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Nordic Local Governments

Credit quality boosted by support expectation and inherent strengths

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Analyst Contacts

Amir Girgis +44.20.7772.5310
Analyst
amir.girgis@moodys.com

Olivier Heinen +44.20.7772.1429
Associate Analyst
olivier.heinen@moodys.com

Roshana Arasaratnam +44.20.7772.5302
Vice President – Senior Credit Officer
roshana.arasaratnam@moodys.com

Nordic local governments are key providers of public services, and therefore benefit from strong links with, and close supervision from, their highly-rated central governments. This makes sovereign support in the event of financial distress likely, despite the sector's generally high degree of fiscal autonomy. Nordic local governments' strong standalone financial characteristics further support their credit profile.

» **Local governments are key providers of public services.** Their role in delivering a wide range of public services means their expenditure accounts for around half of total public spending, and in some cases surpasses central government spending. The Nordic local government model is based on the principle that public services should be delivered as close to the citizens as possible.

» **High degree of fiscal autonomy.** Nordic local governments benefit from self-governance, and this autonomy is constitutionally protected, with the exception of Norway. A high proportion of their revenues stems from own source taxation, enhancing their revenue flexibility. This is particularly true in Sweden, Denmark and Finland, where local governments can also set their own tax rates. In Norway, local tax rates remain under central government control.

» **Strong standalone credit quality.** A combination of solid economic fundamentals, good financial performance and good access to capital markets supports strong standalone credit quality. Even so, we expect some variation in idiosyncratic risk, reflecting the distinctive characteristics of individual local governments.

» **Central government support likely.** Nordic local governments' role in delivering key public services makes them systemically important. In all Nordic countries, the sector is closely supervised by the central government as a result. Central governments have provided timely support in previous cases of local governments facing financial distress in system where local governments cannot be declared under local laws. There is no history of local government default under this system.

Local governments are key providers of public services

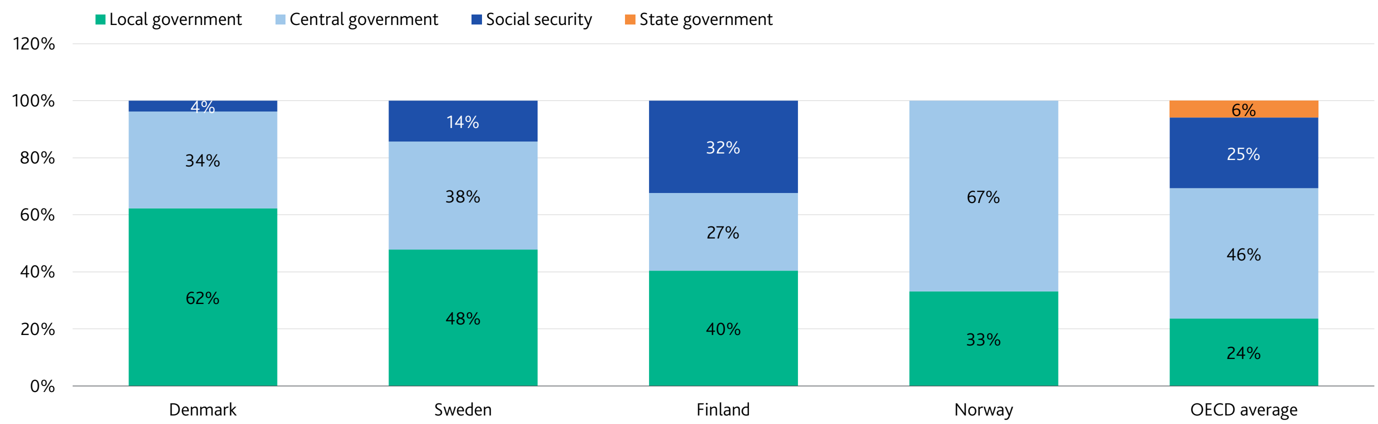
Local government in Denmark, Sweden, Norway and Finland consists of regions and municipalities. The bulk of public services are delivered by municipalities (see Table 1 for a breakdown of responsibilities), in line with the guiding principle that services are most effectively delivered at the local level. Nordic local governments' role as service providers boosts their employee headcount, which accounts for approximately 20% of total employment on average.

A large share of total public expenditure in Nordic countries is carried out at local level (see Exhibit 1). In all Nordic countries apart from Norway, local government expenditure exceeds that of the central government. This is in contrast with most other OECD countries. Nordic countries have the largest local government sectors in the world, reflecting the wide range of responsibilities that are devolved to local level.

EXHIBIT 1

Nordic local governments are big spenders

Share of public expenditure spent by government level, 2014



Source: OECD: Government at a Glance 2015

High degree of fiscal autonomy

Overall high revenue flexibility

Nordic local governments have the right to levy taxes, an important aspect of self-governance. Tax receipts account for the majority local government revenues, with grants, fees and financial income making up the balance. Income tax is by far the most important source of local government operating revenue. Other taxes can include corporate tax, land tax and property tax. For example, Helsinki generates the majority of its operating income (62%) from taxes, including municipal income tax and property tax (see Exhibit 2).

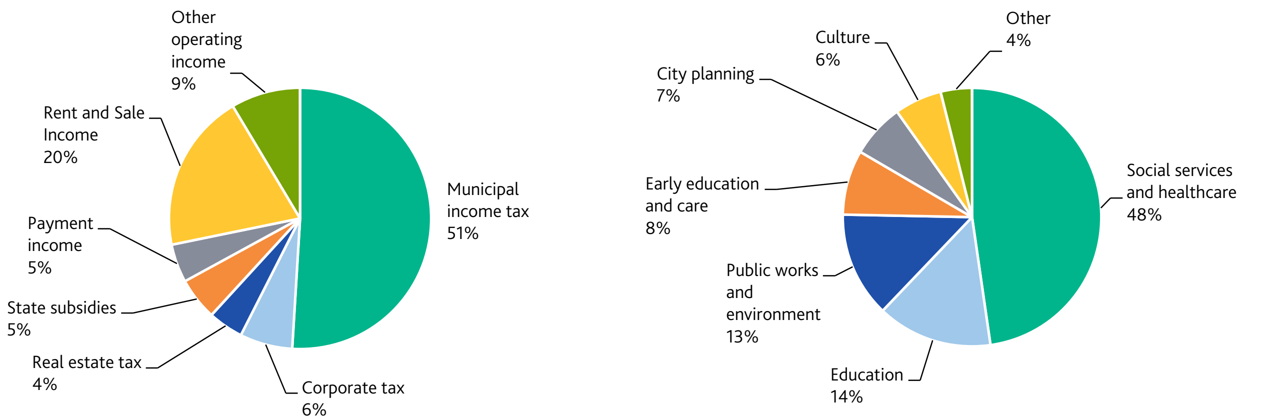
Helsinki earns most of its revenue from municipal taxes

The Finnish capital of Helsinki had revenue of EUR 4.7 billion in 2014, of which approximately 62% came from taxes. The city has the right to set the rates of municipal income tax, dog tax, and real estate property tax. The municipal income tax rate is currently 18.5%. Corporate tax is determined by the central government. State subsidies accounted for only 5% of revenues.

EXHIBIT 2

Helsinki receives most of its revenues from municipal income taxes

Operating income and operating expenses for Helsinki, FY2014



Operating income: EUR 4,777 million

Operating expenditure: EUR 4,565 million

Source: Annual Accounts 2014

TABLE 1

Major tasks performed at each government level

TASKS	DENMARK	FINLAND	SWEDEN	NORWAY
Government Structure				
National Level	- Defense, police - Judicial system - Foreign and monetary policy - Major infrastructure - Higher education - Secondary schools (upper)	- Defense, police - Judicial system - Foreign and monetary policy - Major infrastructure - Higher education	- Defense, police - Judicial system - Foreign and monetary policy - Major infrastructure - Higher education	- Defense, police - Judicial system - Foreign and monetary policy - Major infrastructure - Higher education - Healthcare (hospitals)
Regional Level	- Healthcare (hospitals) - Regional development - Environmental protection - Specialised social institutions	- Regional development - Environmental protection	- Healthcare - Regional development and transport infrastructure	- Secondary schools (upper) - Regional development - Environmental protection - Culture
Municipal Level	- Child care - Elderly care - Social services - Healthcare (primary) - Primary schools - Secondary schools (lower) - Waste management, environmental protection - Local infrastructure - Culture	- Child care - Elderly care - Social services - Healthcare - Primary schools - Secondary schools - Waste management, environmental protection - Local infrastructure - Culture	- Child care - Elderly care - Social services - Primary schools - Secondary schools - Waste management, environmental protection - Culture	- Child care - Elderly care - Social services - Healthcare (primary) - Primary schools - Secondary schools (lower) - Waste management, environmental protection - Local infrastructure - Culture

Source: Danish Ministry for Economic Affairs and the Interior, Association of Finnish Local and Regional Authorities, Swedish Ministry of Finance, Norwegian Ministry of Local Government and Modernisation, European University Insititute Florence

Local governments in Sweden, Finland and Denmark have full autonomy to set tax rates, and therefore have high revenue flexibility. It is therefore common to see differences in local government tax rates across municipalities. In 2013 for example, the municipal income tax levy in Denmark varied from 22.5% to 27.8%. This flexibility in setting tax rates was deployed in Denmark and Sweden during the 1980s when a fiscal squeeze led the central government to reduce general grant levels. The local government sector responded by raising taxes and reducing capital expenditure in order to balance budgets.

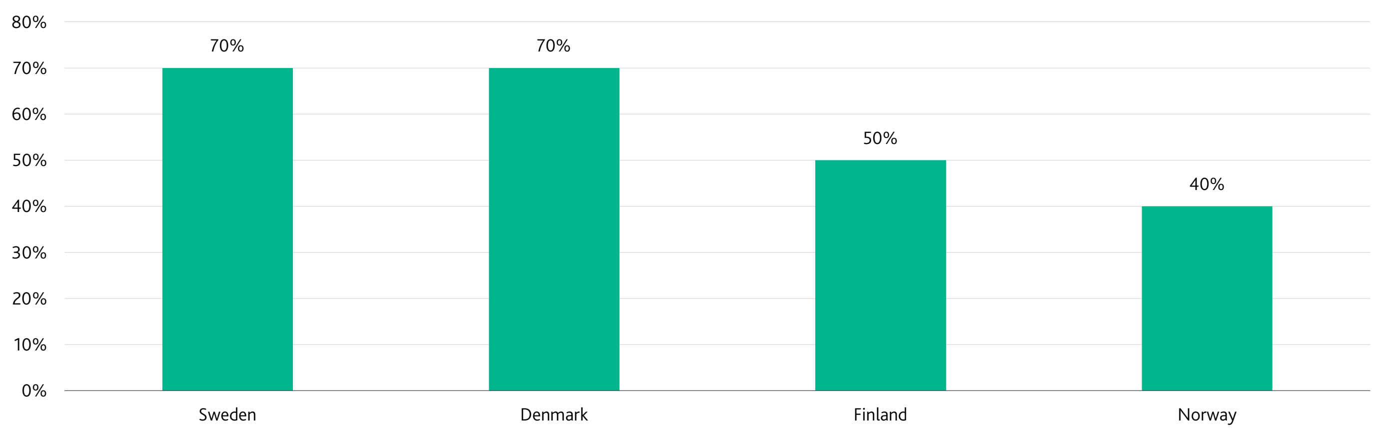
In Norway, however, local governments' fiscal autonomy is more limited. Maximum local tax rates are set by the central government, and local governments have operated at these maximum rates since 1980. Fees and user charges are the only form of own source revenue that the Norwegian local government sector has any flexibility over.

Tax receipts as a percentage of total municipal revenue varies from 70% in Sweden and Denmark to 40% in Norway (see Exhibit 3). In Norway, central government grants (earmarked and block grants) account for about 40% of total municipal revenue, more than in the other three countries.

EXHIBIT 3

Swedish and Danish municipalities receive the majority of their revenue from taxation

Share of local government revenue from local taxation, 2013



Source: Kommuninvest, Kommunekredi t, Association of Finnish Local and Regional Authorities, Norwegian Ministry of Local Government and Modernisation

Strong standalone credit quality

Nordic local governments have strong standalone credit profiles. This reflects a combination of solid economic fundamentals, good financial performance, strong governance, and good access to capital markets. Even so, we expect variations in idiosyncratic risk, reflecting the distinctive characteristics of each individual region and municipality.

Strong economic fundamentals supported by equalisation system

Strong equalisation systems, designed to even out revenue disparities between municipalities so they can offer similar levels of public service, improve the Nordic local government sector's debt-servicing capacity and reinforce local government stability. All Nordic countries apply their own unique equalisation system to determine the net grant level but the over arching purpose is to ensure that demographic, socioeconomic, and geographical discrepencies are accounted for. Municipalities with a higher proportion of elderly citizens may be eligible for an additional grant[1] to offset their lower tax receipts and higher elderly care costs. For example, the Danish municipality of Lolland receives a higher grant for elderly care as over 36% of its population is aged 60 or above, compared with the national average of 25%.

[1] For example in Denmark, the total demographic expenditure need for each municipality is calculated by multiplying the number of people in each age group with the unit amount for that age group. This per unit amount varies, but is generally higher for children between 0 and 16 years (DKR 60 to 80 per person) and for the elderly above 75 years of age (DKR 60 to 120 per person). Source: *Local government equalisation and general subsidies 2014*, Danish Ministry of Economic Affairs and the Interior.

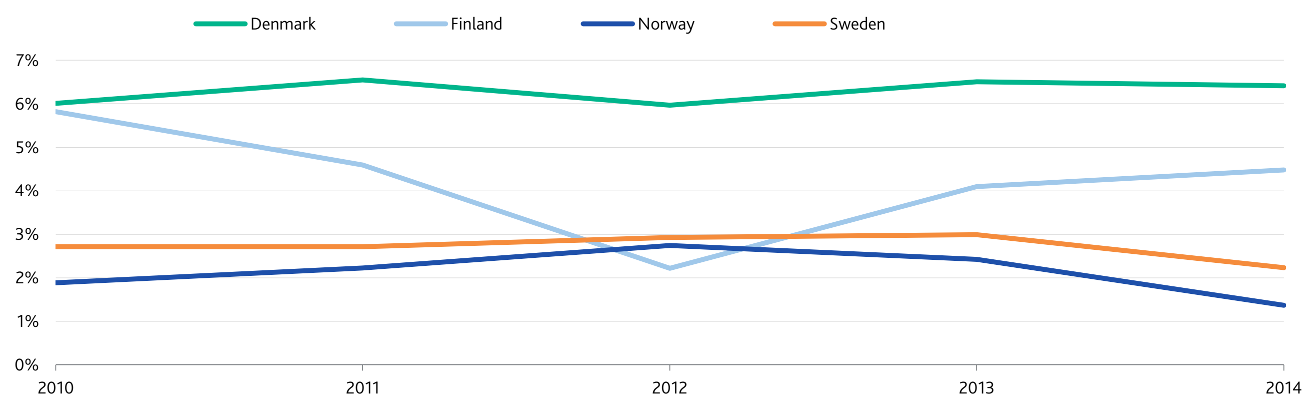
Balanced operating performance

Gross operating balances (GOBs), the difference between operating revenue and expenditure, has consistently been positive for municipalities in all four Nordic countries (see Exhibit 5). The sector as a whole has had an average GOB of 3.8% of operating revenues over the last five years. Danish local governments have delivered particularly strong surpluses due to consistent revenue growth and controlled expenditure. Budget surpluses have been declining in Norway and Sweden, and this negative trend is expected to continue over the next three years as the population grows and ages, pushing up service and healthcare costs.

EXHIBIT 4

Danish municipalities have the strongest gross operating balances

Municipal gross operating balances as % of operating revenues, 2010-2014



Source: Moody's

Low to moderate direct debt levels

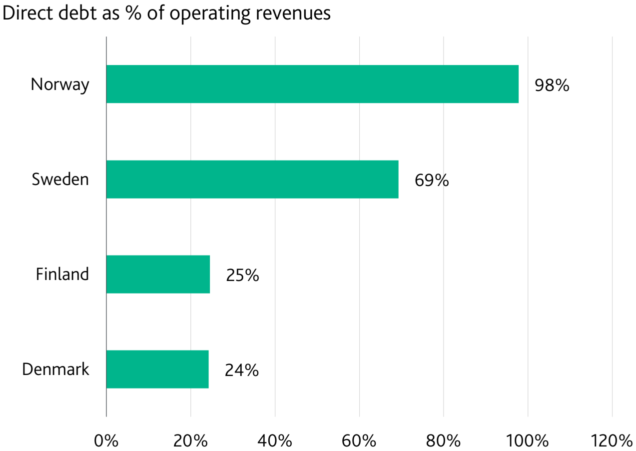
Local governments in Norway and Sweden have higher direct debt levels than their Danish and Finnish peers, reflecting higher investments to support a growing population. The population of the Swedish city of Gothenburg (Aaa, stable), for example, has grown by over 10% in the last decade. Investments to keep pace with population growth will largely be funded by new debt, ensuring continued growth in local government debt, especially in cities experiencing net migration. Norwegian local government debt per person has increased fourfold in the last 20 years, driven by high investments over the last two decades.

EXHIBIT 5

Low to moderate debt levels

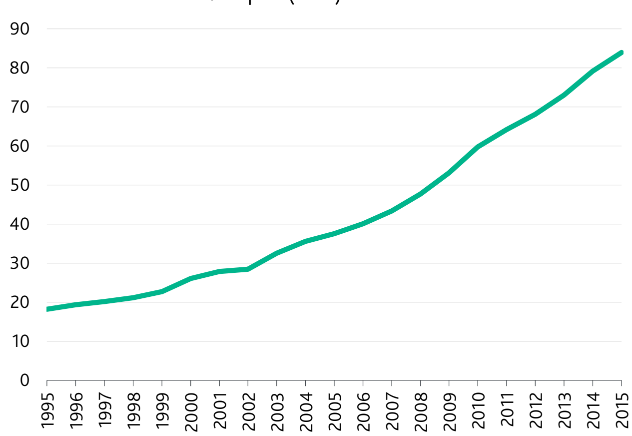
Municipal gross operating balances as % of operating revenues, 2010-2014

Direct debt as % of operating revenues



Source: Moody's

Local Government Debt / Capita (NKK)



Source: Statistics Norway

Denmark and Finland however have very low direct debt levels. In Denmark there are clear constraints on borrowing, as municipalites requires a current and capital account balance.

Strong liquidity supported by specialised lenders

Nordic local government liquidity positions tend to be robust despite holding limited cash reserves and credit lines. However, the sector benefits from access to specialised local government lenders, which issue debt to a wide array of investors, and lend the proceeds to the local government sector. These Aaa-rated organisations have successfully provided the local government sector with continuous access to the capital markets, even during local and global financial slowdowns. However, Nordic local governments have some refinancing risk as they have short-dated loans in comparison with other countries. This is most pronounced in Sweden, as their local lenders (Kommuninvest) average remaining maturity on their loan portfolio at year end 2015 was a comparatively low 2.3 years.

TABLE 2
Nordic specialised lenders provide liquidity but loan portfolio is short dated

COUNTRY	LOCAL GOVERNMENT LENDER	AVERAGE MATURITY OF LOCAL GOVERNMENT DEBT
Sweden	Kommuninvest	2.3 years
Denmark	Kommunekredit	6.1 years
Norway	Kommunalbanken	8.3 years
Finland	Munifin	9.8 years

Source: Specialised lenders average remaining maturity of loan portfolio at year-end 2015 was used as a proxy for debt tenure. For KBN an adjustment was made as KBNs loans predominately represent the sectors long dated loans while they independently issue their own short term funding.

Central government support likely

Nordic local governments' role in delivering key public services makes them systemically important and so we assign a very high assumption of central government support in the unlikely event that they faced acute liquidity stress. This enhances the local governments' standalone credit profile (baseline credit assessment). We take comfort from the fact that timely central government intervention has allowed local government entities to recover whenever they have faced financial stress in the past. Table 3 outlines four such cases across the region.

Consultation between national and local governments

It is ultimately the central government that delegates the tasks. However, frequent consultation between the supervisory body and municipal/regional boards to discuss public service allocation allows the local government to influence the central government. Any changes to in the distribution of services follows extensive consultation, and is accompanied with funding where required. For example, in Sweden, municipalities have received additional grants from the central government to support the integration of refugees[2]. Agreements between the central and sub-national sectors ensure that the municipalities and regions have adequate financing for agreed added responsibilities. In Finland, a 2014 reform designed to shift responsibility for healthcare away from the municipalities towards the regions failed in the Finnish constitutional court. The change was opposed by the municipal sector.

[2] See '*Measures to tackle the refugee crisis*' published October 2015 by Government Offices of Sweden

Strong central government oversight promotes fiscal discipline

Nordic local governments are among the most regulated and supervised in Europe. The sectors right to self-governance is constitutionally protected[3] in the Nordics, with the exception of Norway, where the local government is subordinate to the central government. In the Nordics, while local governments operate with a high degree of fiscal autonomy, the national government exercises strong oversight to ensure fiscal discipline.

National governments maintain fiscal discipline within the wider public sector by imposing strict self-governance requirements on municipalities. These include balanced budgets requirements, which make it unlikely that operating deficits will become a credit concern for the sector.

If local governments were not subject to such constraints, there would be a risk of moral hazard, as the high probability of central government support in the event of a crisis could incentivise overspending. For example, in Sweden, the balanced budget requirement dictates that any budget deficit must be resolved within three years[4]. Expenditure limits may also be enforced.

In addition, supervisory bodies[5] maintain oversight of municipal actions, evaluating whether these fall within their legislative powers and jurisdiction. Regular dialogue between the supervisory body and local government can include discussion of revenue distribution, efficiency measures and allocation of resources, and municipality expenditure.

Municipalities may be subject to other requirements, such as borrowing regulations, adopting rigorous accounting systems and benchmarking standards, or giving citizens and the central government the right to request information. This promotes municipal accountability and transparency.

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[3] See Denmark – *Danish Constitution 1953: Section 82*; Sweden – *Local Government Act 1991: Chapter 1, Section 1*; Finland – *Local Government Act 1995: Chapter 1, Section 1*; Norway – *Local Government Act 1992 (no explicit constitution right).*

[4] See Swedish *Local Government Act 1991: Chapter 8, Section 5.*

[5] Supervisory bodies in the Nordics consist of the Ministry of Social Affairs and the Interior (Denmark), Swedish Association of Local Authorities and Regions (Sweden), Ministry of Local Government and Public Reforms (Finland), and the Ministry of Local Government and Modernisation (Norway).

No history of default among Nordic local governments

While financial stress is possible, there has been no default reported in over 100 years thanks to timely central government intervention. The examples presented support our assumption of very high support under distressed scenarios.

TABLE 3

Central government has demonstrated timely extraordinary support for the sector

	DENMARK	FINLAND	SWEDEN	NORWAY
Local government under stress	Municipality of Farum, (2002)	Municipality of Karkkilla, (1992)	City of Bjuv, (1995)	Municipality of Lebesby, (Late 1980s)
Background	Excessive spending and breaches of borrowing regulations. Several ambitious projects were carried out via opaque public-private partnerships using sale and leaseback loans.	Financial distress of a major state owned company (Karkkila Industrial Village Ltd) with domestic and foreign loans guaranteed by the city. Devaluation of the Markka worsened the situation and guaranteed loans reached 250% of the municipalities tax revenue.	Financial distress due to the overindebtedness of its housing company. Bjuv was not able to raise taxes due to national legislation that suspended their right to raise own taxes.	Provided guarantee for the financial liabilities to a fishing enterprise (revised Local Government Act in 1993 no longer allows this) Fish farm went bankrupt, forcing municipality to take over NOK 50 million in short-term debt
State intervention	Farum was put under the control of the state government and was granted a subsidy of DKK 2 billion. The size of the grants was approximately one year's Farum's budget. This was highly controversial among the public and the first time the State has bailed out a local government. Farum raised taxes from 19.6% to 22.8%.	Karkilla took the liabilities on its balance sheet and the state was given the right to veto the company board. State passed emergency legislation that enabled the payment of a state interest subsidy to the municipality, which has to be repaid. Karkkila raised municipal taxes to the highest level in the country.	State provided SEK 159 million out of the SEK 200 million requested to resolve the crisis. Government allowed Bjuv to keep the housing company with the condition that the government could take it over up until May 31, 2003. Bjuv took a larger management role in the housing company.	State provided additional grant revenues for a number of years, and allowed the debt to be restructured as part of a rescue package. Package included decreased expenditure levels by the municipality, and tighter monitoring by central government.

Source: Farum – Policy making in multilevel systems: Federalism, decentralisation and performance in OECD countries (2013); Karkkila – Finnish local government institutions and creditworthiness (2012); Bjuv – Fiscal Federalism in Unitary States (2004); Lebesby – Recovery of local and regional authorities in financial difficulties (2002)

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Authors:
Amir Girgis
Olivier Heinen

Editor:
Myles Neligan

Production Specialist:
Cassina Brooks

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