Public Finance System Overview:

Norwegian Local And Regional Governments

April 4, 2019

Institutional Framework Assessment:

- **Extremely predictable and supportive**
- Very predictable and well-balanced
- Evolving but balanced
- Evolving and unbalanced
- Volatile and unbalanced
- Very volatile and underfunded

Trend:

- Improving
- **Stable**
- Weakening

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Major Factors

Strengths	Weaknesses
- Extensive central government oversight. - Comprehensive system of grants from wealthy central government. - Formalized procedures for identifying and handling local governments in financial distress.	- Significant run-up of debt due to very high sector investments - Little institutionalized discretion over revenues.

Recent Developments

Over the past few years, Norway has experienced continual urbanization and changing demographics, marked by a growing elderly community and related pressures on costs and investments. This has led to a gradual consolidation of rural governments, with the number of municipalities decreasing to 356 from 422, and the number of counties dropping to 11, from 19, by the beginning of 2020. The mergers are not expected to incur additional costs, but rather release some economies of scale.

Predictability

Frequency and extent of reforms

Norwegian municipalities and counties act as delegated arms of the central government in the provision of public services. The system in which Norwegian local and regional governments (LRGs) operate is mature and predictable, and reforms are implemented gradually. The central government decides the scope of municipal operations, and there is a track record of adequate financing through state grants when additional responsibilities are transferred to the municipal level. Changes to grants and equalization systems are fine-tuned from time to time. However, fundamental changes to the system are rare, and would be discussed at length before a decision is taken by parliament. The previous large reform occurred in the 1960s, when the number of municipalities fell to 454 from 744.

The central government has demonstrated its strong commitment to the LRG sector by consistently adapting and adjusting grants according to imposed changes in the LRGs' responsibilities. This allows the LRGs to make realistic medium-term financial plans. Also, as illustrated by the timeframe for the ongoing LRG sector reform, there is some leeway to negotiate and implement proposed changes, given the almost two years allocated for voluntary mergers, followed by a year for the central government to work on a proposal for the remaining LRGs.

LRGs' ability to influence or oppose reform

Given the centralized system of financing, there are limited possibilities for the LRG sector to formally oppose unwanted changes. Nevertheless, the municipalities can lobby through their political representatives' in the central government. Furthermore, LRG sector associations play key decision-making roles, and the central government's commitment to the sector's functioning and viability mitigates the risk of adverse developments. Norway is a very wealthy country and we do not envision a scenario in which financial stress at the central government would be passed on to the LRG sector.

Revenue And Expenditure Balance

Overall adequacy of revenues to cover expenditures needs

Norwegian LRGs revenue sources sufficiently cover their spending responsibilities. In financing their operations, they rely mainly on taxes and transfers, both administered through the central government (see chart 4). Importantly, the central government sets caps for local tax rates, which limits individual LRGs' financial flexibility. However, we think the state transfers and taxes meet the spending needs. The system for general and special government grants to the sector is designed to capture the differences between LRGs' economic, demographic and geographic conditions; it also provides financing for LRGs to fulfil their responsibilities and adequate resources to administer essential service needs. These transfers are predictable and allocated to LRGs for the budget year, presented in May in the central government's budget bill for the LRG sector.

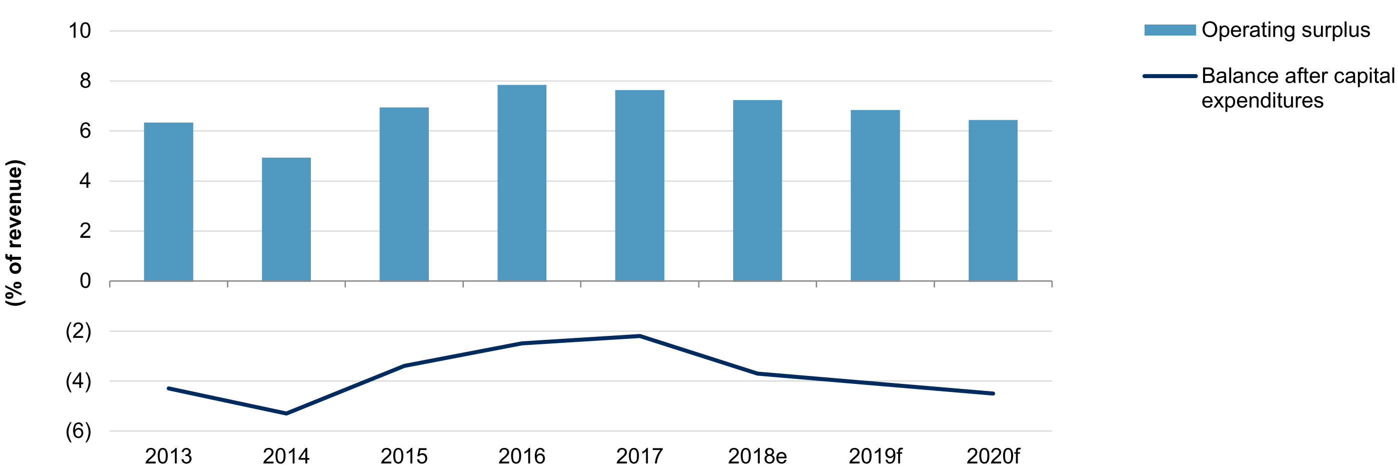
Even though grants increase in line with the central government's expectations of public services growth, deficits after capital accounts may occur as LRGs finance capital expenditures on their own. We observe that LRGs' investments have been significant, primarily to address the needs of the increasing population, but also to proactively address property maintenance. These investments, alongside spending on new responsibilities--such as regional road maintenance, which was transferred to the counties in 2010--has markedly lifted LRG debt levels over the past years. Still, a simultaneous increase in revenues has helped to preserve the debt-to-revenue ratio (see chart 5). In this regard, we observe that central government grants, including some to meet debt service payments, have so far helped sustain interest expenditures. Currently, the low-interest-rate environment has limited the direct financial impact of higher debt on the LRGs.

In parallel, pension costs now represent a larger share of municipal expenditure. Since 2002, Norwegian LRGs have had the option of deferring pension costs to smooth pension payment schedules, which has led to higher pension costs in later years when the deferred costs are recognized. However, we do not regard this as a risk because state transfers are rising to cover LRGs' higher expenditure requirements. Nevertheless, we believe that, in the long term, the most likely way to address the situation will be through reform of the public pension system.

Shifts in responsibilities and the related investments from the central and regional tier to the municipal tier have spurred municipal debt (see chart 5). We estimate that the LRG sector had roughly Norwegian krone (NOK) 530 billion (€53 billion) in debt at end-2018, an estimated 7.7% more than the NOK492 billion at end-2017. However, about 40% of the debt is covered by tax revenues and the rest by fees and charges from services such as water and sewage. About half the long-term debt originates from state-owned municipal funding agency Kommunalbanken.

Chart 1

Norwegian LRGs' Budgetary Performance



e--Estimate. f--Forecast. Source: S&P Global Ratings.

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Chart 2

Norwegian Counties' Operating Expenditure Breakdown

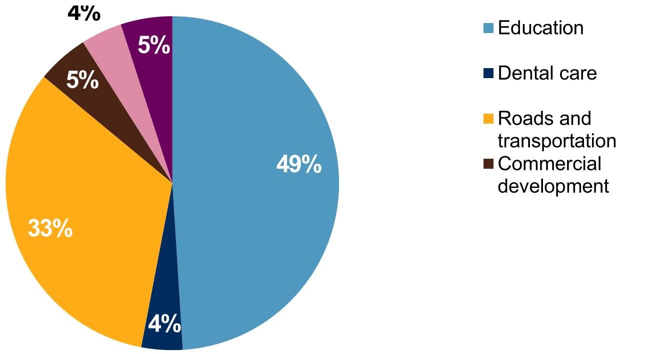

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Chart 3

Norwegian Municipalities' Operating Expenditure Breakdown

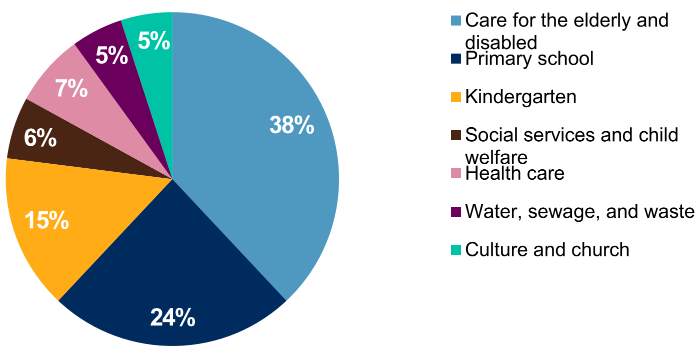

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Chart 4

Norwegian Municipalities And Counties' Operating Revenue Breakdown

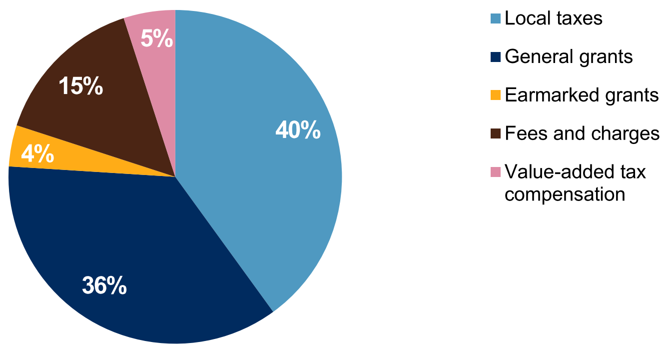

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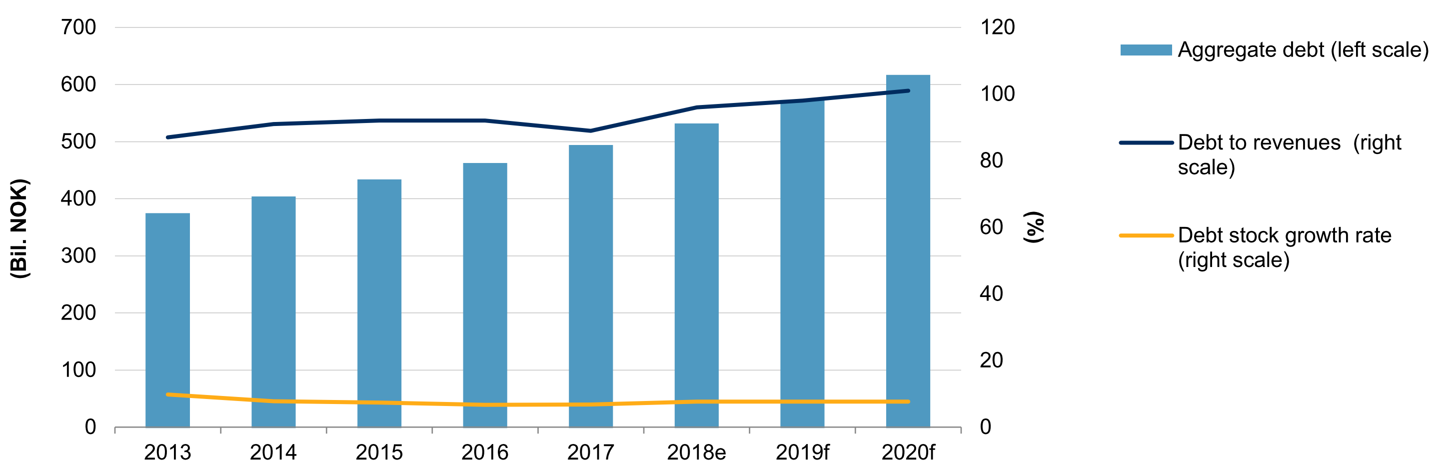
Chart 5

Norwegian LRGs' Direct Debt



NOK--Norwegian krona. e--Estimate. f--Forecast.

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Fiscal Policy Framework

Close central government monitoring and fine-tuning of the fiscal and financing framework help sustain LRGs' ability to manage finance mandated public services. If a municipality's finances were to deteriorate, or if it did not comply with restrictions, the state would put it on the ROBEK list (Register for Government Approval of Financial Obligations) and assume control of critical parts of its financial decision-making if the situation does not to improve. The municipality would stay on this watch list until its finances are balanced.

Extraordinary Support

No Norwegian LRG has ever defaulted. Extraordinary support mechanisms in place usually works preemptively through close central government oversight. However, there was at least one instance when the central government allocated financial assistance to an LRG in order to avoid a default. The Local Government Act stipulates that local governments are not permitted to declare themselves insolvent. The central government has mechanisms in place to monitor and ensure that LRGs do not come under financial distress. If and when an LRG has not submitted a balanced budget before capital accounts to the government, the LRG will be added to the ROBEK list. Consequently, the Norwegian Ministry of Local Government and Regional Development must validate an LRG's resolutions of incurring debt or entrance into long-term rental contracts. Budgets must also be approved by either the ministry or the County Governor. Being on the ROBEK list constrains the economic freedom of the LRG, which often chooses to cut costs by reducing public services and conduct lay-offs to get off the list. If an LRG experienced difficulties meeting its liabilities, as a second line of defense, the central government would step in and appoint a supervisory board to resolve the situation.

No LRG has reached this point. The closest one, however, was in the late 1980s, when the small municipality of Lebesby had provided guarantees for the financial liabilities of private enterprises, which was allowed until 1993. One of the enterprises went bankrupt and the municipality had to take over the debt, which resulted in short-term debt increase corresponding to more than 100% of the annual revenues. Lebesby applied for financial assistance to the central government, which decided to allocate an extraordinary discretionary grant in combination with a restructuring plan containing e.g. expenditure cuts and increased measures for monitoring of the municipality, which resolved the situation.

Transparency And Accountability

Transparency and institutionalization of budgetary process

The budgetary processes for LRGs are transparent, in our view. There is a clear definition of roles and responsibilities between the elected officials that set priorities and the managers implementing them. The interaction with the central government tier is frequent and detailed, including compulsory financial reports that are regularly transmitted to central government for approval.

Disclosure and accounting standards

Accounting standards are generally transparent and consistent. Local government accounts comprise an operating section and an investment section; the former keeps record of operating income and expenses, and the latter tracks non-recurring income and the allocation of investment spending. Income in the investment section cannot be used for operational purposes, but it is possible to use operational income for investment purposes.

Control levels and reliability of information

No external audit of accounts takes place. However, compliance with national laws is monitored through the central government's supervision of financial statements, budgets, and planning documents. The LRGs are required to manage their accounts in accordance with local government accounting practice, in addition to the relevant laws and regulations. The statements are on modified accrual basis and reported directly to the national statistics agency through KOSTRA, the Municipality State Reporting System.

With tight monitoring and supervision from the central government, which regularly collects financial information, procedures for handling noncompliant LRGs are clearly formalized.

Trend

We see a stable trend for the Norwegian institutional framework. Importantly we consider that the central government's close oversight of and strong commitment to the LRG sector will persist. As such, we anticipate that the central government's control of tax revenue and grants will continue to support sound operating balances amid rising pension expenditures and debt-servicing costs related to the sector's increasing debt.

Related Criteria

- Methodology for Rating Non-U.S. Local And Regional Governments, June 30, 2014

Related Research

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Sept. 21, 2017

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