

Public Finance System Overview: Swedish Local And Regional Governments

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Table Of Contents

Assessing The Institutional Framework

Predictability: A Mature And Stable System, With Formalized Processes For Reform

Revenue And Expenditure Balance: A High Degree Of Income Equalization And Tax-Setting Autonomy Provide Flexibility

Transparency And Accountability: Formalized Reporting Standards Ensure Rigorous Financial Planning

System Support: High Degree Of Equalization And A Track-Record Of Extraordinary State Aid To LRGs In Distress

Related Criteria And Research

Public Finance System Overview: Swedish Local And Regional Governments

Standard & Poor's Ratings Services considers the institutional framework for local and regional governments (LRGs) that operate in the Kingdom of Sweden (AAA/Stable/A-1+) to be among the most supportive worldwide. As a consequence, we assign the Swedish system our highest score of '1' in our overall analysis (on a scale of 1 to 6).

The Swedish public sector is a three-tier system with a state level, a regional or county council level, and a municipal level. In practice, the regional and municipal levels provide two-thirds of the nation's public services.

The Swedish regional and municipal levels share significant independence from the state level in a number of areas. One of the most important is their autonomy in setting the municipal and regional/county council income tax rate. With regard to their respective areas of responsibility, the individual municipalities or regions/county councils are free to decide how to provide their mandatory public services to their inhabitants while adhering to certain regulatory requirements regarding user availability, cost, and quality.

Table 1 gives a brief description of the key features of Sweden's municipalities and regional governments.

Table 1

Swedish Local And Regional Government Resources And Responsibilities		
	Municipalities	Regional governments/County councils
Responsibilities		
Education and child care	Yes, but higher education is a state responsibility	No
Health care	Yes, to some extent, although mainly nonmedical care	Yes
Social care	Yes	No
Economic development	Yes	Yes
Transportation	Some are responsible for local public transport, independently or in association with the region or county council.	They usually have responsibility for local and regional public transportation.
Environment	They are responsible for waste and water treatment, as well as performing a control function for local environmental issues.	No
Public housing responsibilities	Yes	No
Resources		
Taxes	Local income tax rates are set individually by each local government. There are no central-government restrictions on the tax rate.	Regional income tax rates are set individually by each regional government. There are no central-government restrictions on the tax rate.
Debt	Swedish LRGs enjoy unlimited rights to raise debt for operations within their defined responsibilities (the Municipal Act restricts borrowing only for speculative purposes). No state level approval of borrowing is needed.	Swedish LRGs enjoy unlimited rights to raise debt for operations within their defined responsibilities (the Municipal Act restricts borrowing only for speculative purposes). No state level approval of borrowing is needed.
LRG sector characteristics		
Decentralization	The Swedish LRG sector enjoys a constitutional right to self-governance. In addition, the "Principle of Financing" applies: Any transfer of responsibilities from one level to another should be accompanied by adequate financial compensation (e.g., state grants or tax shifts).	The Swedish LRG sector enjoys a constitutional right to self-governance. In addition, the "Principle of Financing" applies: Any transfer of responsibilities from one level to another should be accompanied by adequate financial compensation (e.g., state grants or tax shifts).

Table 1

Swedish Local And Regional Government Resources And Responsibilities (cont.)		
Control	There are no formalized control mechanisms. The second (regional) tier of government exercises no control or supervisory function over the municipal level.	There are no formalized control mechanisms.
Defaults	Although there is no formalized sovereign support, the central government has a track record of extending support to several LRGs. LRGs are not allowed to go bankrupt; however, there are no explicit state guarantees for the sector's ability to pay on time. No default has occurred.	Although there is no formalized sovereign support, the central government has a track record of extending support to several LRGs. LRGs are not allowed to go bankrupt; however, there are no explicit state guarantees for the sector's ability to pay on time. No default has occurred.

LRG--Local and regional government.

Besides indirect central-government involvement in LRG operations, we note that the overall framework incorporates a number of key systemic factors. These are codified, most notably in the Municipal Act, and primarily relate to ensuring economic independence and financial viability for all of Sweden's 290 municipalities and 20 regional governments/county councils. The country's local governments differ considerably in size, growth prospects, and tax bases.

A comprehensive system of equalization is therefore built into the system, which, together with LRGs' tax-setting autonomy and state grants, forms the foundation of LRGs' financing possibilities. Thanks to the equalization system, all Swedish LRGs in principle retain similar financial possibilities to provide public services for their inhabitants in line with national standards.

Assessing The Institutional Framework

The system, or institutional framework, within which public finance entities operate, is a crucial component in rating LRGs. As such, Standard & Poor's Ratings Services incorporates an assessment of system supportiveness in its LRG rating methodology.

When assessing system supportiveness for each jurisdiction, we take into account the following:

- **Predictability.** This includes the frequency and extent of reforms affecting the intergovernmental system and predictability of their outcome, alongside an LRG's ability to influence or oppose reforms affecting its financial balance;
- **The revenue and expenditure balance.** This includes the overall adequacy of the revenues that an LRG receives to cover its expenditure mandates, in the form of sufficient autonomy or state subsidies, as well as the existence of a fiscal policy framework imposing prudent limits on an LRG's debt and deficit levels;
- **Transparency and accountability.** This involves the transparency and institutionalization of the budgetary processes, the disclosure and accounting standards for financial reporting in the LRG sector, and the control levels and reliability of information; and
- **System support.** This includes the extent of ongoing support from higher levels of government to ensure the provision of basic services and infrastructure, as well as the degree of extraordinary system support in exceptional circumstances (natural catastrophes, major capital infrastructure projects, and periods of severe and prolonged recession that affect the sector's financial balance).

More details on how we assess the quality of institutional frameworks for LRGs can be found in the article "Methodology For Rating International Local And Regional Governments". Further assessments of institutional frameworks for international LRGs are provided in the article "Institutional Framework Assessments For

International Local And Regional Governments".

Predictability: A Mature And Stable System, With Formalized Processes For Reform

Swedish LRGs operate within a mature institutional system. Important systemic features and principles are formalized in the Municipal Act. Large reforms are rare, but amendments occur from time to time. The process for implementing reforms and amendments is transparent and consensual, and thus the outcome is usually predictable. Moreover, we observe that new features or amendments to the system are generally implemented gradually.

While Swedish subsovereigns as such have no representation in the parliament and hence have no direct power to block the negative consequences of reforms, the reform process is structured in such a way as to ensure that a fair amount of consensus takes place. When the state contemplates major changes to the system, the changes are prepared and discussed at length before any decision is taken.

Moreover, state-initiated enquiries that form the basis of the reform proposal precede any discussions about changes. The state usually submits these enquiries for a national hearing, and the LRG sector, individual local governments, or relevant organizations, such as the Swedish Association of Local Authorities and Regions, supply comments and considerations.

Similarly, any draft government bills are first referred to such relevant organizations before being introduced in parliament. Furthermore, the political parties in LRGs' political assemblies are generally the same ones as those in the national parliament, which we believe enhances the possibilities for communication about upcoming reform initiatives.

Discussions about reforming the structure of the Swedish public sector are underway. Specifically, in 2007, the Committee on Public Sector Responsibilities put forward its recommendations on how to reform the sector. One of its main recommendations was that the current 20 regions/county councils should be replaced by six to nine larger regional authorities and that these new, larger regions would retain primary responsibility for health care.

Until now, the central government's stance with regard to the committee's proposals has been to leave it to the county councils to discuss and forge working relationships with neighboring counties. As such, in the otherwise centralized Swedish system of government, the state level in this matter has sought the input of the other levels before taking any final decision. We think this underscores the state's emphasis on a consensual decision-making process for amendments to LRG sector legislation.

Still, any merger would ultimately need state approval. Recent government signals indicate that the central government would prefer to speed up the process, and the reorganization with a new regional framework should near completion as the next general elections in 2014 approach. Mergers and splits within the LRG sector occur from time to time, and we note that the principles for dividing assets and liabilities are fairly well established.

Revenue And Expenditure Balance: A High Degree Of Income Equalization And Tax-Setting Autonomy Provide Flexibility

Swedish LRGs rely on tax revenues to finance most of their operations because about 70% of their revenues come

from locally generated income tax. The remainder consists mainly of general and earmarked grants (16%) and local charges and fees (10%).

The Swedish constitution provides that Swedish LRGs--both at the municipal and regional levels--enjoy autonomous power of taxation. Because of this autonomy, Swedish LRGs have strong possibilities to manage their own revenues and to balance expenditures for the provision of public services.

Although tax-setting autonomy is an important tool for LRGs to manage their revenues and expenditures, temporary imbalances, for example during economic downturns, do occur, particularly in situations where the national economic context and tax base deteriorate sharply. In such situations, increases to the local income tax rates--for municipalities and regions/county councils--is a viable option to boost revenues. However, there is a certain time lag from the time the LRG modifies the tax rate and the receipt of greater revenues.

Normally, an LRG's political body decides on the income tax rate for the following year in its budget procedures. Budget decisions can be revised and the income tax rate for the following year can be modified with only one month's notice. Consistently increasing the level of taxation could be politically sensitive, particularly in election years. But, in theory, the sector enjoys unlimited possibilities to increase the local income tax rate. Charts 1 and 2 give a breakdown of the revenue items for Swedish LRGs.

Chart 1

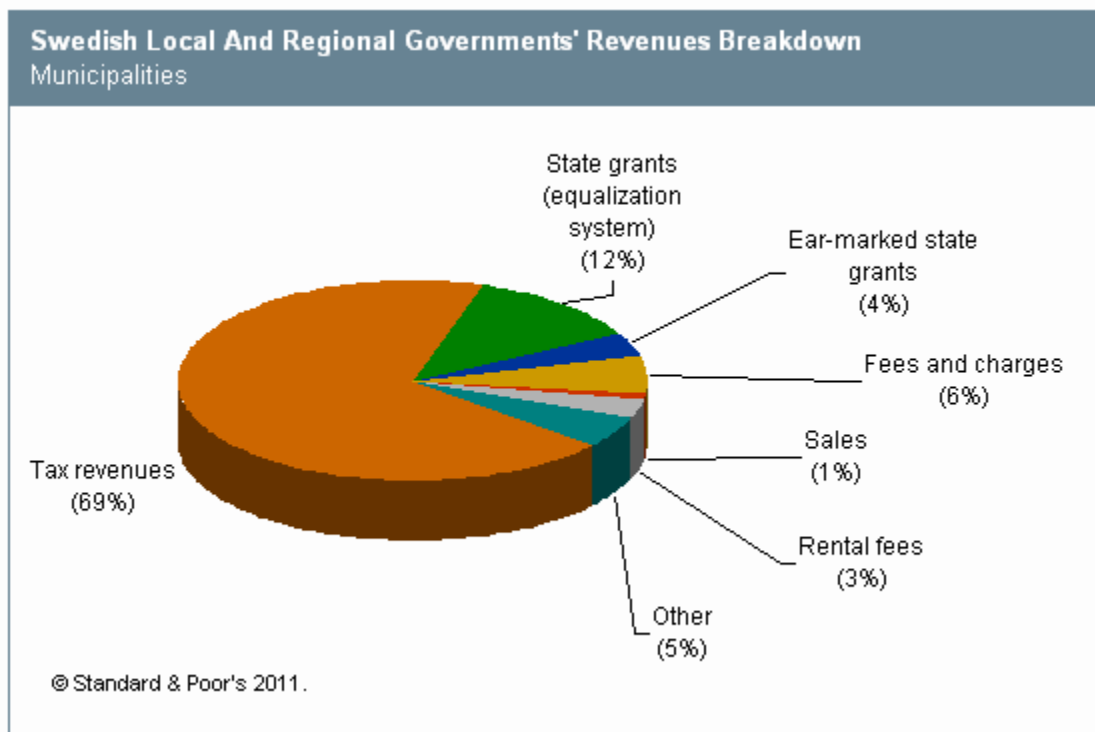
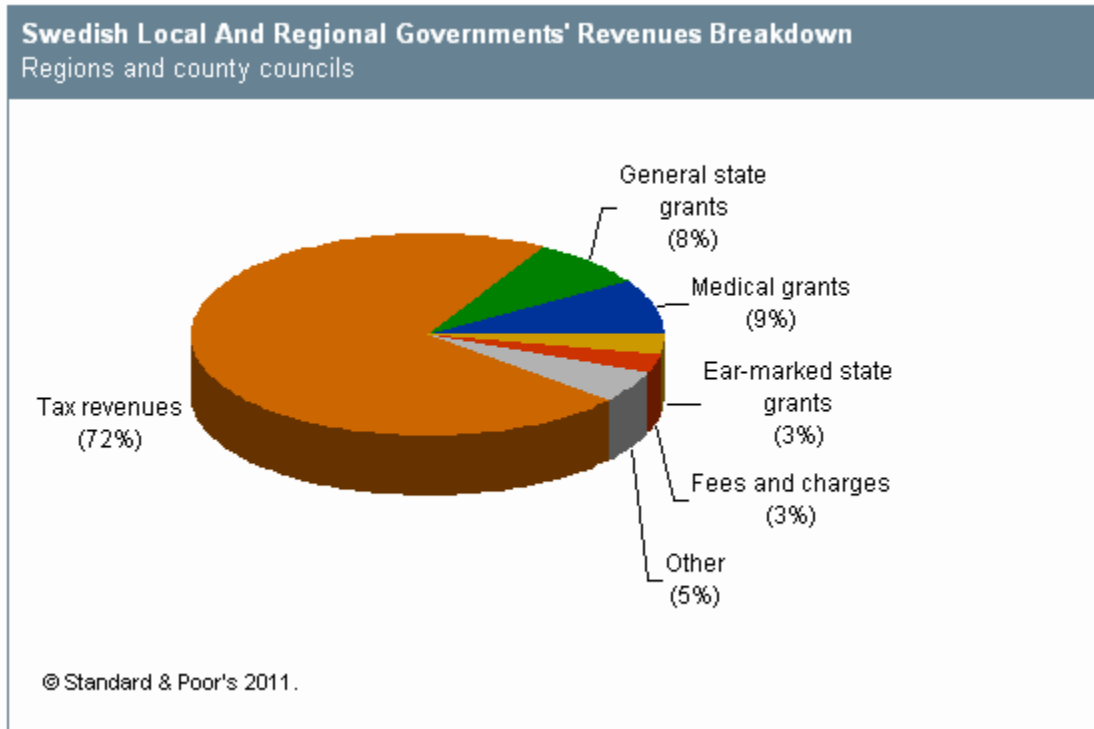


Chart 2



Swedish LRGs' expenditure side is rather inflexible. For both municipalities and regions/county councils, a large part of expenditures relate to responsibilities mandated by national legislation on volume and user costs. In addition, these public services are generally very labor intensive and are difficult to cut without impairing the service level. Charts 3 and 4 show the concentration of regional expenditures within health care, whereas municipalities have a wider scope of expenditures in kindergartens, education, elderly care, social care, and special needs services.

Chart 3

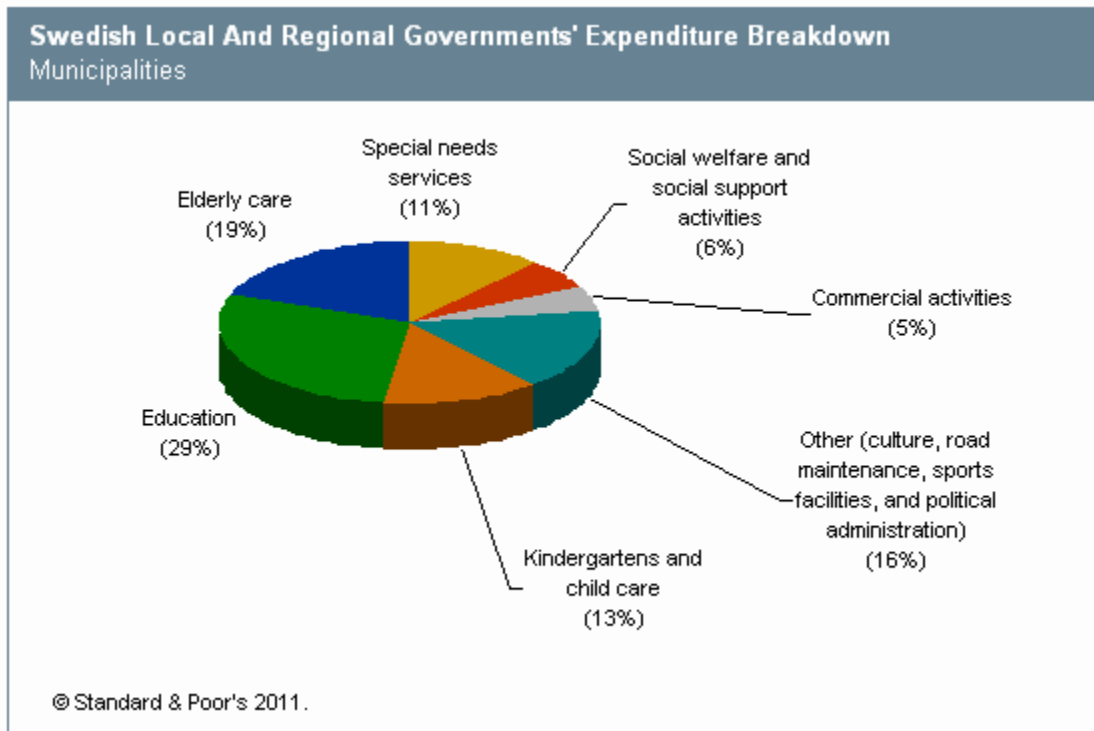
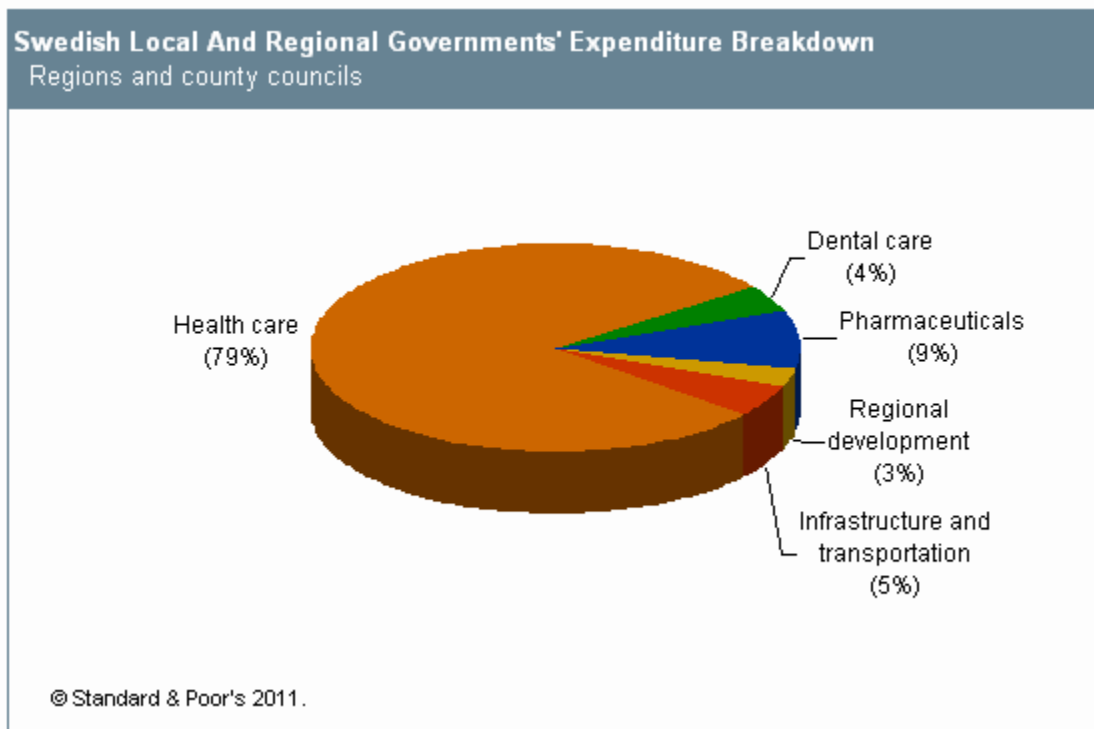


Chart 4



Furthermore, the Swedish LRG framework includes an established principle known as the "local government financing principle". Essentially, this principle ensures that if the central government takes decisions that directly affect the operations of the subsovereign governments, for example mandating new responsibilities, these decisions must be accompanied by a corresponding change in the financing grant from the state. The rationale for this setup is that the local governments should not have to resort to tax increases to deliver new state-mandated public services.

Standard & Poor's currently rates 12 municipalities and two county councils in Sweden (see table 2 below). The population-weighted shares of Swedish LRG ratings are about 30% for municipalities and about 40% for county councils. Most of them are growth centers within their respective regions. That means that growth prospects and subsequent investment needs are high. Nevertheless, we observe that although capital expenditures are at times heavy in a Swedish context, the LRGs have so far avoided surges in indebtedness. Instead, they have accumulated debt gradually and in an overall sustainable fashion.

The state usually funds major infrastructure projects, with the municipal and region levels cofinancing minor parts. Although the concept of cofinancing has increased in recent years, the central government's handling of most major infrastructure investments significantly limits the municipal sector's funding needs. Moreover, when changes in the setup for provision of public services occur--for example, the recent change in provision of public transportation being moved from the municipal to the regional level--tax shifts between the different levels of government work to efficiently balance the expenditure position.

The Municipal Act restricts LRGs' fiscal policy. For example, there is a balanced-budget requirement that obliges an LRG to present a budget document for the coming three years that establishes that an LRG's revenues are greater than its expenditures. If the actual result shows a deficit, however, the Municipal Act gives the LRG three years to make up the deficit.

However, we note that, although awareness has increased over the past few years, throughout the sector there are still numerous deviations from the balanced-budget requirement. Moreover, as there are no sanctions for noncompliance, LRGs are left on their own to balance their accounts.

The central government has no formalized mechanisms for monitoring the financial situations of individual LRGs. The LRGs are not required to submit reports or budget documents for approval from any government ministry. Rather, the Ministry of Finance relies on the LRGs to comply with accounting standards and promptly signal and report potential financial problems. However, the absence of formalized government monitoring has not proven overly relaxed, because the central government has been properly notified about financial problems at individual LRGs. We also note that the central government has historically extended support in instances of reported financial distress in the LRG sector.

There are loose restrictions on the LRGs in terms of debt and liquidity management, in our view. The central government sets no caps on debt levels, and LRGs are allowed to borrow to finance their responsibilities. The Municipal Act does not allow LRGs to raise debt for speculative purposes, however. That said, there is no continuous monitoring by the central government in this respect,.

Transparency And Accountability: Formalized Reporting Standards Ensure Rigorous Financial Planning

The roles and responsibilities between the elected political officials setting the overarching agenda and managers that implement it are clearly defined. Still, because LRGs are politically run organizations, managers have only limited power to stand against decisions with potentially financially distressing implications. Generally, however, we observe that there is good cooperation between the political side and the financial management throughout the sector.

Swedish LRGs adhere to nationally established accounting standards. Accounting standards are very high, with accrual-based accounting and consolidated accounts available for the LRGs and their company sector. In addition, the year-end accounts are subject to a formal audit. This audit is performed by in-house auditors in cooperation with external auditors. Consequently, instead of having the central government controlling the LRGs' finances, this control function is fulfilled by internal auditors (assisted by qualified professional auditors) who annually review whether the LRGs' operations have been managed in an appropriate and financially satisfactory way, and recommend (or not) that the LRG board should be discharged from liability.

In addition, legislation requires LRGs to publicly disclose comprehensive and timely information on their budget execution. At least one interim report must be presented to the local government and publicly disclosed. Overall, financial reporting is frequent and budgets include multiyear financial planning for three years in advance.

System Support: High Degree Of Equalization And A Track-Record Of Extraordinary State Aid To LRGs In Distress

A significant degree of state transfers tightly link Sweden's LRG sector to the state level. These transfers are incorporated within and deployed through the sector's far-reaching equalization system. This overall framework is a prominent example of the tight links, ongoing system support, and notion of solidarity on which the system is based. Essentially, the national government implicitly bears responsibility for the financial health of the system, as LRGs have legally mandated obligations.

The Municipal Act further stipulates that a Swedish subsovereign government cannot be declared bankrupt. Even though no earmarked funds are allocated for bailouts, the system has in severe cases provided case-by-case extraordinary support to the LRG sector in situations such as economic crisis, ailing municipal companies, or one-off shocks to local labor markets. However, no explicit guarantee of timely support exists.

An important part of the ongoing systemic support we factor into our assessment of the Swedish LRG system is its comprehensive equalization system. The equalization system comprises two major parts: one on the revenues side, which is structured to even out the differences in tax base per capita; and one on the expenditures side, which distributes funds and grants to local governments with adverse cost structures and unfavorable demographic compositions. The handful of LRGs that hold a tax base above the set cut-off levels are in effect net contributors to the overall scheme.

In principle, there is strong political consensus regarding the necessity of an equalization system to provide equal financing possibilities for the different LRGs, but the actual format of the equalization is often disputed.

Nevertheless, strong consensus regarding the need to ensure equal financial possibilities to uphold a certain standard of public services exists. The equalization system is under revision, and although some minor changes will likely occur, we believe that the overall setup, and certainly its purpose, should remain more or less intact.

With regard to extraordinary support, we note that there is no formal monitoring of subsovereign governments' finances by the state. Hence, if an LRG experiences financial distress, it must itself initiate the process to receive possible state support. Although there are no formal procedures or clearly established framework for bailouts, the central government has a very strong track record of supporting LRGs in severe financial distress or with structural imbalances, and consequently, no Swedish LRG has ever defaulted.

Financial support is normally regulated through the state grant system, through which the equalization system evens out regional financial imbalances. However, extending support through the established equalization and grants system effectively occurs with a time lag and is not immediate.

In situations where a municipality's financial situation deteriorates more rapidly, the state has acted swiftly, albeit on an ad-hoc basis, to remedy the situation. Extraordinary state support has taken various forms. Upon reception of state support, the local government usually commits itself to undertake a series of measures such as cutting costs, increasing the tax rate, and/or selling assets in exchange for extraordinary support. One notable example of this occurred in the mid-1990s, when the municipality of Haninge found itself unable to pay on guarantees it had extended to the local public housing company.

However, the central government took quick action, appointed a supervisor for the financial affairs of the municipality, and the payment difficulties were remedied in exchange for the central government's taking over a large part of the property stock of the housing company and eventually assuming control of the entire company. In addition, the state supervisor drew up an action plan for Haninge's financial situation, including cutting costs and increasing the local municipal income tax rate. The Haninge case represents the closest situation to default that a Swedish LRG has faced. In our view, the state's action illustrates its commitment to the financial stability and viability of the sector.

Importantly, we note that the central government is not formally obliged to support an LRG asking for additional funds. In fact, it has refrained from doing so on a few occasions, presumably because the state perceived that the LRG could and should have coped with the financial situation itself.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010
- Institutional Framework Assessments For International Local And Regional Governments, March 2, 2011

Table 2

Rated Swedish Local And Regional Governments		
	Issuer credit rating*	Nordic national scale rating*
Goteborg (City of)	AA+/Stable/A-1+	K-1
Helsingborg (City of)	AA+/Positive/A-1+	K-1
Huddinge (Municipality of)	AA+/Stable/A-1+	K-1

Table 2

Rated Swedish Local And Regional Governments (cont.)		
Lund (Municipality of)	AAA/Stable/A-1+	K-1
Malmö (City of)	AAA/Stable/A-1+	K-1
Norrköping (Municipality of)	AA+/Stable/A-1+	K-1
Municipality of Örebro	AA+/Stable/A-1+	K-1
Stockholm County Council	AA+/Stable/A-1+	K-1
Stockholm (City of)	AAA/Stable/A-1+	K-1
Sundsvall (Municipality of)	AA+/Stable/--	K-1
Taby (Municipality of)	AAA/Stable/--	K-1
Uppsala (City of)	AA+/Stable/A-1+	K-1
City of Västerås	AA+/Stable/A-1+	K-1
Västra Götaland (Region of)	AAA/Stable/A-1+	K-1

*As of May 19, 2011.

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