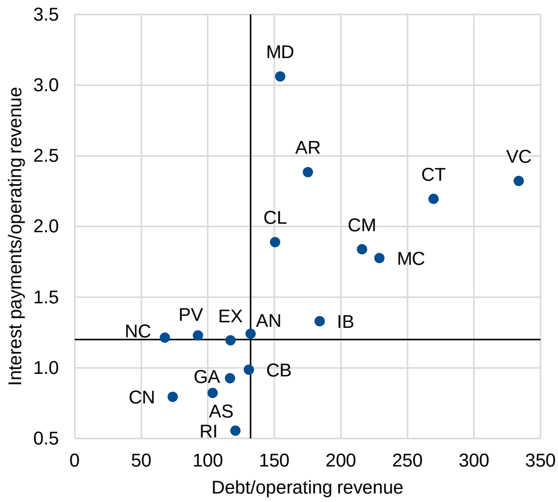


Source: Ministry of Finance, Scope Ratings

Debt servicing is manageable due to reduced interest costs, facilitated by central government on-lending in recent years. The average interest burden had fallen to 1.7% of operating revenue by the end of 2021, down from around 7.0% in 2014. Regions that depend on government funding typically have higher debt on shorter average maturities, leaving them more exposed to increases in interest rates. However, the potential absorption of regions' debt by the central government could result in a decrease in interest payments.

Debt levels vary among Spanish regions in the ordinary regime (**Figure 20**). With high interest rates, a continued decline in debt-to-operating revenue will be crucial to support debt sustainability.

Figure 20. Debt and interest burden by region
%, weighted average over 2020-2022



Axes cross at the respective median. Source: Ministerio de Hacienda, Scope Ratings

Higher interest costs will narrow the regions' budgetary room for manoeuvre and put debt sustainability into greater focus, although financing costs are still modest from a historical perspective. The regions' ability to service their debts is assured by access to central government liquidity if needed.

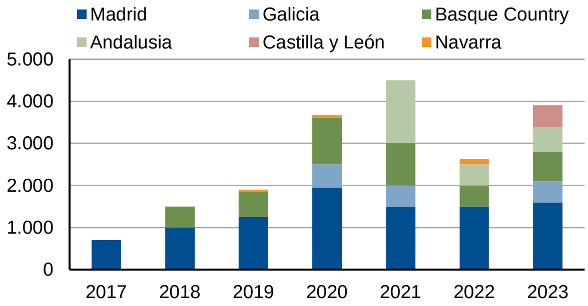
Tighter financing conditions slowed regions' bond issuance but select debt deals were well received. Only a few regions are regular issuers in capital markets, led by Navarre and Basque Country in the 'foral' regime in addition to Andalusia, Asturias, the Balearic Islands, the Canary Islands, Castille y Leon, Galicia and Madrid.

Loans from the central government remain the primary funding source, contributing roughly 60% of the regions' debt in the ordinary regime. The two 'foral' regions do not have access to central government liquidity. The Region of Madrid has substituted central government borrowings with its own funding since 2020. Other regions are gradually gaining financial autonomy but still depend mostly on central-government borrowing.

Spain's regions are unlikely to significantly increase bond issuance in the coming years. Authorisation for capital market debt issuance is granted only to regions meeting budgetary targets. In addition, the regions must earmark the proceeds for investment, resulting in the regions' autonomous issuance mostly replacing existing debt. In terms of Spain's other sub-sovereigns returning to capital markets, it is likely to be gradual given many financial profiles remain weak.

However, some regions with relatively robust credit profiles are gradually moving towards greater financial independence, tapping debt capital markets for funding, notably through the issuance of ESG-linked bonds (**Figure 21**).

Figure 21. ESG bonds in public markets
EUR m



Source: Bolsa y mercados espanoles, Finsight, Scope Ratings

All the regions have created green or sustainable-financing frameworks aligned to the main market standards encompassed by the ICMA Sustainability and Green Bond Principles to facilitate the issuance of ESG-linked debt.

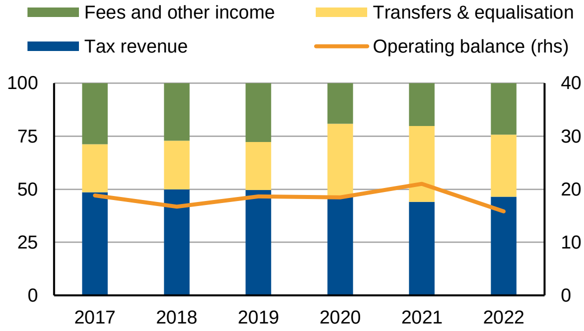
Italian regions and cities: transfers withdrawal amid cost pressures and limited revenue flexibility

Budgetary Performance and Outlook

A robust economic recovery supported the budget performance of Italian regions in 2022, resulting in a gradual improvement on operating revenue after the significant reduction due to the Covid-19 shock, only partly offset by the increase in transfers from the central government. Despite a gradual recovery in tax revenue, we expect Italian regions to continue to face budgetary challenges in the 2023-24 period given higher operating costs amid persistent inflationary pressures and cuts in transfers from the central government in view of the reintroduction of EU fiscal rules.

Municipal finances have also experienced a robust recovery in 2022, supported by high, albeit declining, government transfers, as well as by strong tourism recovery which, especially in large cities, had a positive impact on revenues (**Figure 22**).

Figure 22. Operating performance – 4 largest cities
% of operating revenue



Source: Ragioneria Generale dello Stato, Scope Ratings

Regional and municipal budgetary margins will remain under pressure in 2024, given the rigidity of revenues. For regions, tax revenues constitute a low share of operating revenue, while the share in VAT is paid out via transfers based on pre-determined healthcare funding needs. Special-status regions (three small northern regions and the two islands) should instead benefit from favourable revenue dynamics, as they retain taxes generated in their territory.

For municipalities, revenue rigidity is mostly explained by the high share of the less cyclical property tax. Pressures on the revenue side will also come from the withdrawal of extraordinary central government transfers related to the Covid and energy shocks, together with less generous central-government resources provided to local governments over the next years as part of a renewed effort to contain public expenditure given the reinstatement of EU fiscal rules this year. The 2024 Budget Law introduced annual cuts of resources for EUR 200m and EUR 350 over 2024-28 for municipalities and regions, respectively.

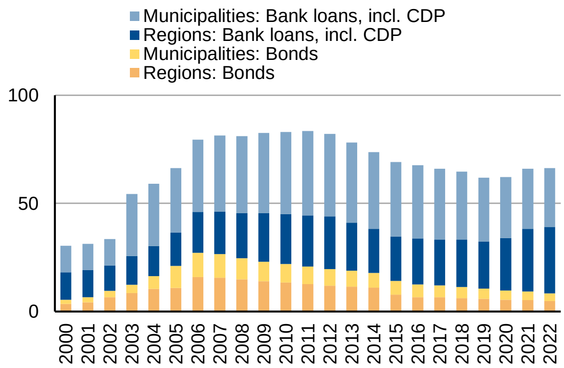
On expenditure, limiting cost inflation will be challenging, notably for healthcare, a main cost item for regions. The 2024 Budget Bill increased resources for the national healthcare fund by EUR 3bn this year, bringing total funds at EUR 131bn. This increase is still insufficient to offset the impact of inflation, given that EUR 2.4bn are earmarked for personnel costs. Finally, Italy's ageing population continues to create increased demand for healthcare services.

The energy crisis and the consequent increase in inflation have also dent city budgets, with rising goods and services prices limiting room for cost containment. Transfers provided by the central government for the higher energy costs, amounting to around EUR 1bn in 2022 and EUR 350m in 2023, have only partially covered the increase in operating expenditure for municipalities. Given the required contribution for local governments to the national fiscal consolidation effort, these transfers are likely to be withdrawn more rapidly than cost pressures will ease.

Debt burden and affordability

Since the global financial crisis, Italian sub-sovereigns have ceased active issuance on bond markets. The introduction of stricter borrowing rules and budgetary limits has led to continued deleveraging, with borrowing from the central government through state-owned development bank Cassa Depositi e Prestiti (CDP) the main source of funding (**Figure 23**). This results in favourable sub-sovereign debt profiles which are less exposed to interest-rate risks. CDP loans are usually amortising, reducing refinancing risks. CDP also channels central government support to sub-sovereigns, including reprofiling of loans and liquidity advances during shocks like the pandemic.

Figure 23. Sub-sovereigns' debt, by instrument
EUR bn



Source: Banca d'Italia, Scope Ratings

We expect little recourse to debt financing for Italian sub-sovereigns over the coming years, given the need to ensure fiscal consolidation at the general government level, strict borrowing limits in place and the large allocation of EU funds to finance investment.

Reforms of the financing framework aimed at increasing financing autonomy for Italian regions ("fiscal federalism") have not advanced since 2009, although it is included in the reforms targeted by the National Recovery Plan for 2026.

The new government is pushing the parallel project of "regionalismo differenziato", namely a devolution plan initiated in 2018 by three of the wealthiest ordinary status regions – Emilia-Romagna, Lombardia and Veneto – to acquire greater responsibilities and related spending powers over a wide range of policy areas currently held by the central government. While the reform could lead to a more efficient management of resources at the local level, it remains unclear at this stage how viable the plan is. This project would also contrast with some objectives of the tax reforms underway, including the gradual cancelation of one of the major regional taxes (IRAP), which is likely to further curtail the limited fiscal autonomy that the regions have.

Swiss cantons: resilient fiscal performance despite SNB dividend distribution suspension

Budgetary Performance and Outlook

Switzerland's 26 cantons have ample autonomy in terms of fiscal and borrowing decisions, compared with other European sub-sovereign sectors included in this outlook, and there is no formalised exceptional support mechanism. Consequently, we view stand-alone factors as having a greater weight for credit ratings. At the same time, recent shocks such as the Covid crisis showed how the Swiss federal system still benefits from strong policy coordination, comprehensive fiscal equalisation, and central government support. The federal government also offers financing and co-financing as important means of fiscal support during system-wide shocks.

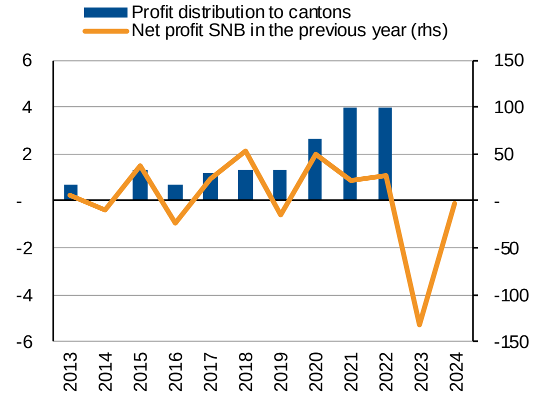
Canton finances held up relatively well in 2020-22 during the pandemic and energy shock, with the sector showing fiscal and economic robustness. The cantons' costs will remain at structurally higher levels versus the pre-pandemic trend much in line with experience of other European sub-sovereigns. Still, operating, borrowing and investment cost pressures will be less pronounced than in other European countries. First, inflation has remained lower in Switzerland, due in part to the strong Swiss franc. Secondly, with inflation less rampant, monetary policy is less tight. The Swiss National Bank (SNB) has increased its policy rate to 1.75% at end-2023, well below 4% in the euro area.

Strong fiscal performance in 2020-22 partly reflected large dividend distributions by the SNB, amounting to an aggregate CHF 10.7bn, or, on average, 2.8% of operating revenue and 36% of the operating balance. As the SNB recorded a CHF 132bn net loss in 2022 and an estimated CHF 3bn net loss in 2023, there will be no dividend distribution in 2023-24, representing an important revenue shortfall of up to 4% of operating revenue and more than 40% of operating surplus in the most reliant cantons (**Figure 24**). Moreover, restoring the distribution reserve, currently at a CHF 39.5bn deficit, will take time, making dividend payments unlikely for some years.

However, the introduction of the OECD/G20 minimum tax rate for multinationals in the form of a supplementary tax could generate positive effects for the cantons' operating revenue.

Preliminary government estimates show an initial increase in tax revenue of around CHF 1bn to 2.5bn. Three quarters of the receipts will be directly distributed to the cantons, proportionally to the ones with lower tax rates to compensate for any tax competitiveness likely to emerge among cantons.

Figure 24. SNB dividend distribution to cantons
CHF bn



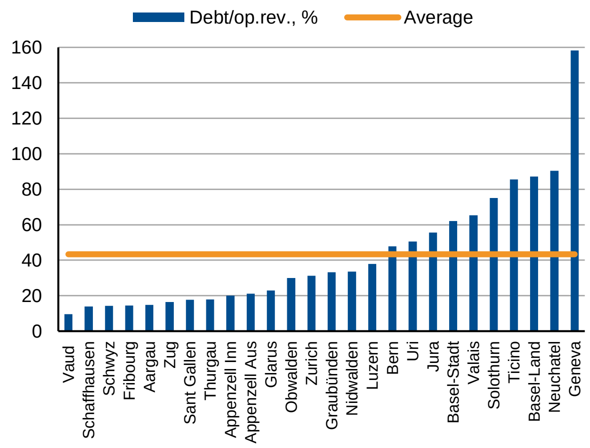
Source: Swiss National Bank, Swiss Federal Finance Administration, Scope Ratings

Debt burden and affordability

Swiss cantons typically benefit from strong debt affordability and limited exposure to rising interest rates.

However, indebtedness varies widely among the cantons. Given the ample autonomy over borrowing rules and debt limits, but also large difference in economic structures and sizes, debt ranged from around 10% of operating revenue to up to 158% in 2022 (**Figure 25**). The aggregate level across the sector was a relatively modest 43% at YE 2022.

Figure 25. Cantons' debt burden
Financial debt, % of operating revenue, 2022



Source: Finanzdirektorenkonferenz, Scope Ratings

Risks from potential increases in cantons' debt levels given the ambitious medium-to long-term investment plans are largely offset by favourable funding costs and debt profiles, due to a deep domestic capital market.

In addition to direct debt, an important credit challenge for cantons are contingent liabilities, mostly comprising maintenance obligations and/or guarantees for cantonal bank debt, and pension liabilities. Both types of risks could benefit from higher interest rates, as the banks benefit from a wider net interest margins amid higher interest rates while the present value of pension liabilities falls due to higher discount rates.

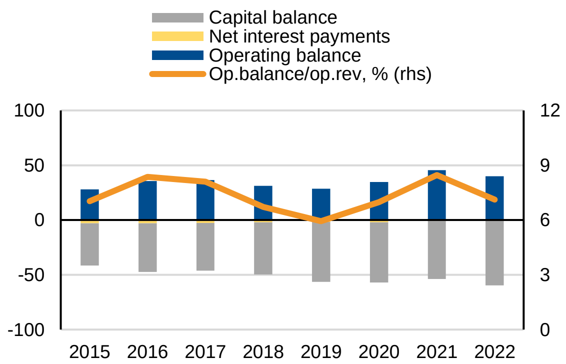
Cantons will record resilient fiscal performances in 2024. Still, the absence of SNB dividends over multiple years will require structural cost cutting to maintain solid budgetary margins. Lower inflation and interest rate pressures result in more manageable operating cost inflation vis-à-vis European peers.

Norwegian cities: borrowing for investment amid spending pressures

Budgetary Performance and Outlook

Norwegian cities demonstrated a solid operating performance, with ample margins to cover their interest payments (**Figure 26**). The sector's operating performance should remain robust, underpinned by a sound economic outlook, improving tax revenues, and by the supportive stance of the central government. We expect solid operational performance through to 2025, albeit slightly weaker than 2021-2022, with moderate tax revenue growth. Inflation-driven expenditure growth in 2023-2024, especially in employee-related costs, may strain operating margins. Central-government transfers and cost-containment are expected to help offset these pressures.

Figure 26. Budget performance, municipalities
NOK bn (lhs), % (rhs)



Source: Statistics Norway (KOSTRA), Scope Ratings

The inflation shock will test the ability of Norwegian cities to maintain cost controls, given that personnel costs account for a large share of operating expenditure (around 60%). Inflation will also impact investment plans, maintaining the need for debt financing. Inflation-induced expenditure growth will likely pose pressures on operating margins in the coming years.

The sector's investment needs are elevated, hence regular recourse to debt financing. We expect sustained high levels as the Norwegian municipality population expands and demographic changes occur, including migration patterns, urbanisation trends, change in birth rates and household structures. However, there may be some flexibility in the budget, allowing for potential postponement of capital expenditures. Most investments will focus on constructing and maintaining schools, buildings, and care facilities.

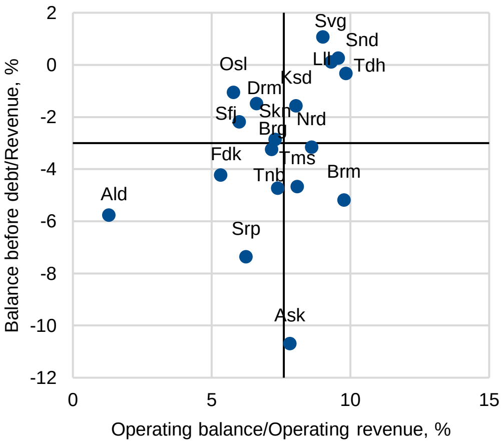
Most municipal tax revenue in Norway comes from personal income tax, which is shared with the central government. The national parliament sets a maximum tax rate each year. Other taxes are levied on wealth and natural resources. Municipalities also collect property taxes. Grants play a significant role in local government finances and are primarily allocated through the equalisation system. While most grants can be used freely, some are earmarked for specific purposes. Operating revenue from service fees and dividends from municipality-owned companies, especially utilities, also explain the stability of the cities' budgets.

Any individual city's budgetary flexibility is constrained by the large degree of equalisation and the cap on the personal income tax rate. However, the structural operating surplus in the sector indicates that revenue is broadly sufficient to meet to spending needs.

Budgetary performance varies (**Figure 27**) but all municipalities have positive current ratios, indicating good liquidity, although weaker entities have narrower margins. Reserves are generally elevated.

Figure 27. Individual budget performance

%



Axes cross at the respective median. Source: Statistics Norway (KOSTRA), Scope Ratings

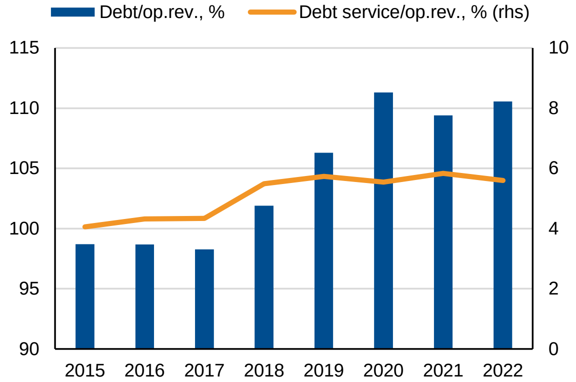
Debt burden and affordability

The Norwegian sub-sovereign sector's investment funding needs typically surpass available resources. This is not expected to result in significant pressures on debt affordability, however, thanks to the ample fiscal buffers maintained by Norwegian local governments.

Debt levels in the Norwegian sub-sovereign sector are generally high by international standards, especially at the municipal level, both as a share of operating revenue and in running at one third of total general government debt. This reflects important investment responsibilities and financial autonomy. The debt burden has gradually increased (**Figure 28**).

Figure 28. Debt burden, municipalities

%



Debt service inlcudes net interests, instalments and maturing bonds

Source: Statistics Norway (KOSTRA), Scope Ratings

Even so, debt affordability remains high despite different degrees of indebtedness among municipalities. The net interest payment burden as a share of operating revenue is negligible for Norwegian cities, reflecting their considerable financial assets, income which reduces net interest payments. Total debt service, including loan instalments and maturing securities is below 10% of operating revenue.

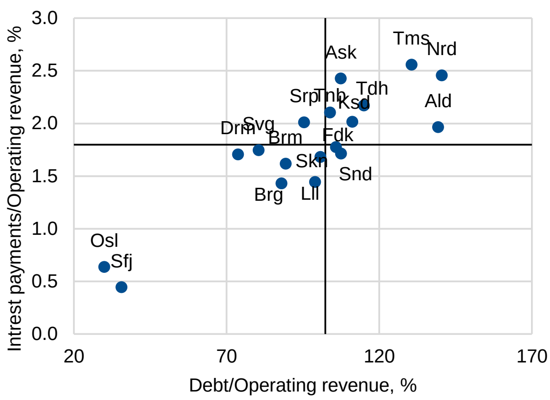
Sub-sovereign debt mostly consists of loans, particularly by Kommunalbanken, which accounts for around 50% of sector debt. Counties and cities frequently issue securities in domestic capital markets.

Local governments are putting climate-related challenges at the top of the policy agendas, increasing the relevance of green finance. In 2022 and 2023, the counties of Agder and Vestland followed Oslo's lead in 2015 by issuing their first green bonds.

That said, direct issuance of green bonds remains limited, as Norwegian municipalities can instead access these funds through Kommunalbanken's green-loan programmes. Green loans extended by Kommunalbanken have risen substantially over recent years.

Figure 29. Debt and interest burden

%



Source: Statistics Norway (KOSTRA), Scope Ratings

Annex I: Scope's sub-sovereign coverage

Sub-Sovereign	Rating	2024 calendar review date
Germany (AAA/Stable)		
Baden-Wurttemberg	AAA/Stable	10-May | 25-October
Bavaria	AAA/Stable	23-February | 9-August
Berlin	AAA/Stable	10-May | 9-August | 25-October
Brandenburg	On subscription	10-May | 25-October
Bremen	On subscription	10-May | 25-October
Hamburg	On subscription	10-May | 25-October
Hessen	On subscription	10-May | 25-October
Lower Saxony	On subscription	10-May | 25-October
Mecklenburg-Western Pomerania	On subscription	10-May | 25-October
North Rhine-Westphalia	On subscription	10-May | 25-October
Rhineland-Palatinate	On subscription	10-May | 25-October
Saarland	On subscription	10-May | 25-October
Saxony	On subscription	10-May | 25-October
Saxony-Anhalt	AAA/Stable	10-May | 25-October
Schleswig-Holstein	On subscription	10-May | 25-October
Thuringia	On subscription	10-May | 25-October
Länderjumbos	On subscription	10-May | 25-October
Spain (A-/Stable)		
Andalusia	On subscription	12-April | 20-September
Catalonia	On subscription	12-April | 20-September
Galicia	On subscription	12-April | 20-September
Madrid	On subscription	12-April | 20-September
Valencia	On subscription	12-April | 20-September
Italy (BBB+/Stable)		
City of Milan	BBB+/Stable	16-February | 19-July | 6-December
Region of Lombardy	On subscription	16-February | 19-July | 6-December
Switzerland (AAA/Stable)		
Canton of Geneva	On subscription	26-January | 12-July | 6-December
Canton of Zurich	On subscription	26-January | 12-July | 6-December
Canton of Basel Country	On subscription	26-January | 12-July | 6-December
Norway (AAA/Stable)		
City of Trondheim	AAA/Stable	01-March | 28-June | 25-October

See our *Publication Calendar 2024* for Sovereign, Sub-sovereign and Supranational Rating here.

Annex II: Scope's sub-sovereign research

Germany: uneven demographic trends weigh on medium-term growth as near-term downturn worsens	19 Sep 2023
German Länder: budgetary pressures, energy funds to lead to higher borrowing needs in coming years	11 Jul 2023
Norway's local government sector: robust framework supports credit profile; funding needs on rise	26 Jun 2023
Spain's environmental governance challenge: regional elections take place amid rising climate risk	26 May 2023
Spain's regional elections offer chance for economic, fiscal reform; political fragmentation at risk	25 May 2023
Germany's Länder: budgetary pressures grow but sovereign support, debt brakes ensure resilience	15 Feb 2023
Spanish regions' budget outlook improves, financing conditions stabilise, after difficult 2022	14 Feb 2023
Italy: regional devolution plan could exacerbate divides, test predictability of public finances	9 Feb 2023
Sub-Sovereign Outlook: structural budgetary pressures mount; central government support diminishes	30 Jan 2023

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