

The Creditworthiness of Swedish Local Governments



Swedish Association
of Local Authorities
and Regions

PREFACE

Sweden has a long tradition of far-reaching self-government at a local level. 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 seaports, buildings, energy sources, machinery and road networks, as well as cabling and pipelines for energy, water and sewerage. Local governments are funded by taxation, charges and state grants. Significant external borrowing is required to even out the flow of payments over time as investment costs do not always match income.

The local governments in Sweden (including their companies) have an external borrowing debt of approximately SEK 380 billion. The 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 Kommuninvest and The Swedish Association of Local Authorities and Regions, and is also available in Swedish and Japanese.

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INTRODUCTION

Sweden is characterised by financial stability and a low national debt.

Sweden is a constitutional monarchy with a parliamentary system and an advanced economy. The country is ranked one of the world's leading countries in The Economist's Democracy Index and is tenth in the United Nations' Human Development Index 2011. Sweden has been a member of the European Union since 1 January 1995 and is also a member of the OECD.

With an area of 449,964 km², Sweden is the third largest country in the European Union by size and has a population of just over 9.4 million. Sweden is a democracy and is governed by the Swedish government, which is led by a prime minister.

In Sweden, the State has overall responsibility for ensuring that public services develop in a way that is compatible

with socio-economic balance. The country's municipalities and county councils are responsible for a significant proportion of public sector services, in which the emphasis on welfare is at local level through regions, county councils and municipalities.

Background to Swedish local governments

Sweden has undergone three nationwide municipal reforms, in 1863, 1952 and 1971. Today there are 290 municipalities and 20 county councils, including the regions of Skåne, Gotland, Halland and Västra Götaland. The median municipality has a population of approximately 15,000 and Sweden's municipalities have an average population of just over 30,000. The county councils/regions have an average population of 472,000. Just under 60 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 (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 of 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 connected 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 city council, as elected by the citizens. Elections are held every four years at the same time as parliamentary (Riksdag) elections. The city 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 insight and influence into 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 areas such as the budget, tax rates, fees and borrowing are made by the city 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 area of obligatory responsibility for municipalities and county councils is regional and local public transport, which is organised in different ways in different municipalities and county councils.

In just over half of the counties, the county council has sole responsibility for public transport, in the other counties public transport is a joint responsibility for municipalities and county councils.

Municipal cooperation

It is common for several municipalities to join forces and form an association of local authorities, and work together on particular issues. The goal is to create efficiency and skills-enhancing measures. 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 1,600 companies owned by local governments in Sweden, with around 50,000 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, as well as transport and communication.

| 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 | Building homes | | | |
| Water/sewerage | Business development | | | |
| Emergency services | | | | |
| Libraries 1) | | | | |
| Crisis contingency planning | | | | |
| Housing provision | | | | |

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 more than 1.1 million employees, which equates to 26 per cent of all employees in Sweden.

Studies show that Swedish municipalities are among the best-run municipalities in the world, and from a European perspective they have an average level of public debt.

The income and costs of the local governments

In 2010, the local governments' income amounted to just over SEK 770 billion, of which municipalities accounted for SEK 520 billion and county councils for SEK 250 billion. From an international perspective, Swedish local governments enjoy extensive financial autonomy. Eighty per cent of total income comes from taxes, fees and other income.

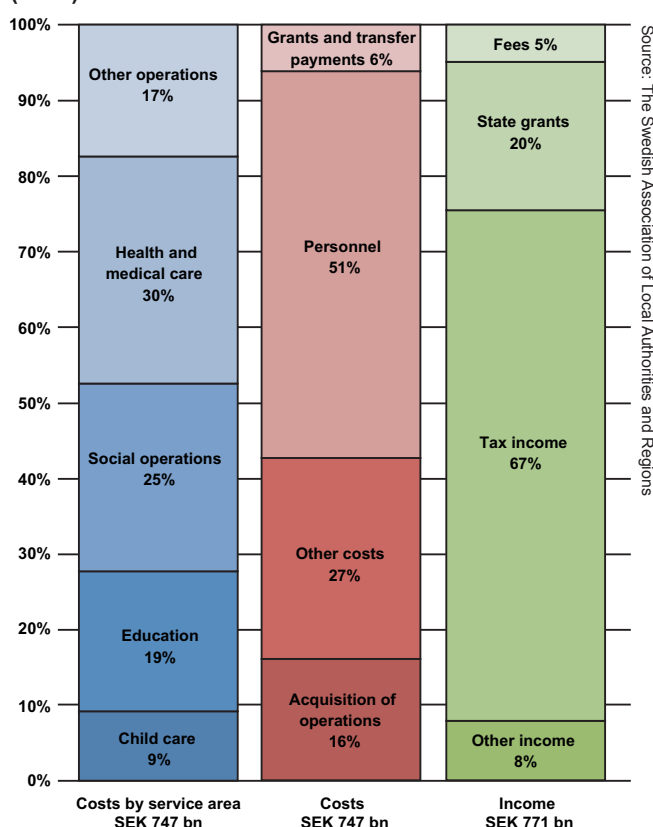
Education, social services and health/medical care are the largest operations in terms of finances, jointly accounting for 74 per cent of total municipality and county council costs. The activities are personnel-intensive, and the cost of personnel and procurement of operations (personnel) account for 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 68 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 2010, the local government tax amounted to an average of 31.5 per cent of residents' income in Sweden. The county councils accounted for 10.8 per cent and municipalities for 20.7 per cent.

The local governments are also entitled to charge fees for particular services they provide. Services for which fees are charged include child care and care of the elderly, as well as health and medical care. The fees are normally determined by the main council of the local government body. Under the prime cost principle, local governments may not charge fees in excess of the cost of the services provided. This is a general rule for all services managed by local governments.

Local governments' income and costs (2010)



The State contributes to 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 funding through general and targeted grants. The grants equate to 20 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 (Parliament).

The local governments' assets and liabilities

The local governments in Sweden have to prepare consolidated financial accounts. As the operations of companies owned by local governments are often extremely capital-

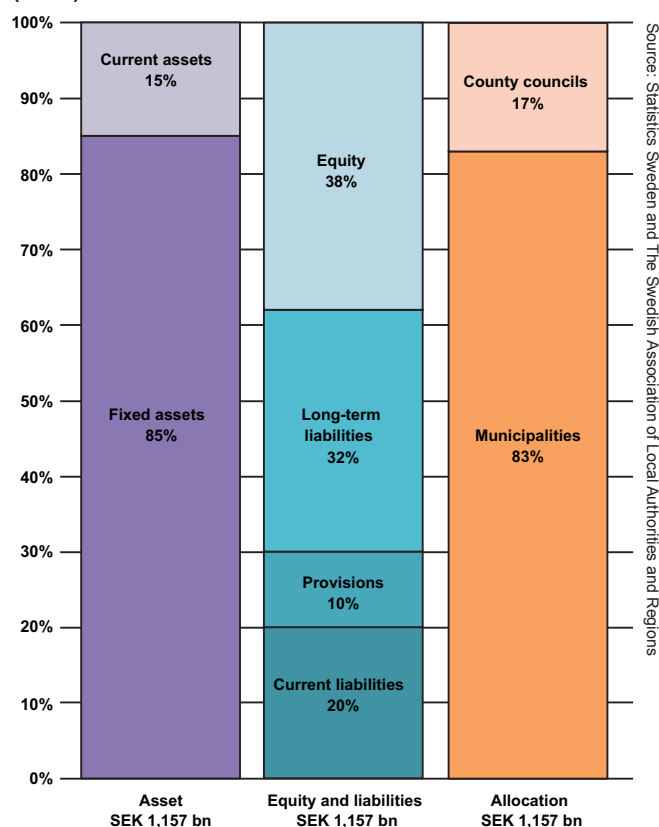
intensive, consolidated accounts provide the clearest picture of the local governments' overall assets and liabilities. Assets in 2010 amounted to SEK 1,160 billion, of which municipalities accounted for SEK 960 billion and county councils for SEK 200 billion. The assets are partly funded by 38 per cent equity and 32 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 in the 2000s

Following the recession that affected Sweden's local governments in the early 2000s, the economy has developed very positively. In 2010 the local governments (excluding companies owned by them) reported a surplus of 3.0 per cent of taxes and state grants. The surplus is slightly higher than what is deemed sound public fund management, and is required in areas such as funding reinvestment and pension obligations.

The local government sector's assets and liabilities (2010)



FINANCIAL REQUIREMENTS IMPOSED ON THE LOCAL GOVERNMENTS

The Local Government Act (1991:900) regulates the local governments' organisation and expertise. Under the Act, the local governments must maintain sound financial management and a balanced budget, which means they must manage their finances responsibly.

Sound financial management

The overall goal of 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 financial management. These goals are to be expressed both as financial and operational goals. The goals and guidelines are pivotal to the financial 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.

One common goal for local governments is that earnings should amount to 2 per cent of income from taxation and general state grants. In fulfilling sound financial management, factors such as pension liability and reinvestment needs are also be taken into account.

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 charges 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 remedying the deficit after no more than three years.

It should be noted that the balanced budget requirement is not the same as sound financial management. To meet the sound financial management requirement, earnings should be on a level that strengthens finances.

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 financial 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 financial 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.

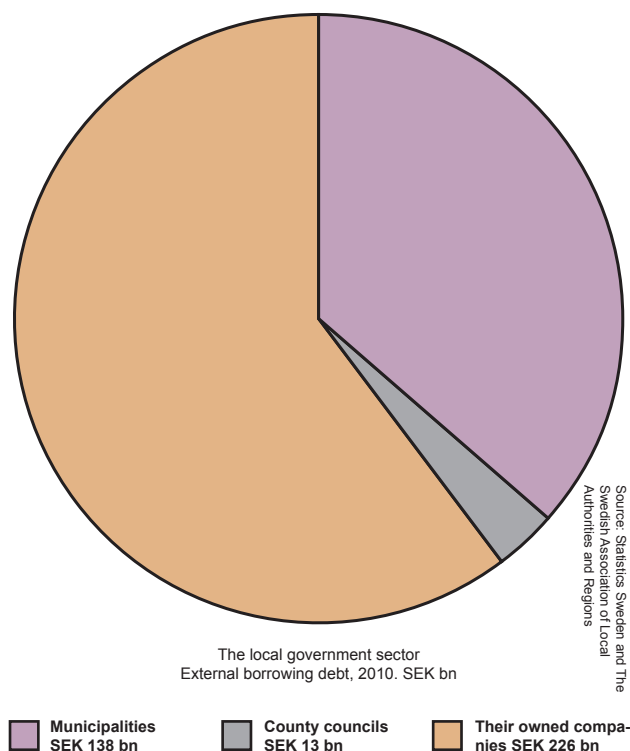
Indirect limitation of borrowing

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 380 billion, which equates to 11 per cent of GDP. Of the total borrowing, municipalities account for approximately SEK 138 billion and county councils for SEK 13 billion. A proportion of municipal borrowing refers to onward lending to their companies.

The local government sector's external borrowing



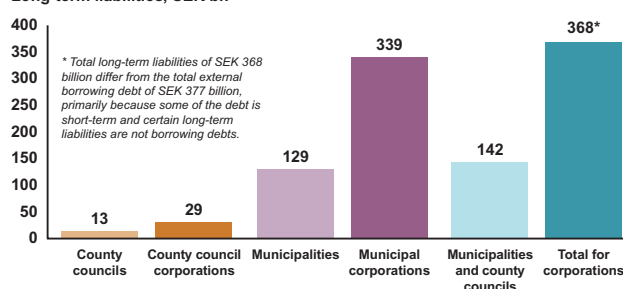
On average, the municipalities (excluding owned companies) have borrowings of SEK 14,600 per capita and an equity/assets ratio of 52 per cent, excluding pension obligations earned before 1998. The county councils have average borrowings of SEK 1,400 per capita and an equity/assets ratio of 25 per cent.

The table shows that borrowings in the local government sector are at a restricted, controlled level. The largest borrowing per capita is for municipalities (including companies owned by municipalities) with a population of between 50,000 and 200,000.

| Population | Long-term liabilities per capita | | Equity/assets ratio excluding pension obligations before 1998 | |
|-------------------|----------------------------------|-------------|---|-------------|
| | Municipality | Corporation | Municipality | Corporation |
| 0 - 4 999 | 14 858 | 33 003 | 46 | 39 |
| 5 000 - 9 999 | 11 321 | 34 078 | 44 | 31 |
| 10 000 - 14 999 | 10 719 | 36 613 | 48 | 32 |
| 15 000 - 19 999 | 10 806 | 35 334 | 53 | 36 |
| 20 000 - 29 999 | 10 787 | 38 000 | 52 | 36 |
| 30 000 - 49 999 | 10 781 | 34 163 | 58 | 41 |
| 50 000 - 99 999 | 12 120 | 43 013 | 56 | 37 |
| 100 000 - 199 999 | 18 359 | 41 143 | 53 | 37 |
| 200 000 - 899 999 | 21 069 | 27 096 | 47 | 48 |

Source: Statistics Sweden and The Swedish Association of Local Authorities and Regions 2010

Long-term liabilities, SEK bn



Companies owned by local governments are the main borrowers

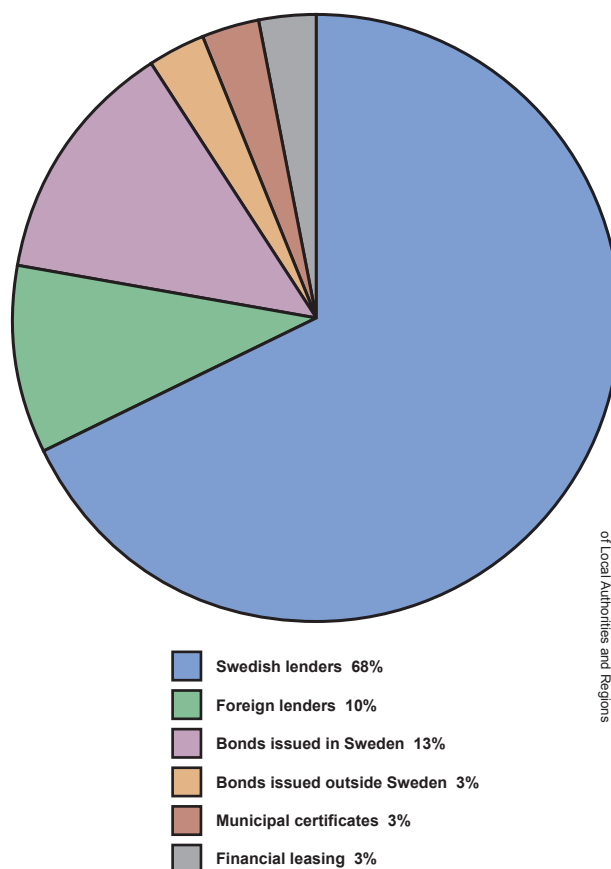
Companies owned by local governments can borrow directly on the market, but the local governments have insight into their companies' borrowing activities in several ways. Under the owner directive, the local governments can control their companies' return and equity/assets ratio, and therefore indirectly their companies' borrowings. A number of local governments require that all borrowing in the companies is via the municipality or county council. It is also common for companies to borrow using municipal guarantees.

Local government loans and lenders

Kommuninvest, which is owned by Swedish local governments, is by far the largest lender to local governments. Alongside Kommuninvest, the main commercial banks are important lenders to local governments.

Almost 80 per cent of local government borrowing is comprised of promissory note loans. Only 20 or so large municipalities and county councils with high loan volumes take out bond loans. Bond loans account for 16 per cent of total local government borrowing (excluding companies owned by local governments).

Local governments' loans and lenders (2010)



Source: Statistics Sweden and The Swedish Association of Local Authorities and Regions



THE LOCAL GOVERNMENT SECTOR'S CREDITWORTHINESS

Swedish local governments have a very high credit worthiness. 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 government sector 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 is responsible for socio-economic stability

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.

Credit ratings for local governments

Local governments represent a very low credit risk. Credit market company Kommuninvest i Sverige AB, which is owned and guaranteed by Swedish local governments, has had the highest rating from Moody's since 2002 and from Standard & Poor's since 2006.

Securities issued by Kommuninvest may be treated the same as securities issued or guaranteed by the Swedish State. One of the reasons for the rating is the high credit-worthiness of the owners.

Ten or so municipalities and two county councils have a rating. At Standard & Poor's the credit rating varies between AA and AAA: one municipality has AA; seven municipalities and two county councils have AA+; three municipalities have AAA.



Kommuninvest is responsible for Swedish local governments' coordinated procurement of financing and for financial stability in the local government sector. 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 is run on a commercial basis.



The Swedish Association of Local Authorities and Regions (SALAR) is an employer and interest organisation whose main objective is to safeguard its members' interests and offer them support and service. All of Sweden's municipalities, county councils and regions are members. SALAR is a politically led organisation with the task of giving municipalities and county councils better conditions for local and regional self-government, raising issues and leading opinion with the aim of developing welfare.