

The Creditworthiness of Swedish local governments



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PREFACE

The Swedish local governments are responsible for the majority of all public services to the country's citizens.

The extensive service production, along with the sector's general responsibility for social development and function, requires considerable investment activity in a smoothly functioning infrastructure. This includes harbours, buildings, machinery and road networks, as well as cabling and pipelines for energy, water and sewerage.

The local governments' tangible assets are funded by taxation, charges and state grants. Significant external borrowing is required to even out the flow of payments over time.

The local governments in Sweden (including their companies) have an external borrowing debt of SEK 350 billion. The local sector has extensive freedom to arrange this external funding requirement in a secure, efficient manner.

This report of the local governments' creditworthiness has been produced to fulfil the needs of the credit market and individual financing institutes for easily accessible information about the financial strength and distinctive nature of the Swedish local governments. The report has been jointly formulated by The Swedish Association of Local Authorities and Regions, Kommuninvest and the Department of Public Administration at the Ministry of Finance. The report is also available in Swedish.

Stockholm and Örebro, March 2006

INTRODUCTION

The democratic system in Sweden is divided into a national and a local level. The State is responsible for the national level, and sets the framework for the local level through laws and regulations. The state level is also divided into counties. The State is represented at the county level by 21 County Administrative Boards.

The emphasis of public welfare is on the local level, which is represented by 310 local governments; 290 municipalities and 20 county councils. The municipalities operate in a smaller geo-

graphical area and the county councils, whose remit requires a larger population base, operate in a wider geographical area. The county councils are a separate form of local authority, and they are not in a superior position to the municipalities.

On average, the municipalities have 31,000 inhabitants and the county councils 448,000. Over 50 per cent of the Swedish population lives in municipalities with more than 50,000 inhabitants.

LOCAL SELF-GOVERNMENT

All power in Sweden comes from the people. Power shall be exercised by representative and parliamentary assemblies and put into practice partly through local self-government. In an international perspective, Swedish local governments enjoy a highly autonomous position.

Local self-government established in the Constitution

Sweden has a long tradition of local self-government. It hails back to the 19th century and since 1974 has been part of the Swedish Constitution (The instrument of Government). Local self-government entails an autonomous and, within certain national limits, free right of decision-making for the local governments. The right of decision-making is exercised by elected assemblies. An important aspect in local self-government is the right for the local governments to levy taxes to fund their activities.

Local Government Act sets guidelines

The Swedish Local Government Act applies to all local governments, both to municipalities and county councils, and regulates everything from the division into authority districts to working guidelines on boards and committees. According to the Act, the local governments may them-

selves deal with affairs of public interest related to their geographical area or inhabitants. The Act also specifies rules for organisation and operating approaches, as well as for financial management and auditing.

Many tasks regulated in special legislation

The tasks of the local governments, and the extent to which they can levy taxes to finance their activities, are largely regulated in special legislation. For example, there are particular laws for health and medical care, social services and education. Several of the laws are general laws which can be supplemented with detailed ordinances by the Government or with regulations by state authorities. The State exercises inspection and control over the operations of the local governments via a number of authorities.

Public access to official records

Sweden's Constitution grants the right of public access to official records, which means there is extensive openness in affairs of state and in the activities of the country's municipalities and county councils. This principle guarantees a virtually unique insight which enables the public to access most documents and decisions.

THE LOCAL GOVERNMENTS' ORGANISATION AND RESPONSIBILITIES

Political organisation

The highest decision-making body in a local government is the main council, as elected by the citizens. Elections are held every four years at the same time as parliamentary (Riksdag) elections. The main council appoints a board and decides upon which other bodies and committees to establish. The board manages and coordinates the administration. This role gives the board a central function for supervision and influence over the various operations. The board is responsible for producing budget proposals and drawing up annual and interim financial reports, and is also otherwise responsible for financial administration. Important financial decisions relating to, for example, the budget, tax rates, fees and borrowing are made by the main council.

Primary tasks

Special legislation has given the local governments responsibility for important social functions which are often compulsory tasks. The local governments may also decide to conduct various voluntary tasks of general interest to residents. The municipalities have a wide range of tasks to carry out, while the main focus of the county councils relates to health and medical care. One shared area of compulsory responsibility for municipalities and county councils is regional and local public transport, which is organised in different ways in different municipalities and coun-

ty councils. One municipality, that of the island of Gotland, has both municipal and county-related tasks. For a trial period, two county councils have taken over responsibility for regional development from the state-run County Administrative Board.

Municipal cooperation

It is common for several municipalities to join forces and form an association of local authorities, and work together on particular issues. As a legal entity, an association of local authorities is equivalent to a municipality. The obligations of the association are guaranteed by its members. Other forms of cooperation also exist.

Companies owned by the local governments

The local governments may also conduct operations through other legal entities, such as limited companies, if there is no particular regulation in law governing how an operation should be run. Activities conducted in other legal entities are also covered by the rules of municipal jurisdiction. There are more than 1,500 companies owned by local governments in Sweden, with around 65,000 employees engaged in municipal activities. The majority of these are owned by municipalities, and they are limited companies. Municipally owned companies are most common in capital-intensive areas such as housing provision, property management and energy supply.

| Municipalities | | | County councils | |
|---------------------------------|---------------------|------------------|-------------------------|-----------|
| Compulsory | Voluntary | Joint | Compulsory | Voluntary |
| Social services | Leisure and culture | Public transport | Health and medical care | Culture |
| Education | Technical services | | Dental care 2) | Education |
| Building/planning issues | Energy supply | | | Tourism |
| Environmental/health protection | Streets/roads | | | |
| Waste/sanitation | | | | |
| Water/sewerage | | | | |
| Emergency services | | | | |
| Libraries 1) | | | | |

1) A public library in every municipality

2) Free dental care for children and young people up to age 20

THE LOCAL GOVERNMENT SECTOR'S FINANCES

A large part of the public sector

The majority of public sector services, including education, medical care and care of the elderly, are provided by the local governments. The local governments' consumption (excluding their companies) accounts for 70 per cent of public consumption expenditure and 20 per cent of GDP. The local government sector (including their companies) has approximately one million employees, which equates to 25 per cent of all employees in Sweden.

The income and costs of the local governments

In 2004, the local governments' income amounted to just over SEK 590 billion, of which municipalities accounted for SEK 400 billion and county councils for SEK 190 billion. From an international perspective, Swedish local governments enjoy extensive financial autonomy. 85 per cent of total income comes from taxes, fees and other income.

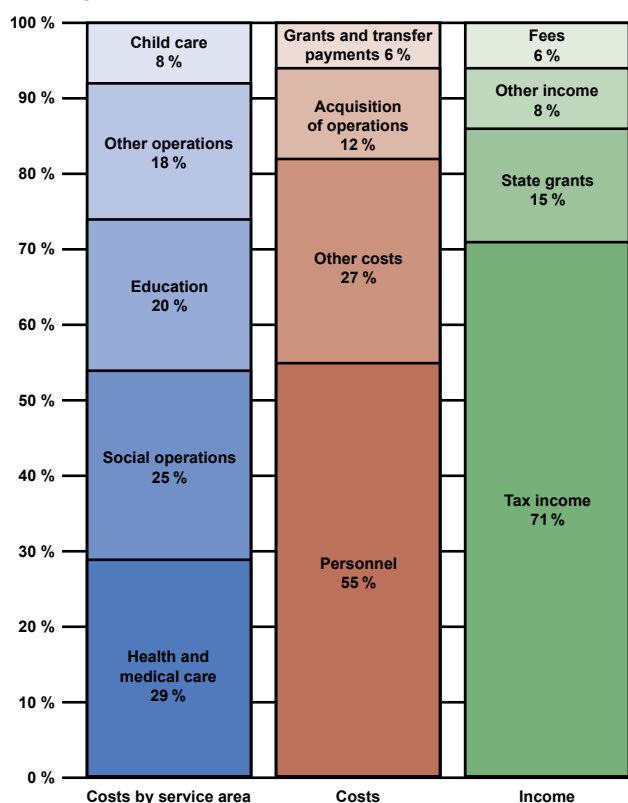
Education, social services and health/medical care are the largest operations in terms of finances, jointly accounting for 75 per cent of total municipality and county council costs. The activities are personnel-intensive, and the cost of personnel and procurement of operations (personnel) account for two-thirds of the overall costs.

Unrestricted right to set tax rates

The local governments in Sweden have a constitutional right to levy taxes for carrying out their tasks. Income from taxation accounts for just over 70 per cent of all funding. Each local government sets its own tax rate. The tax base is based on the residents' income, and there is no restriction in law on the size of the tax base. In 2005, the local government tax amounted to an average of 31.6 per cent of residents' income in Sweden. The county councils accounted for 10.8 per cent and municipalities for 20.8 per cent.

The local governments are also entitled to charge fees for particular activities, within certain limits.

Local governments' income and costs



Source: The Swedish Association of Local Authorities and Regions

The State contributes to the local governments' revenues

To further strengthen the financial situation of the local governments, and to ensure equality of circumstances between different local governments, the State contributes to their revenues through general and targeted grants, as well as through a system of local government financial equalisation. The grants equate to 15 per cent of total income.

Powerful system for financial equalisation

To ensure that all local governments, irrespective of their tax base and structural conditions, have equal basic conditions for providing their residents with services, Sweden has a system of balancing incomes and costs known as *local government financial equalisation*.

The systems – one for municipalities and one for county councils – basically comprise two parts: income equalisation and cost equalisation. *Income equalisation* evens out differences in the tax base of the local governments, and is primarily state-funded.

Cost equalisation evens out differences in structural costs. Local governments with an unfavourable cost structure are paid a cost equalisation grant, while those with a favourable structure pay a charge. The charge finances the contribution towards equalisation, and the cost equalisation is therefore neutral in terms of state finances.

The Swedish equalisation system has been described as one of the strongest in the world by leading rating institutions.

The local government financing principle

One important cornerstone in the interaction between the State and the local governments is what is known as the *local government financing principle*. This means that if the State should decide on measures that directly affect the activities of the local governments, the financial effects of that decision should be neutralised by altering the level of the state grant. The principle has been approved by the Swedish Riksdag.

The local governments’ assets and liabilities

The local governments in Sweden have to prepare consolidated financial accounts. As the operations of owned companies are often extremely capital-intensive, consolidated accounts provide the clearest picture of the local governments’ overall assets and liabilities.

Assets in 2004 amounted to SEK 842 billion, of which municipalities accounted for SEK 723 billion and county councils for SEK 119 billion. These assets are partly funded by 36 per cent equity and 37 per cent long-term liabilities.

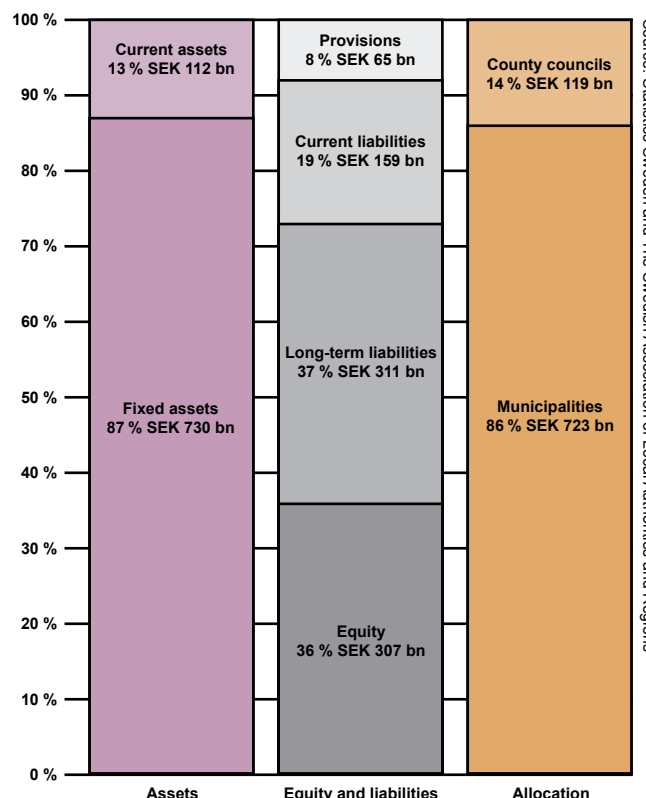
The local governments in Sweden have particular rules on accounting for and administering pension obligations, which means for instance that pension rights earned before 1998 are recognised as a contingent liability.

The local governments’ financial development

Following the economic crisis of the early 1990s that affected Sweden as a nation, as well as its local governments, the economy has developed very positively. Today Sweden has a high growth rate and a surplus in public finances in a European comparison.

The economies of the local governments have also developed positively. In 2005 the local governments had a surplus of 2 per cent of taxes and state grants. The surplus is in line with the objective for sound economic management, and is required in areas such as funding reinvestment and pension obligations.

The local government sector’s consolidated assets and liabilities



FINANCIAL REQUIREMENTS IMPOSED ON THE LOCAL GOVERNMENTS

High demands are placed on the economies of the local governments in Sweden. They must maintain sound economic management, including a balanced budget.

Sound financial management

The overall goal of the financial management in the local governments is to maintain *sound financial management* in the operation, which entails using resources economically in the short and long term. Each local government has to set goals and guidelines for the operation which are of significance to sound economic management. These goals are to be expressed both as financial and operational goals. The goals and guidelines are pivotal to the economic management. The annual financial report has to include an assessment of whether the goals have been achieved, and the auditors also have to assess goal achievement autonomously.

The balanced budget requirement

Every year, local governments have to define a budget and a financial plan for the next three years (including the budget year). The *requirement for a balanced budget* has applied since 2000, which means that the budget should normally be set with income exceeding costs. If the council decides to introduce new expenditures during the current budget year, the decision must also contain details of how the expenditure is to be funded. If a deficit is reported for a particular financial year, the general rule is that the council, after looking into the balance requirement, must adopt an action plan for restoring the deficit after no more than three years.

The local governments' financial reporting

From an international perspective, there are high demands on how the local governments in Sweden report their finances. Accounting and reporting must be in line with generally accepted accounting principles, and every year the local governments must draw up an annual report and at least one interim report for examination by the main council. The annual report must contain an administration report, an income statement, a balance sheet and a cash flow analysis. Legislation requires the local governments to compile consolidated accounts also encompassing operations conducted under a separate legal entity.

Controls are carried out via audits

The State conducts no inspection or control of the financial management of the local governments. Instead, control and inspection are carried out by auditors selected by the main council amongst citizens nominated by the political parties. The selected auditors are assisted by qualified professional auditors.

The auditors review annually whether the operation has been managed in an appropriate and financially satisfactory way. They also provide an assessment as to whether the accounts are true and fair, and internal controls are adequate.

In their audit report, the auditors state whether or not they recommend that Boards, committees and so on should be discharged from liability. The auditors' inspection reports and statements then form the basis of the main council's examination of liability.

THE LOCAL GOVERNMENT SECTOR'S BORROWING

Adequate security and sound economic management

Adequate security and sound financial management are key concepts in the local government sector's borrowing. Borrowing should build the foundation for a good operational and financial return on investments to an adequate degree of security. Funding operating costs with loans or by selling assets is not consistent with sound economic management. Loans are generally raised to finance investments, and raising loans in a speculative manner is consistent neither with the requirement for adequate security nor with municipal jurisdiction in the Swedish Local Government Act.

Autonomous decisions on borrowing

The local governments in Sweden have the right to make autonomous decisions on their borrowing, without scrutiny or approval by the State. The local governments decide for themselves, without legal impediment, which products and markets are to be used to raise borrowing. The main council adopts guidelines and policies to limit operational risks. The majority of the local governments have, for instance, set limits on debts in foreign currency.

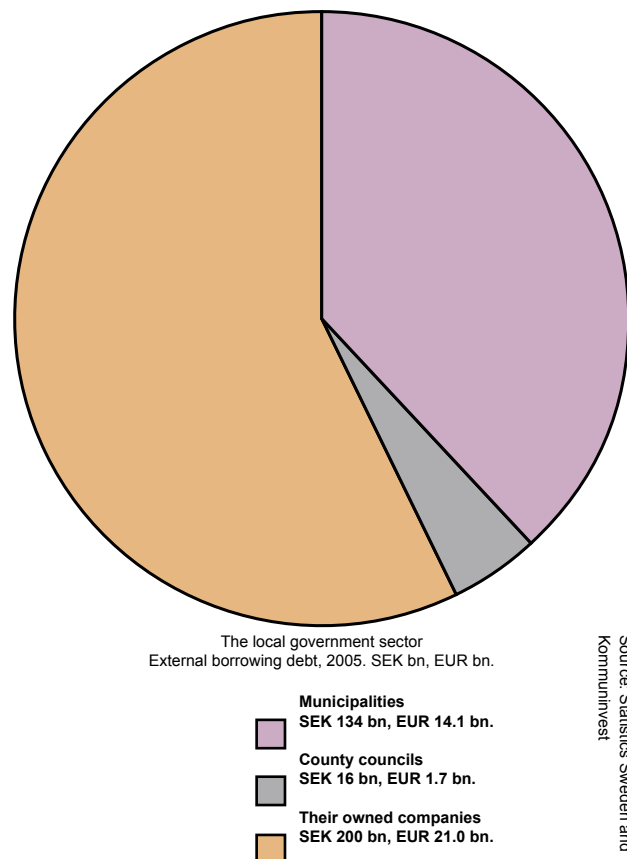
Indirect limitation of borrowing

Borrowing is indirectly limited in that all costs associated with the debt must be included in the balanced budget. There is no direct volume limit restricting the borrowing of the local governments.

The local government sector's borrowing

The local government sector's (including owned companies) total borrowings amount to SEK 350 billion, which equates to 13.7 per cent of GDP.

The local government sector's external borrowing



Of the total debt, municipalities account for SEK 134 billion and county councils for SEK 16 billion, which equates to 5.5 per cent of GDP. A large proportion of municipal borrowing refers to onward lending to their companies.

The municipal companies are the main borrowers

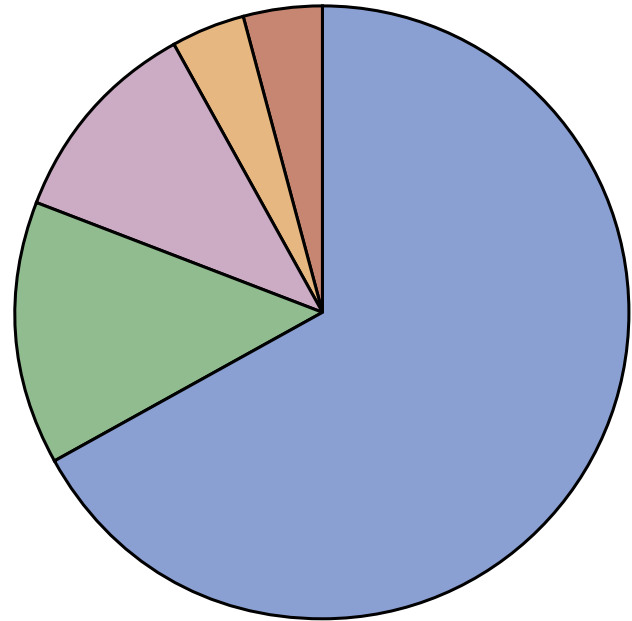
In addition to the debt that the municipally controlled companies have via the owner, the companies' external borrowing amounts to approximately SEK 200 billion. Guarantees from the municipalities act as security for the majority of this debt. Other forms of security include mortgages or floating charges.

Municipality and county council loans and lenders

The most important lender to municipalities and county councils, alongside the main merchant banks, is Kommuninvest i Sverige AB, which is owned by Swedish municipalities and county councils. These jointly account for two-thirds of municipality and county council borrowing.

More than 80 per cent of municipality and county council borrowing is comprised of promissory note loans. Only a few, very large, municipalities and county councils with high loan volumes take out bond loans. Bond loans account for 15 per cent of total municipality and county council borrowing.

The local governments' loans and lenders



Source: Statistics Sweden



THE LOCAL GOVERNMENT SECTOR'S CREDITWORTHINESS

Swedish local governments have a very high creditworthiness. No local government has ever failed to fulfil an agreement entered into with a lender.

Loans to Swedish local governments carry an extremely low risk, and prevailing capital cover rules state that exposure to the local governments should be equated with state exposure and have a risk factor of 0 per cent.

A local government cannot be declared bankrupt

Due to the particular position of the local governments in the constitution and their right to levy taxes, they cannot be declared bankrupt. Moreover, it is forbidden to pledge local government property as security for a loan, which means that the local governments are liable for all obligations they enter into, with all their tax power and their total assets.

Moreover, a local government cannot cease to exist. Only the Riksdag can decide on mergers of local governments. In the event of such a merger, responsibility for assets and liabilities is transferred to another local government. The same applies to the division of local governments.

The State supports financial stability in local government

Although Sweden has extensive local self-government, the State has ultimate responsibility for ensuring that public services as a whole develop in socio-economic balance. The State therefore closely monitors the local governments' financial development and position, and also has a number of instruments for supporting individual local governments in times of short-term difficulties.

Every year the State makes a provision of funds for special measures in vulnerable local governments. The aim of this provision is to assist local governments experiencing particular financial problems due to special circumstances.

Credit ratings for local governments

Because local governments represent such a low credit risk, there is very little need for credit rating. Therefore, only a few local governments have a rating. The City of Stockholm, Sweden's capital, has a credit rating of Aa1 and AA+ from Moody's and Standard & Poor's. Credit market company Kommuninvest i Sverige AB, which is owned and guaranteed by Swedish municipalities and county councils, has a rating of Aaa from Moody's. The main reason for this rating is the high creditworthiness of the owners.



REGERINGSKANSLIET

Finansdepartementet

The Swedish Government Offices have the task of drafting governmental affairs and otherwise supporting the Government and the Ministers in their activities. The Ministry of Finance is responsible within the Government Offices for matters relating to economic policy, the central government budget, taxes, banking, security and insurance, international economic work, and central, regional and local government. With 470 employees, the Ministry of Finance is one of the biggest ministries in the Government Offices.



KOMMUNINVEST

Kommuninvest is the local debt office for the local governments in Sweden. As an interest organisation, Kommuninvest aims to improve general conditions for the sector's funding. The aim of the operation is to offer favourable funding, consultation and methods for effective financial management to its members, which comprise the majority of Sweden's municipalities and six county councils. Kommuninvest is Sweden's largest inter-municipal cooperative society. The cooperation is voluntary, and services are provided competitively.



**Swedish Association
of Local Authorities
and Regions**

From 1 January 2005, The Swedish Association of Local Authorities and The Federation of Swedish County Councils have been cooperating under a joint name – The Swedish Association of Local Authorities and Regions. At the beginning of 2007, the two organisations will merge to form a new, joint federation under this name. All of Sweden's municipalities, county councils and regions are members. The Association aims to develop municipal self-government with extensive freedom of action and a strong link to citizens, to be an active supporter of members' interest nationally and internationally, and to promote and develop cooperation between members. The Association is the employers' organisation for its members.