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Article

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Overcoming weaknesses in municipal investment

By Marcel Fratzscher, Ronny Freier, and Martin Gornig

Germany's economic vitality and competitiveness as an industrial nation are based on a modern infrastructure and highly skilled workers. In order to continue providing a high standard of living and good employment opportunities in the future, Germany must begin making the necessary investment now.

This DIW report examines public investment activity in Germany. Beyond federal and state government investments, the analysis focuses on municipal investment in particular. How have the investment behaviors of federal, state, and municipal governments changed over time? How is investment activity distributed regionally among the municipalities? Can investment from municipal companies counteract the decline in investment in the core municipal budgets?

DIW's findings on these issues are documented in three articles in our current *Wochenbericht*. In summary, the studies point to two recommendations for action:

- Germany's municipalities need to be investing more, and the funding of this investment must be more evenly distributed across the regions.
- Municipal planning capacities and municipal companies should be strengthened, which will contribute significantly to overcoming investment weaknesses.

Germany's infrastructure is falling apart

Germany invests too little. The first article in the current *Wochenbericht* documents the decline in investment

activity since the 1990s – especially among the municipalities, whose annual investment expenditures dropped by nearly half between 1992 and 2013. Of particularly grave concern for municipalities is the fact that the actual investments being made are not sufficient to compensate for the deterioration of the infrastructure. The balance of municipalities' net investment (gross expenditure for investment minus depreciation) has been negative since 2003 – cumulatively, over 46 billion euros worth of infrastructure has not been replaced.

Investment inequality on the rise

Municipal investment activity differs greatly from region to region. For example, municipalities in Bavaria spend nearly three times as much per capita on investment as do municipalities in Mecklenburg-Vorpommern. Investment in East Germany is declining dramatically with the reduction of funds in the Solidarity Pact II, but even in some West German states like North Rhine-Westphalia and Saarland, the level of investment is comparatively low. Assuming that Bavaria's level of municipal investment is based on actual need, Germany would have to raise its investment in the public sector by 14.4 billion euros – an increase of about 65 percent – in order to meet the municipal investment needs of all other states.

In addition to examining these discrepancies among the states, the second article explains the major differences among individual districts and district-free cities (*kreisfreie Städte*), both nationwide and within the states. For example, the Munich administrative district spent nearly

700 euros for every inhabitant in 2013 (724 euros per capita) than did the district-free city of Wilhelmshaven in Lower Saxony (35 euros per capita). Furthermore, the report shows that these regional differences have not changed much over the course of several years, and that regional investment levels are highly dependent on social spending: Economically underdeveloped regions with a high level of social expenditure, which are already less attractive to investors, are being further left behind through lack of investment, even in the long term.

Weak municipal budgets, strong municipal companies

A major portion of public investment is made by municipal companies. The third article in the *Wochenbericht* examines the investment activities of the municipal providers of public utilities: water and energy. In contrast to the core municipal budgets, no signs of inadequate investment can be seen here. The comparison of municipal and private providers in the water and energy sectors shows that the investment volume—regardless of the legal status—is similarly high in both groups. The report also shows that there is no clear link between regional population development and the investment behavior of municipal businesses. Municipal companies, which often have a relatively high degree of autonomy and clearly defined roles, are therefore quite a successful model for securing and efficiently implementing public investment.

Municipalities are responsible for many important areas of public services: for example, education (nurseries and schools), water and energy, and local roads. And the future challenges are manifold: The social infrastructure of public utilities and nursing must be continually adapted to a changing society. Last but not least, it is the municipalities who are organizing and managing the influx of refugees. By investing in integration, municipalities are not only shaping these individuals' futures, but their own futures as well.

Based on the studies presented here, DIW Berlin recommends three measures for overcoming weaknesses in municipal investment:

First, policymakers must work on a solution to sustainably ensure a better and more balanced funding of the mu-

nicipalities. The federal government's creation of a special 3.5 billion-euro "Municipal Investment Promotion Fund" (spread out over four years) was a step in the right direction. However, this is ultimately just a drop in the bucket, and such one-offs offer no systematic solutions.

One way to make sustainable improvements to municipalities' financial resources is for the federal government to relieve the communities of their social expenditures. The 1 billion-euro-per-year relief fund that was decided on by the federal government in 2015 is not expected to bring about any radical improvements. This is also the case with the federal government's planned integration aid for people with disabilities, which amounts to roughly 5 billion euros annually, since it is not aimed at the heavily burdened municipalities in particular.

A far more targeted support of the economically weak communities could be achieved if the federal government took over the municipal expenditures on accommodation and heating (about 11 billion euros per year). This would relieve the cash-strapped municipalities to which no financial leeway has yet been made available. To emphasize the long-term nature of municipal investment promotion, the revenue from the solidarity surcharge should be used to finance the measures.

Secondly, the reallocation of public funding in the restructuring of the inter-state fiscal adjustments (*Länderfinanzausgleich*) should be based more strongly on the individual municipalities' financial situations, prioritizing municipalities with struggling economies and low investment activity. Currently, "municipal financial power" accounts for only 64 percent of the factors used to calculate the inter-state fiscal adjustments (in a narrower sense). If municipal tax revenues were fully taken into account, it would enable the cash-strapped federal states—through the additional redistribution of just under 2 billion euros—to make more funding for investment purposes available to their communities.

Thirdly, the strengthening of municipal companies can and should critically improve investment conditions. Municipal companies already finance a substantial portion of infrastructure in many communities. Organizing public

investment in municipal companies is useful in decoupling the essential investment decisions from the community's day-to-day politics, and in making the cost-benefit analyses more transparent. Our analyses indicate that the investment activity of municipal companies, unlike investment in the municipal core budgets, is largely stable and evenly distributed, and exhibits a similar level of investment activity to that of private companies. Accordingly, municipal

companies (via inter-municipal cooperation, as well) should take on more functions—for example, constructing buildings such as administrative offices and care facilities.

Investment within Germany is the foundation for our future prosperity and competitiveness. Regardless of the specific measures and the organization of public investment, we must not neglect to make the necessary and profitable investments.

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