

# The Economy Report.

*On Swedish Municipal and County Council Finances – May 2009*



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# Foreword

**The Economy Report** illustrates the financial situation and conditions of county councils and municipalities and the development of the Swedish economy over the next few years. It is published twice yearly by the Swedish Association of Local Authorities and Regions (SALAR).

This issue looks forward to 2012. It is also more extensive than in the past; the rapid and severe weakening of the economy has drastically worsened the financial conditions of municipalities and county councils. This has made it important to give a particularly full description of the financial situation of the sector this time.

This abridged version of the report has been written by staff at the SALAR Section for Economic Analysis. The people who have participated in the work and can reply to questions are given on the inside cover page. Other SALAR staff have also contributed facts and valuable comments. The Summary (supplemented with some tables and diagrams from the main report), the sections on *Poorer economic conditions*, *The balanced budget requirement* and the Annex are published here as a separate English document. The translation is by Ian MacArthur, following slight revisions by Anders Brunstedt and Elisabet Jonsson. We are very grateful to the municipalities and county councils that have replied to our questionnaire.

Stockholm May 2009

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## Summary and conclusions

*The financial situation of municipalities and county councils appears increasingly troubling. The economic statistics published in recent months point to an even weaker development of the economy than previously foreseen. Lower employment will result in a greatly reduced growth of local government sector income this year and next year. The reinforced central government funding announced by the Government from 2010 will not compensate for the loss of income. Municipalities and county councils have to choose between improving efficiency, making reductions in services and increasing taxes in the coming years. Many municipalities and county councils now face a difficult budget process ahead of 2010.*

We are still in a phase in which **GDP** in large parts of the world is falling. The **GDP** of OECD countries is expected to fall by 3 per cent this year, with Sweden's **GDP** falling by just under 4 per cent. In 2010 a weak increase of 0.7 per cent is expected in Sweden's **GDP**.

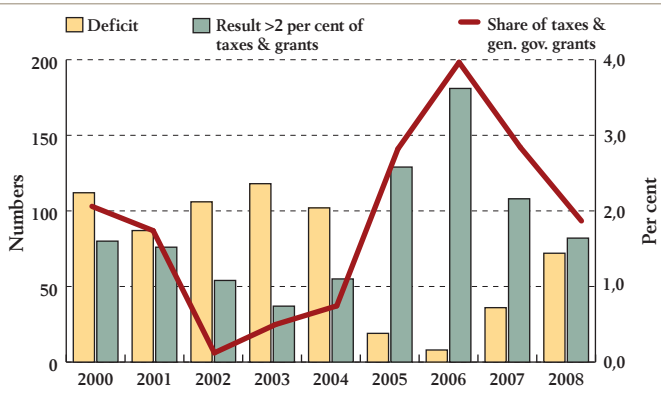
Exceptionally weak **GDP** growth is inevitably followed by a considerable weakening of the labour market with declines in both the labour supply and employment. **Employment** will fall this year especially, and the number of people in employment is expected to fall by 250 000 up until 2010. At the same time, unemployment is expected to almost double to just under 12 per cent. The rapid deterioration of the labour market will lead to a decline in the rate of pay growth as well as low inflation, well under the Riksbank inflation target. However, the parties in a large part of the labour market are bound by central agreements extending some way into 2010. This means that the full impact on the rate of pay growth will only be seen in agreements and outcomes thereafter.

A lower rate of pay growth, in combination with fewer hours worked, will result in a sharp fall in the growth of **local government sector tax base**. On average, the tax base will grow at the record low rate of 1 per cent in 2009 and 2010. In real terms, taking account of the price and wage inflation that affects municipalities and county councils, the tax base will fall by an average of 1 per cent per year in 2009 and 2010.

In 2011 and 2012 higher economic growth is expected. This will be accompanied, though with some delay, by some improvement of the labour market resulting in rising incomes. However, the slow growth of the tax base, at an average rate of 3 per cent per year, will continue in these years. By comparison, in 2006–2008 the tax base grew by 5 per cent per year on average.

The very weak tax base growth will present municipalities and county councils with major challenges in the next few years. Municipalities and county councils now have to take speedy action on a broad front to cope with their financial situation. There is great crisis awareness. Despite tax increases and action to restrain cost growth we expect the **local government sector as a whole** to report sharp decreases in net income. For

Diagram 2 • Number of municipalities with financial deficits and with net income above 2 per cent of taxes and grants, along with net income for the sector as a share of taxes and grants



In 2001, 3 out of 10 municipalities had deficits. That figure increased during the previous recession but fell when growth turned upwards in 2005–2007.

Sources: Statistics Sweden and the Swedish Association of Local Authorities and Regions.

2009 we expect the sector to report a deficit of SEK 3 billion. The Government's additional funding of SEK 7 billion next year will help the sector as a whole to report finances in balance in 2010. However, there are very substantial differences in the starting situations of municipalities and of county councils.

For 2008 more than 70 municipalities reported negative net income, while municipalities as a group showed a surplus. We forecast that net income in municipalities will fall rapidly in 2009 and 2010. For the municipalities as a group negative net income of about 2 billion is expected in 2009, with weak positive net income in 2010. In making this forecast we have taken account of both tax increases (SEK 0.1) and higher government grants, while expecting the municipalities to restrain cost growth substantially. These weak levels of net income mean that many municipalities will report financial deficits. The crisis awareness in municipalities is high. Different municipalities choose different strategies to meet the crisis. They involve everything from tax increases to staff reductions and lower consumption. This is the picture that emerges from the case studies presented in the report.

For 2011 and 2012 the situation appears even more troubling with large deficits. These are due both to the lower government grants and to the accumulated effects of weak tax base growth. In these years

Table 4 • Cost increase of various components in 2002–2012  
Contribution in percentage points, constant prices

	Outcome	Forecast		Calculation	
	2002–2008	2009	2010	2011	2012
Demographic needs	0.4	0.3	0.3	0.1	0.1
Central government reforms, incl. bonus jobs	0.5	–0.4	0.0	–0.1	0.0
Support and Services for persons with certain disabilities (LSS)	0.4	0.2	0.1	0.1	0.1
Other volume change	0.2	0.4	–1.1	0.9	0.8
<b>Total services proper*</b>	<b>1.5</b>	<b>0.5</b>	<b>–0.7</b>	<b>1.0</b>	<b>1.0</b>

In 2009, when the crisis will have its impact, volume growth will be much lower and in 2010, when cost-reducing measures will have their full impact, the volume of services will decrease. The figures for 2011 and 2012 are not a forecast. They are a calculation assuming a trend increase in the volume of costs.

\* Excluding financial support (social assistance).

Source: the Swedish Association of Local Authorities and Regions.

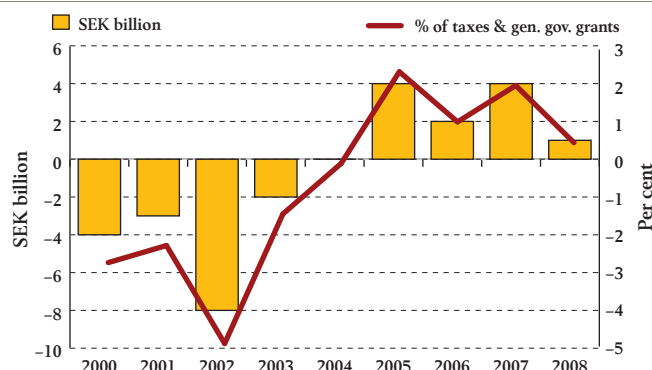
the municipalities will be forced to take vigorous action to cope with their financial situation.

In general, the financial situation of the **county councils** appears more troubling than that of the municipalities. Last year half the county councils had a deficit. Our forecast is that, as a group, they will report negative net income of about SEK 1.4 billion in 2009 and financial balance in 2010. However, achieving this will require both tax increases (SEK 0.11) and vigorous action to moderate cost growth, including staff reductions. So, on its own, the additional central government funding announced by the Government for 2010 will not be enough to achieve balance in 2010. Over and above tax increases, the county councils still face a tough period with difficult decisions.

At the same time, improvement work is under way in many areas of health care. Examples are increasing accessibility and reducing health care-associated infections. It is important that the current financial crisis does not hamper this development. There is a risk that the crisis may prevent a long-term improvement of effectiveness through short-term decisions, resulting in a loss of legitimacy. The county councils will have to keep a firm grip on cost growth while conducting development work. This is a difficult balance to strike.

The work of the county councils on using resources more efficiently and effectively must also continue over the next few years. Otherwise the county councils risk reporting substantial negative levels of net income of SEK 5 and 7 billion respectively in

Diagram 11 • County council net income before extraordinary items SEK billion and per cent



After twelve years of deficits the county councils have reported positive net income for the past four years. The most important single explanation for the surpluses is a substantial increase in employment and the tax base. During two of these years the sector achieved the target for healthy finances (i.e. 2 per cent of taxes and grants).

Source: the Swedish Association of Local Authorities and Regions.

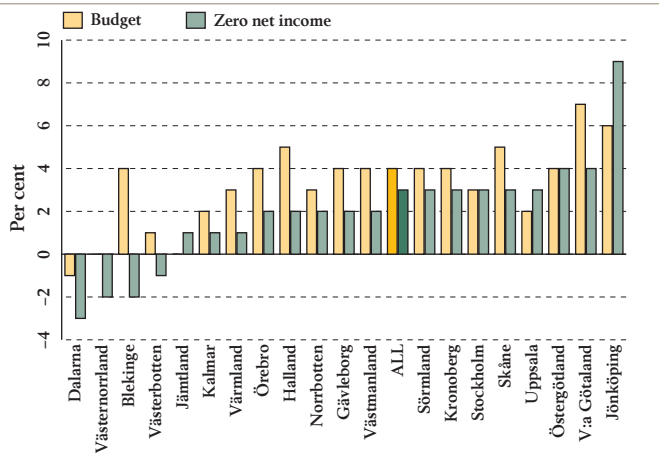
Table 7 • Cost increase of various components in 2002–2012 Contribution in percentage points, fixed prices

	Average Outcome		Forecast		Calculation	
	2002–2007	2008	2009	2010	2011	2012
Demographic needs	0.8	0.9	0.8	0.8	0.7	0.7
Central gov reforms	0.4	0.1	0.1	0.1	0.0	0.0
Long-term trend	0.7	0.7	0.7	0.7	0.7	0.7
of which pharmaceuticals over and above demography	0.3	0.5	0.4	0.4	0.4	0.5
<b>Total cost pressure</b>	<b>2.0</b>	<b>1.7</b>	<b>1.7</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>
Other volume change	-0.2	0.4	-0.6	-1.1	0.0	0.0
<b>Total volume change</b>	<b>1.7</b>	<b>2.1</b>	<b>1.1</b>	<b>0.6</b>	<b>1.5</b>	<b>1.5</b>

The cost pressure is constant over several years.

Source: the Swedish Association of Local Authorities and Regions.

Diagram 18 • Net cost change in county councils in 2009 according to budget and to reach zero net income  
Percentage change, current prices



The scope for cost increases varies greatly in 2009. There is least scope in Dalarna and most in Jönköping. The diagram also shows the cost increase budgeted for. In cases where the cost increase budgeted for is greater than the scope for a zero budget, the county council risks negative net income for 2009.

Note: The first column compares the net costs budgeted for in 2009 with the outcome for 2008. The second column estimates the scope for net costs in 2009 with a budget in balance, i.e. 0 per cent of taxes and grants. Revenue is estimated in the following way. Taxes and grants are allocated based on the population in November 2008 and data from the system of financial equalisation. The government grant for the sickness leave billion has been distributed per inhabitant here. Net financial income is based on budget values corrected in the light of our assessment of the national level in 2009.

Sources: Statistics Sweden and the Swedish Association of Local Authorities and Regions.

2011 and 2012, according to our impact analyses for these years. In addition to the present economic crisis, the county councils are also grappling with a long-term funding problem. This is best seen in the fact that the county councils have only reported positive net income in isolated years. However, we must not forget the improved medical results that have been achieved in health care at the same time.

The question has been raised of the most reasonable way to apply the **balanced budget requirement** in the present extraordinary circumstances. According to the balanced budget requirement in the Local Government Act, budgeted costs must not exceed revenue and if a deficit nevertheless arises, it has to be restored within three years. Our view is that the underlying logic of the balanced budget requirement has to be maintained. However, it must be possible to apply the requirement in a way that provides a fairly stable basis for planning services. In this situation many local authorities/municipalities see it as rational to use parts of the surpluses from recent years to cover a year or so of temporary deficits. In our view it should be possible, within the framework of **healthy finances**, to take a retrospective decision that this can be what is called an exceptional reason to count some of the surpluses from previous years. However, this possibility should only be open to municipalities and county councils that have consolidated their finances in real terms in recent years.

There are **strong national economic reasons** for strengthening municipalities and county councils in the present situation. Staff reductions in a situation of great unemployment are a waste of resources. The staff that the sector is forced to dismiss may be needed again in a couple of years. Moreover, if reductions are made too quickly, this can have a detrimental effect on the development work being conducted in order to improve effectiveness in the somewhat longer term. **Our forecast for 2010** is that the local government sector as a whole will have net income close to zero. This means that many individual municipalities and county councils will report deficits. Our assessment is that tax increases will be hard to avoid, and we expect an increase of SEK 0.21 in the average tax rate, giving a surplus of SEK 3.4



billion. In addition, costs will be held back so that they will rise somewhat less than is required to compensate for price and pay rises. This is a very substantial saving.

Table 17 • Rate of tax base increase according to the Association's tax base forecasts and the overall price trend for municipalities and county councils in 2008–2012

*Percentage change*

	2008	2009	2010	2011	2012	2008–2012
<b>April 2009</b>						
Nominal	5.0	0.8	1.1	2.5	3.7	9.6
Price	3.7	1.7	2.0	2.1	2.1	
Real	1.3	–1.0	–0.9	0.4	1.5	–0.2
<b>October 2008</b>						
Nominal	5.5	3.2	3.9	4.7	5.0	18.5
Price	3.9	2.5	2.9	3.2	3.4	
Real	1.5	0.6	1.0	1.5	1.5	4.7
<b>April 2008</b>						
Nominal	5.7	4.8	4.8	4.8		21.7
Price	4.1	3.7	3.7	3.7		
Real	1.5	1.1	1.1	1.1		4.8

*The weakening of the economy since last spring has led to unusually large revisions of the tax base forecast.*

Sources: Swedish Tax Agency and the Swedish Association of Local Authorities and Regions.

To avoid these tax increases and savings the sector would therefore need to receive additional funding of around SEK 5 billion. Many municipalities and county councils will be forced to take further action in 2011 in the form of tax increases or savings. If the cost increase is restricted solely to the cost increase resulting from demography, the deficit can be limited to around SEK 8 billion. If the local government sector as a whole is to be in balance in 2011, either cuts on a corresponding scale or a tax increase of about SEK 0.30 will be required.

This means that for 2010 and 2011 there is a shortfall of SEK 5 billion and 8 billion respectively that municipalities and county councils must meet by improving efficiency and making cuts or raising taxes.

## Poorer economic conditions

*The rapid and surprisingly severe weakening of the economy has resulted in a drastic deterioration in the financial conditions for municipalities and county councils. The increase in government grants for next year does not compensate for the loss of tax revenue in the wake of the economic crisis. In order to hold back costs, savings are being made that risk leading to poorer local government services, and tax increases will probably be inevitable. Nevertheless many municipalities and county councils will grapple with deficit problems. To maintain long-term respect for the balanced budget requirement in the Local Government Act it is important for this requirement to be applied in a way that does not prevent a wise adjustment to the difficult economic situation.*

This is certainly not the first time our Economy Report has warned that municipalities and county councils face major challenges. But at the moment that view seems perhaps more justified than ever. The global economic crisis has a very hard impact on a small and trade-dependent country like Sweden. Most economic assessments now suggest that 2009 will go to history as one of the worst years for the Swedish economy in modern times. Municipalities and county councils already felt the effects of the financial crisis last year – in the form of falling prices of financial assets and difficulties in obtaining credit, for example. This year and next year the crisis will mainly be seen in lower tax revenue.

What make this crisis special is its global spread. Almost 90 per cent of the economies in the rich world are in recession, i.e. their GDP is falling. World trade, whose trend growth has been greater than for GDP, is expected to shrink very severely this year. At the same time, economic policy is unusually vigorous, with very expansive monetary and fiscal policies alongside considerable action to remedy the problems on financial markets.

Our forecast is based on the assumption that these policies will be successful and that 2009 marks a temporary, but deep, dent in the growth curve. Next year, in common with most other forecasters, we expect weak, but nevertheless positive, growth. The challenge for municipalities and county councils is to bridge a few very challenging years. But the world economy has not been in this situation before and there is great uncertainty about what the future holds. It is not possible to rule out a more protracted period of recovery for the world economy.

### Don't trust the forecasts

The crisis has come quickly and unexpectedly. A year ago the Association predicted that the international economy would make a 'soft landing' in 2008 and that growth in Sweden would be about 2.5 per cent in both 2009 and 2010. Since then the forecasts for both growth and the local government tax base have been revised downwards on several occasions, and the current assessment is that GDP will instead fall by al-

most 4 per cent this year and grow by more than a half of one per cent next year.

In the Association's most recent tax base forecast, tax revenue is expected to be almost SEK 25 billion lower this year than estimated a year ago when work on the 2009 budget started. The difference in the forecast is even bigger for 2010. If municipalities and county councils keep their tax rates unchanged, tax revenue will be 6.1 per cent, or SEK 30 billion (SEK 3,400/inhabitant), lower this year than we assumed six months ago in the Economy Report, October 2008. Part of this downward revision is explained by the considerably lower wage and price rises, which result in a lower tax base but also in lower costs for municipalities and county councils. After taking account of changes in prices and wages, tax revenue is now expected to be some SEK 20 billion lower in 2010 than we assumed in October.

Table 2 • Key indicators for the Swedish economy  
Percentage change from previous year

	2007	2008	2009	2010	2011	2012
GDP	2.7	-0.5	-3.8	0.7	2.6	3.2
Employment, hours	3.5	0.9	-3.8	-2.3	0.4	1.2
Open unempl., level	6.2	6.1	9.6	11.5	10.7	9.3
Hourly pay	3.2	4.8	3.4	2.6	2.3	2.3
Consumer prices	2.2	3.4	0.0	0.7	1.9	2.0
Tax base*	5.4	4.9	1.1	1.1	2.5	3.7

*A severe downturn in GDP entails a poorer development of employment and tax base, but also a decline in the rate of pay growth.*

\*Excluding changes to regulations.

Source: the Swedish Association of Local Authorities and Regions.

Would it have been possible to foresee this development at an earlier stage, thus giving municipalities and county councils more time to prepare? That is a question all forecasters have reason to ask themselves. The Association has not differed from other commentators. Some forecasts have been more pessimistic than the Association's, while others have been more optimistic. If, in spring 2008 or even in October 2008, the Association had forecast a GDP fall of 4 percent in 2009, we would not have been regarded as credible. It has only become clear in the past few months that the financial crisis would have much more severe effects on production and employment than previously assumed.

Forecasters always say that the situation is hard to assess and that there is uncertainty in their forecast. Developments over the past year have illustrated more clearly than before that this is not just a manifestation of general prudence. Forecasts can only be based on known facts and correlations. New events happen all the time and there is also a flow of new information, about financial markets for example, that can alter the picture of economic developments. There is also a new situation

meaning that, to some extent, old correlations are no longer applicable. For example, trade has decreased much more than indicated by previous correlations between growth and trade.

For municipalities and county councils this means that their planning builds on particularly uncertain forecasts. At the same time, budgets must be based on an assumption about the development of tax revenue. But there has to be an awareness that things may turn out very differently and preparedness to deal with such a turn of events. This is especially true in times of sudden shifts, like the present. A strategy should be in place for alternative courses of development. This applies both to upturns and to downturns. Just as forecasters have missed the downturn, they may also miss the upturn when it actually occurs.

### Higher grants

Recently the Association has pressed for central government to provide additional general funding for the local government sector. This is easily dismissed as a special interest being advocated by a sector that does not want to bear its share of a crisis that affects all of society. But there are strong national economic reasons for strengthening municipalities and county councils in the present situation.

The services that municipalities and county councils are responsible for have a greater need of stability than many other activities. There is just as much need for education, health care and social services in bad times as in good. The reductions now being made in the business sector are largely manifestations of structural change. When the economy picks up, growth will take place in other industries or companies. But in the case of health care and elderly care demand will rise in the long term. Cuts to cope with a crisis may add up to a waste of resources in a long-term perspective. The staff that local authorities may be forced to dismiss may be needed again within a couple of years.

Local government services can also be run more efficiently and effectively. The past two decades have seen a considerable development of new management models along with more knowledge about how resources can be used to achieve better results. But the potential for improving efficiency is probably more limited now than, for example, in the crisis of the 1990s, and measures that take time to implement are often required. Making quick cost reductions in a time of crisis risks leading to long-term inefficiency.

Staff reductions in a situation of great unemployment are a waste of resources. If the alternative is unemployment that is a drain on central government finances, it is socially profitable for these people to keep working in local government services instead. The next few years will also see high retirement rates, which means that there is a need to recruit more young people to local government.

In the Spring Fiscal Policy Bill the Government announced both temporary extra funding of SEK 7 billion intended for 2010 and a permanent increase of SEK 5 billion in government grants for later years. This improves the conditions for local government and leads to greater stability. But the extra funding does not fully compensate the tax shortfall resulting from the crisis.

### Does the balanced budget requirement prevent a wise adjustment?

The rapid and drastic worsening of their economic conditions has created difficulties for many municipalities and county councils in living up to the balanced budget requirement in the Local Government Act. According to this requirement, budgeted costs must not exceed revenue and if a deficit nevertheless arises, it has to be restored within three years. The question has been raised of whether it is reasonable to apply the balanced budget requirement in the present extraordinary circumstances. The legislation permits certain exceptions, for instance when the municipality or county council is in a strong financial position or when there are exceptional reasons. However, there is no established case-law concerning how to interpret these conditions for exceptions.

The overall objective must be compliance with the healthy finances requirement of the Local Government Act, one aspect of which is that every generation must finance its own local government services. Most municipalities and county councils should have a financial objective of showing a surplus so as to meet the healthy finances requirement. But it should be possible to view the objective over several years instead of applying it strictly to every single year. In the event of a severe downturn, this can entail deficits without endangering the long-term objective. It is reasonable to build up reserves when times are good and to use them when times are bad. In the good years some municipalities and county councils have strengthened their financial position and they should also be able to use this reinforcement without this being seen as postponing the adjustment and leaving it to future generations.

But in the light of developments in recent years, it is apparent that many municipalities and perhaps most county councils will be unable to present a budget for 2010 showing a deficit without breaching the balanced budget requirement. They must therefore make a financial adjustment by reducing costs or raising taxes. This brings the risk that municipalities and county councils will contribute to a weakening of an already weak economic situation.

### Prospects for the coming years

Since a substantial downward revision of tax revenue has also been made since local authority budgets were adopted, we expect the local

government sector to report a deficit for 2009. Our forecast for 2010 is that the local government sector as a whole will have net income close to zero. But this means that many individual municipalities and county councils will report deficits in 2010.

Here we have assumed that vigorous measures will be taken to sort out their finances. Our assessment is that tax increases will be hard to avoid, and we expect an increase of SEK 0.21 in the average tax rate, giving a surplus of SEK 3.4 billion. In addition, costs will be held back so that they rise less than is required to compensate for price and pay rises. This is a very substantial saving. A further cost increase of more than SEK 2 billion would have been needed to keep pace with population growth. So to avoid these tax increases and savings the sector would need to receive additional funding of around SEK 5 billion.

A calculation is presented for 2011 instead of a forecast. It assumes a cost increase that not only follows from demographic developments but also includes higher ambitions that are difficult to avoid, based on experience. One example is new pharmaceuticals in health care. Even though the Government has decided to increase governments grants from 2011, its decision means reducing the level by SEK 2 billion compared with 2010. Added to this, price and pay rises erode government grants. Together with weak tax base growth, this will result in a severe deterioration in net income for the sector, which is estimated to show a deficit of some SEK 12 billion.

It is hardly likely that this scenario will play out in practice. This suggests that municipalities and county councils will be forced to take further action in 2011 in the form of tax increases or savings. If the cost increase is restricted solely to the cost increase resulting from demography, the deficit can be limited to about SEK 8 billion. If the local government sector as a whole is to be in balance in 2011, either cuts on a corresponding scale or a tax increase of about SEK 0.30 will be required. This means that for 2010 and 2011 there is a shortfall of SEK 5 billion and 8 billion respectively that municipalities and county councils must meet by making cuts and improving efficiency or raising taxes.

The conduct of stabilisation policy, i.e. maintaining production and employment in bad times, is a task for central, not local, government. Instead local government services should be protected from economic fluctuations and be given stable financial conditions. Given the conditions we see, there is a great risk that the local government sector will reinforce the recession. At the same time, the experience of the crisis in the 1990s in particular demonstrates the importance of keeping public finances under control. However, compared with other countries Sweden is still in a strong position concerning general government net lending and indebtedness. Our assessment is therefore that there should be scope for stimulus in the next few years without endangering the long term health of public finances.

# The balanced budget requirement

## Application of the balanced budget requirement in times of crisis

*In these times, with a recession that is hard to forecast and an unusually small increase in tax revenue, a discussion is in progress on whether the balanced budget requirement may need to be modified. The Government therefore intends to make a review of the need for changes in the balanced budget requirement and other accounting matters. For instance, the Government wants to examine whether incentives can be set up to encourage financially sound and well-managed municipalities or county councils to save money in good years so as to be able to make some use of them in bad years. Our interpretation is that the present regulatory framework already provides possibilities of countering certain lock-in effects of surpluses from previous years. However, more comprehensive changes require a study of the legislation.*

One question raised by ideas about changing the balanced budget requirement is whether it is municipal and county council funds or central government funds that should pay for stabilisation policy. Our firm view is that any more general stabilisation policy must be conducted and financed by central government. Municipalities and county councils have very limited scope to conduct a local government »business cycle policy« and should not do so.

We also take the view that the underlying logic of the balanced budget requirement must be maintained. One widely held view is that the balanced budget requirement and the rules for healthy finances have made a substantial contribution to increasing understanding for financial realities and bringing order to financial balances.

At present the interpretation given to the regulatory framework is that only municipalities and county councils with a very strong financial position can budget for deficits. However, in recent years most municipalities and county councils have reported positive net income. In many cases their net income has exceeded the level justified to consolidate their own finances. It therefore seems reasonable to interpret the regulatory framework as enabling these local authorities to use part of their surpluses from previous years in the next few years. However, in order to count part of their surpluses in their assessment of compliance with balanced budget requirement, these municipalities and county councils ought to be able to show that their own finances have been consolidated over the past few years.

### **The logic behind the balanced budget requirement should remain in place!**

Municipalities and county councils are led and governed by thousands of politicians. There are plenty of strong interest groups demanding an expansion of services. In their difficult role of weighing these demands

against the financial realities, the leading politicians and officials in local authorities need a clear and logical regulatory framework that is also sustainable over time. This regulatory framework must not only be understood and accepted by politicians and officials in municipalities and county councils, it must also be communicated to and gain acceptance among citizens and various interest groups. This also means that the regulatory framework has to work whatever the state of the economy and that it must not prevent a wise, long-term adjustment of local government services.

The fundamental principle for local government finances is the healthy finances requirement in the Local Government Act. Under this principle, which, in various forms, has long been part of the Local Government Act, every generation has to finance its own local government services and not leave this burden to coming generations. Basically, this is a question of inter-generational equity. We assume that this principle will remain in place.

The balanced budget requirement has been applied since 2000 and was introduced after many municipalities and county councils had had difficulty restoring financial balance following the crisis of the 1990s. The general principle of healthy finances was not sufficient. One widely held view is that the balanced budget requirement has helped to increase understanding for financial realities and has therefore encouraged compliance with the principle of healthy finances. Municipalities and county councils have a high credit rating. This is based on their right of taxation. But the balanced budget requirement also plays an important role for the confidence of lenders in the local government sector.

The logic behind the balanced budget requirement must remain in place. The balanced budget requirement has also gained great and widespread acceptance among politicians, officials, voters and other actors in society. However, it must be possible to apply the requirement in a way that provides a fairly stable basis for planning services.

### **Present regulatory framework**

Under the Local Government Act, municipalities and county councils have to draw up a budget each year in which revenue exceeds costs. If the net income reported still turns out to be negative, this has to be adjusted no later than during the third year after the negative net income was reported. However, this balanced budget requirement is subordinate to the Act's healthy finances requirement. The balanced budget requirement is the minimum acceptable level.

Exceptions to the rule that the budget has to be drawn up so that revenue exceeds costs may be made if there are exceptional grounds. Ultimately it is up to the municipal or county council assembly to decide whether there are exceptional grounds. The preparatory works to the Act specify some circumstances that can be regarded as exceptional grounds for presenting a budget with a deficit. These include the mu-



nicipality or county council having a strong financial position. This means that, at the least, equity exceeds the local authority's entire pension commitment, i.e. the pension debt reported as a contingent liability. When these matters have been covered, the local authority's own circumstances have to be defined on the basis of its indebtedness and the impact of other risk exposure on its cash flow. Moreover, a budget can show a deficit if it is burdened by costs for restructuring measures being taken in order to achieve healthy finances.

Under the regulatory framework and the preliminary works to it, changes in financial conditions due to changes in tax revenue are not to be regarded as exceptional grounds. The regulatory framework thus assumes that, as a whole, municipalities and county councils can foresee and thereby handle the scale of an economic downturn.

A surplus that has arisen in one year can be earmarked in the annual accounts for that year for special projects in the future (temporary cost increases or revenue decreases). Typical examples that can be accommodated within this regulatory framework are the earmarking of funds for higher pension costs in the future, earmarks for extensive restructuring costs when services are changed or clearly defined spending during one year. The use of surpluses from previous years to cover future costs that normally form part of ongoing operations is not approved according to the preliminary works to the Act. So, under a strict interpretation of the Act, a municipality or county council has very limited scope to use surpluses from previous years to stabilise its own finances in tougher times.

### **Interpretation of healthy finances**

As a result of the present extremely deep recession, revenue growth has deteriorating quickly in a drastic way. In this situation many commentators see it as natural and rational to use parts of the surpluses from recent years to cover a year or so of temporary deficits. The regulatory framework along with the preliminary works to the balanced budget requirement do not address this problem. One interpretation of what is said in the preliminary works leads to the conclusion that only the local authorities that have a very strong financial position can permit themselves to plan for such a strategy.

Now, with a few years' experience of the rules concerning healthy finances and the balanced budget requirement, it can be concluded that in many cases the application of the rules for earmarking surpluses complicates financial management for the municipalities and county councils that have had large surpluses in recent years. Now that they are suffering the effects of a deep recession, it should, in our view, be possible within the framework part of healthy finances to take a retrospective decision that this can be an 'exceptional reason' to count some of their surpluses from previous years. However, this possibility should only be open to municipalities and county councils that have consolidated their finances in real terms in recent years. Our interpretation is that the re-

restrictions on doing so set up in the preliminary works to the legislation are primarily aimed at the municipalities and county councils that have not lived up to these objectives in recent years. In the period 2005–2008 the economic conditions were very favourable for municipalities and county councils. In the same way as it can now be justified for deficits to arise, it was reasonable during those years to expect large surpluses.

To evaluate whether a municipality or county council has consolidated its finances and thus lived up to healthy finances, it is reasonable to make an analysis of economic developments over a longer period of time. During a recession it can be reasonable to aim for small surpluses or temporary deficits without having to adjust them, on condition that the local authority has achieved levels of net income in recent years that mean that it is not eroding or worsening the financial situation of future generations.

It is difficult to give a general or exact description of the limits for how large a part of previous surpluses it can be defensible to draw on. However, in such an analysis it does appear natural to check how much of net income growth in recent years has been in excess of the level needed to consolidate the local authority's finances. That is that net income over time has covered the increase in pension debt, the need for reinvestment, etc.

An interpretation of the regulatory framework in line with the above discussion would make it easier for many municipalities and county councils to conduct more stable activities over an economic cycle while consolidating their financial position in the long term. This approach provides an incentive for municipalities and county councils to apply ambitious net income objectives during the good years.

Obviously, this interpretation will be of no assistance in the short term to the municipalities and county councils that have not managed to consolidate their finances in recent years. These local authorities still have substantial financing problems that are also found, to varying degrees, in most municipalities and county councils.

Our assessment is that many municipalities and county councils will guide their finances in the direction of lower surpluses than many have had in recent years. If it was also possible to make some use of surpluses from previous years, corresponding resources would also be released. It is difficult or impossible to estimate the scale of this with any precision. If this is combined with higher government grants, municipalities and county councils will be able to do their bit towards softening the effects of the economic downturn. However, it is not possible to ignore the fact that there will also be a number of municipalities and county councils that will have difficulty achieving the balanced budget requirement over the next few years.

Our view is that the approach outlined above can be accommodated within the present regulatory framework. More sweeping changes of the balanced budget requirement or healthy finances will require a separate government study.

This annex contains some key indicators and a number of tables and diagrams taken from the municipality and county council sections that have been summed here to give an **overall picture**.

The **income statements** of municipalities and of county councils are presented as tables.

This is followed by diagrams showing the breakdown of **costs** and **revenue** for municipalities and county councils separately. (They are identical to that of the autumn issue of *the Economy Report*.)

## An aggregate picture of municipalities and county councils

Table 27 • Key indicators for municipalities and county councils  
Per cent and thousands

	2007	2008	2009	2010	2011	2012
Average tax rate, per cent	31.55	31.44	31.52	31.73	31.73	31.73
Municipalities, incl. Gotland	20.78	20.71	20.72	20.82	20.82	20.82
County councils*, excl. Gotland	10.84	10.79	10.86	10.97	10.97	10.97
Number of employees**, thousands	1,113.4	1,095.4	1,098.7	1,092.7	1,103.1	1,113.5
Municipalities	842.0	826.2	829.5	824.5	833.6	842.7
County councils	271.0	269.2	269.2	268.2	269.5	270.8

\*The tax base of Gotland is not included, which is why the totals do not add up.

\*\*Thousands; average number of people in employment according to the National Accounts.

Source: Statistics Sweden.

Table 28 • Aggregate income statement  
SEK billion, current prices, unless otherwise stated

	Outcome	Forecast		Calculation	
	2008	2009	2010	2011	2012
Income of activities	139	140	142	146	150
Expenses of activities	-708	-730	-745	-771	-799
Depreciation	-22	-22	-23	-23	-24
Net expenses of activities	-592	-612	-625	-649	-673
Tax revenue	502	507	516	529	548
Gen government grants & equalisation	97	102	110	109	109
Net financial income	0	1	1	0	0
Net income before extraordinary items	8	-3	1	-12	-16
Share of taxes and grants, %	1.3	-0.5	0.1	-1.8	-2.5

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

Diagram 31 • Municipal and county council net income before extraordinary items  
Percentage of taxes and transfers

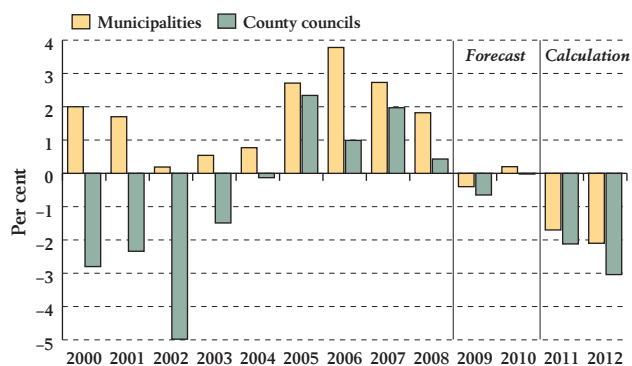


Diagram 32 • Aggregate cost growth broken down by volume and price in municipalities and county councils  
Per cent

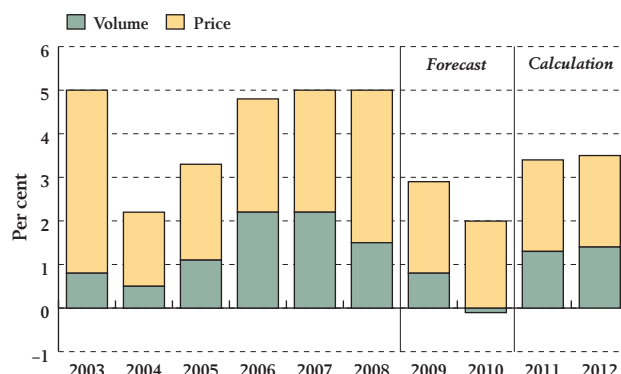


Table 29 • Income statement for the municipalities, 2008–2012  
SEK billion

	Outcome	Forecast		Calculation	
	2008	2009	2010	2011	2012
Income of activities	108	108	109	111	115
Expenses of activities	-477	-490	-499	-516	-535
Depreciation	-15	-16	-16	-16	-17
Net expenses of activities	-384	-398	-406	-421	-437
Tax revenue	331	333	338	347	359
Gen gov grants & equalisation	58	62	67	66	66
Net financial income	2	2	2	2	2
Net income before extraordin. items	7	-2	1	-7	-9
Share of taxes and grants, %	1.8	-0.4	0.2	-1.7	-2.1

Table 30 • Income statement for the county councils, 2008–2012  
SEK billion

	Outcome	Forecast		Calculation	
	2008	2009	2010	2011	2012
Income of activities	34	35	36	37	38
Expenses of activities	-234	-242	-249	-258	-267
Depreciation	-7	-7	-7	-7	-7
Net expenses of activities	-207	-214	-220	-228	-236
Tax revenue	171	174	177	182	189
Gen gov grants, equalisation & pharmaceutical benefits	39	40	43	43	43
Net financial income	-2	-1	-1	-2	-2
Net income before extraordin. items	1	-1	0	-5	-7
Share of taxes and grants, %	0.4	-0.7	0.0	-2.1	-3.0

Sources: For diagrams 31–38 and tables 29–37 the data come from the Swedish Association of Local Authorities and Regions.

## Breakdown of costs

The core tasks of municipalities (education and social care) and county councils (health and medical care) account for a substantial part of total costs, three quarters for municipalities and 90 per cent for county councils. This relationship between age

**Table 31 • Municipal costs per activity or service, 2005—2007**  
SEK million

	2005	2006	2007	Share, %
Preschool services & school age child care	51,168	54,594	58,432	13
Compulsory school	74,437	74,942	76,033	17
Upper secondary school	30,722	33,048	35,326	8
Other education	16,666	17,186	17,705	4
Elderly care	80,256	83,560	86,827	19
Disability care	42,429	45,013	48,125	11
Financial assistance	9,864	9,795	9,573	2
Individual & family care (excl. financial assistance)	17,971	18,345	19,374	4
Commercial activities	23,774	25,916	26,624	6
Other activities	63,163	68,963	73,858	16
<b>Total</b>	<b>410,450</b>	<b>431,362</b>	<b>451,878</b>	<b>100</b>

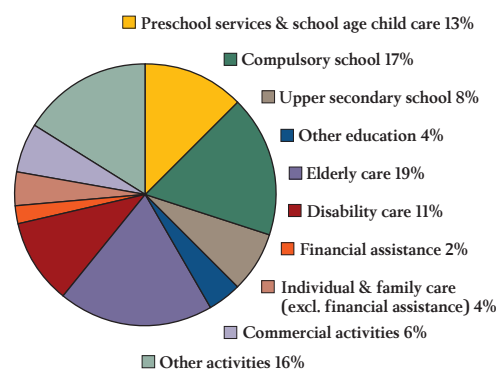
**Table 32 • County council costs per activity or service, 2005—2007**  
SEK million

	2005	2006	2007	Share, %
Primary care	30,596	32,295	33,700	15
Spec. physical health care	91,921	97,148	101,804	46
Spec. mental health care	16,673	17,313	18,231	8
Dental care	8,099	8,231	8,402	4
Other health care	16,366	16,760	18,251	8
Pharmaceuticals (open)	19,052	19,326	19,972	9
Regional development	5,502	5,854	5,957	3
Political activities	1,115	1,244	1,251	1
Transport & infrastructure	9,079	10,178	11,525	5
<b>Total</b>	<b>198,403</b>	<b>208,350</b>	<b>219,093</b>	<b>100</b>

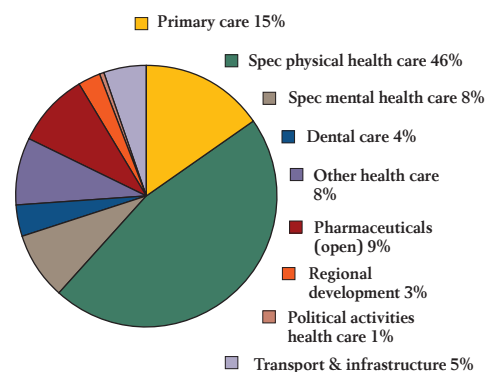
**Table 33 • Break-down of municipal and county council costs by cost type**  
SEK million

	Municipal.	County c.	Total	Share, %
Personnel	255,938	107,367	363,305	54
External goods	33,271	39,841	73,112	11
Purchase of activities	64,625	23,311	87,936	13
Other services	29,397	23,254	52,651	8
Grants & transfers	25,154	14,179	39,333	6
External rents for premises	18,153	4,662	22,815	3
Calculated capital costs, depreciation etc	25,340	6,479	31,819	5
<b>Total</b>	<b>451,878</b>	<b>219,093</b>	<b>670,971</b>	<b>95</b>

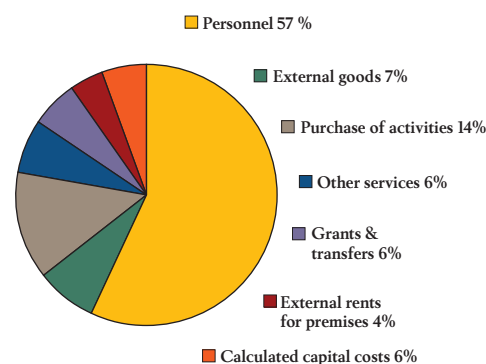
**Diagram 33 • Breakdown of municipalities' costs for activities in 2007, ca SEK 452 billion**



**Diagram 34 • Breakdown of county councils' costs for activities in 2007, ca SEK 219 billion**



**Diagram 35 • Breakdown of municipalities' costs by cost type in 2007, ca SEK 452 billion**



**Diagram 36 • Breakdown of county councils' costs by cost type in 2007, ca SEK 219 billion**

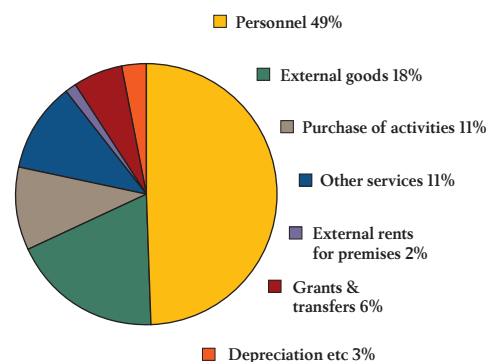


Diagram 37 • Breakdown of municipalities' revenue for activities in 2007, ca SEK 462 billion

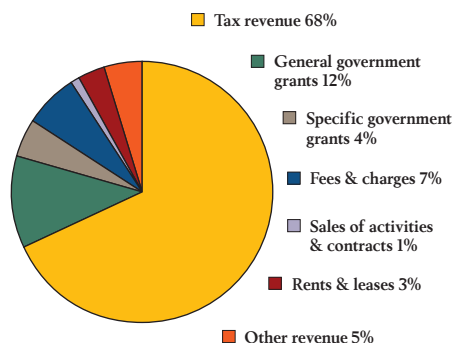


Diagram 38 • Breakdown of county councils' revenue for activities in 2007, ca SEK 225 billion

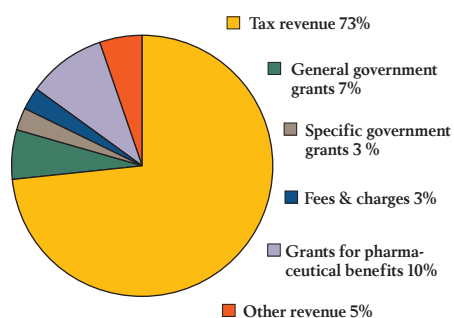


Table 34 • Level of charge-financing in municipal tax-financed activity or services, 2007

Per cent

	2005	2006	2007
Infrastructure & protection	13.0	12.6	13.2
Culture & leisure	5.6	5.7	5.6
Preschool etc	9.0	8.8	8.9
Education	0.3	0.3	0.3
Elderly care	3.8	3.8	3.7
Disability care	0.8	0.8	0.8
Other activities	1.1	1.1	1.0
<b>Total</b>	<b>3.5</b>	<b>3.5</b>	<b>3.5</b>

Table 35 • Level of charge-financing in county council tax-financed activity or services, 2007

Per cent

	2005	2006	2007
Primary care	3.7	3.6	3.5
Spec. physical health care	1.7	1.6	1.6
Spec. mental health care	1.4	1.3	1.3
Dental care	32.6	31.7	31.0
Other health care	0.7	0.7	0.6
Pharmaceuticals (open)	0.0	0.0	0.0
Regional development	0.2	0.2	0.2
Political activities	1.2	1.1	1.1
Transport & infrastructure	1.3	1.1	1.0
<b>Total</b>	<b>2.7</b>	<b>2.7</b>	<b>2.7</b>

structure and costs is stronger for municipalities than for county councils. The sector has small possibilities of reducing costs when the tax base falls off since much of its activities are regulated by law. The largest single cost type is personnel and related costs, which account for 70 and 60 per cent respectively.

### Breakdown of revenue

Tax revenue and charges finance 80 per cent of activities. However it can be difficult to raise taxes. Nor is it easy to raise charges since central government introduced maximum charges. The remainder of revenue consists of transfers from central government. For municipalities these take the form of unrestricted additional funds while for county councils the grant for the pharmaceutical benefits scheme accounts for a large share. A small part consists of targeted funding linked to the performance of a specific service.

### Breakdown of revenue from charges

Charges account for quite a small share of revenue. They have a dual role: as a source of income and as an instrument for influencing consumption. Since 2001 revenue from charges has de-

Table 36 • Some key indicators for municipalities, 2005–2007

	2005	2006	2007	06–07, %
Child care, SEK/inhabitant	5,230	5,530	5,860	6.0
Child care, SEK/child enrolled	97,338	102,901	106,416	3.4
Compulsory school, SEK/inhabitant	8,627	8,642	8,711	0.8
Compulsory school, SEK/pupil	73,561	76,764	80,831	5.3
Upper secondary school, SEK/inhabitant	3,810	4,012	4,245	5.8
Upper secondary school, SEK/pupil	89,880	91,892	94,719	3.1
Elderly care, SEK/inhabitant	10,211	10,652	11,061	3.8
Regular housing, SEK/care recipient	217,960	224,746	219,639	-2.3
Share inhabitants 65– years in regular housing, %	8.1	8.3	9.0	9.2
Special housing, SEK/care recipient	453,512	480,383	511,457	6.5
Share inhabitants 65– years in special housing, %	6.4	6.2	5.9	-4.9
Disability care, SEK/inhabitant 0–64 years	5,853	6,204	6,585	6.1
Housing under LSS*, SEK/resident	565,419	594,461	612,180	3.0
Share inhabitants 65– years with LSS*, %	0.8	0.8	0.7	-6.7
Individual & family care, SEK/inhabitant	2,374	2,424	2,521	4.0
Child & youth care, SEK/inhabitant	1,105	1,130	1,220	7.9
Misuser care for adults, SEK/inhabitant	355	384	414	7.7
Other adult social care, SEK/inhabitant	114	126	102	-18.7
Financial assistance, SEK/inhabitant	749	731	730	-0.2

\*LSS (Lagen om stöd och service...), is a law stipulating special support and service for disabled persons.

Table 37 • Some key indicators for county councils, 2005–2007

	2005	2006	2007	06–07, %
<b>In-patient physical health care</b>				
Cost, SEK/inhabitant	5,868	6,012	6,193	3.0
Number of patients	849,553	858,876	861,673	0.3
Number of discharges	1,390,172	1,402,429	1,423,589	1.5
Productivity*	2.8%	-0.5%	-2.8%	
<b>In-patient physical health care</b>				
Cost, SEK/inhabitant	848	887	862	-2.8
Number of patients	46,021	46,406	48,667	4.9
Number of discharges	87,358	88,468	89,890	1.6
<b>Primary health care</b>				
Visits to doctors (000s)	12,718	13,010	13,212	1.6
Other visits than to doctors (000s)	23,353	24,004	24,344	1.4
Hospital beds total	26,478	26,223	26,184	-0.1
Visits to doctors (000s) total	25,394	25,734	25,899	0.6
Other visits than to doctors (000s) total	32,671	33,616	34,182	1.7

\*Cost per diagnosis-related group (DRG) point.

creased by SEK 2 billion due to the introduction of maximum charges for some services. The largest charge revenue is in pre-school services and school-age child care. Elderly care and infrastructure and protection also have substantial charge revenue. The level of charge-financing (charges/costs) in municipalities is 3.5 per cent, a reduction since 2002. In county councils the level of charge-financing (charges/costs) is 2.7 per cent. Here dental care has the highest level of charge-financing. ■









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The financial situation of municipalities and county councils appears increasingly troubling. The exceptionally weak state of the economy and lower employment will result in a substantial reduction in the growth of the local government sector's income this year and next year. Municipalities and county councils will have to choose between improving efficiency, making reductions in services and increasing taxes. Many face a difficult budget process ahead of 2010.

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