Local government borrowing and the role of KommuneKredit: An international comparative analysis

English summary

Niels Jørgen Mau Pedersen and Jonatan Kjældgaard Jensen

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VIVE – The Danish Center for Social Science Research
Herluf Trolles Gade 11, 1052 Copenhagen K, Denmark
www.vive.dk

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Preface

The Danish report “Kommnernes låntagning og KommuneKredits rolle i et internationalt perspektiv” has recently been published by VIVE.

The present paper constitutes an English summary of the Danish report and is based mainly on the summary in the Danish report. It is not a direct translation of the Danish summary but coincides largely with it.

Analyses and descriptions in the Danish report use a wide range of sources of knowledge, e.g. official and professional reports, journal articles and legal documents. The references can be found in the final part of the Danish report. We therefore refer to the Danish report for details. This also applies to information about the Danish and international interviews and contacts made for the investigation.

Ulrik Hvidman, Head of Research, VIVE Governance and Management
2021

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1 Background, purposes and issues of investigation

1.1 Background and purposes

Danish local governments, i.e. municipalities and regions, are important service providers with significant economic importance in the social economy and in the Danish economy in general.

Therefore, it is important that the decentralised sector's economy is healthy and that financing is carried out in an appropriate manner. An issue that seldom receives much attention – but nevertheless is of great importance to the financing of local governments – concerns funding by loans and local governments' access to loans. With the report (in Danish) and this English summary, we wish to cover the need for up-to-date knowledge on local government borrowing.

In order to gain access to cost-effective loans, it is necessary that both domestic and foreign lenders understand how the local government borrowing is regulated in Denmark and to understand the Danish model of vertical coordination between the national government and local governments.

Thus, the purpose of the report – and the summary at hand – is to provide communicable knowledge on local government borrowing in Denmark, including the Danish way of providing credit to the decentralised public sector, regulation of local government borrowing in Denmark and Danish intergovernmental coordination with relevance to local government borrowing.

Our approach to investigating, explaining and describing the abovementioned areas of knowledge is to apply an international comparative analysis. Hence, we aim to put the Danish model of local borrowing into perspective by considering other possible ways of organising credit and intergovernmental coordination. Thus, the method involves a comparison with other countries, i.e. countries that have core similarities with Denmark but also differ from Denmark in their ways and methods with regard to borrowing restrictions, intergovernmental coordination and providing credit to the decentralised public sector.

In the following section, we describe the principal issues of investigation. When dealing with the various issues of investigation, we apply the following approach: First we describe the Danish model with respect to the issue of investigation, and subsequently the Danish model is put into perspective by relating to the conditions of OECD countries in general. The third step is to make more 'in-depth' comparisons with four selected countries.

1.2 Principal issues of investigation

The analyses in question involve three issues of investigation:

1. Fiscal policy issues, i.e. local government borrowing interaction with national fiscal policy, macroeconomic activity levels fluctuation and efforts to ensure sound local government finances.

The issue here is the interplay of local governments' borrowing with national fiscal policy, with local governments acting both as automatic stabilisers in the economy and as possible active participants in the overall fiscal policy of the country. The issue also includes the ways of shielding local governments' economy from national economic downturns or shocks. Moreover, the analysis contain descriptions and international comparisons of the central government's use of so-called 'fiscal rules' aiming at sound local finances, and the effect of these rules.

2. Vertical coordination of local government borrowing in Denmark and other countries.

This issue relates specifically to a description and comparison of the guidelines, rules and other kinds direct or indirect regulations of local borrowing, i.e. fiscal rules for budget balance, borrowing restrictions and approval arrangements from the central government authorities. It also includes descriptions of ways for the central government to handle a potential economic crisis in a single local government.

3. The content of and rationale behind the financial institution of KommuneKredit seen in an international, comparative context.

Besides the KommuneKredit way of supplying loans to local governments, the investigation includes a number of alternative methods of providing loans to the local government sector. The analysis evaluates the different methods separately according to relevant criteria and considerations. This includes a comparison with the loan arrangements of local governments in other countries and the results from some relevant studies in the existing economic literature.

2 Choosing countries for comparison and analytical methods

As mentioned earlier, our approach is to perform an international comparative analysis as we believe that the Danish system of local government borrowing is more accessible when put into perspective via comparisons with OECD and EU countries. Moreover, as already indicated, and for the same reasons, we want to make a more in-depth comparison with a limited number of countries. For this purpose, four countries were selected, based on them having core similarities with Denmark making them comparable to the Danish case. Thus, the four countries for in-depth comparisons all have to be comparable to Denmark to a certain extent on key variables, such as the general level of welfare in the country and the national creditworthiness. On the other hand, we want to choose countries for in-depth comparison that also differ from Denmark in their ways and methods regarding regulation of borrowing, inter-governmental coordination/fiscal policies and provision of credit to the decentralised public sector. In other words, we want the countries to differ in the main conditions of interest. We ended up choosing Sweden, Finland, The Netherlands and Austria for our in-depth comparative analysis.

The analytical methods include desk research of relevant economic literature, reports and written rules, as well as use of Danish and international databases. In addition to this, we collect information from semi-structured interviews of ministerial authorities, credit agencies and relevant institutions for social science research. The interviews were carried out both in Denmark and with contacts from the four countries of comparison.

The aim of the analysis of the public sector is the decentralised level of the sector, i.e. regions and, especially, municipalities. When we mention the local level of the public sector, we are mostly referring to municipalities. We mainly deal with traditional financial loan types, though various rental arrangements, sale and lease-back etc. may be mentioned as possible substitutes for traditional loans.

3 Fiscal policy, fluctuations of activity levels and local borrowing

When dealing with local government borrowing, it seems obvious to include a discussion on fiscal policy issues, i.e. of the extent to which local governments are exposed to fluctuating activity levels of the national and local economy, the role of the municipalities in the overall national fiscal policy and the efforts to achieve sound local finances. We will take as our starting point the Danish situation.

3.1 Fiscal policy and The Danish case

- ⇨ *Danish municipalities are protected against local effects of economic fluctuations to a very high degree.*

When taking into account both the economic significance of municipalities in Denmark and the general political desire to have a stable supply of core welfare services, it would seem beneficial to have municipalities working as a stabilising element of the social economy. On the other hand, part of the municipal tax revenues as well as part of the local expenditures for income transfers are susceptible to national economic fluctuations.

Several schemes are in place in Denmark to provide a sort of economic shield to protect the local governments from changing activity levels. Thus, local governments are rendered able both to secure a stable supply of welfare to their citizens and play a stabilising role in the economy.

Those shields may be termed ”safety nets” for local governments. Firstly because they consist of statutory arrangements compensating local governments via the block grant for fluctuations in expected revenues and needs for expenditures, which are related to the general activity level of the economy or to economic crises in general (like the COVID-19 situation). Secondly, because the Danish central government uses automatic or discretionary changes of the amount of the yearly block grant for municipalities to protect further the local economies. The yearly negotiations between the central government and the Association of Local Governments may influence the size of the block grants. Finally, because the equalisation system expanded through the years contributes to neutralising the effects of economic fluctuations.

As a result of those efforts, we see only rather modest variations in the total budget balance – the so-called net lending balance – for Danish local governments from one year to another. Instead, the effects of cyclical movements on the public sector budgets are mainly deposited in the central government budget balance.

While local governments in Denmark use the central government's ”safety nets” to stabilise their economies, we do not normally see municipal cash balances used in this way. This is contrary to the situation in several other OECD countries, cf. below.

⇨ *Danish municipalities play only a very limited role in what is labelled 'active national fiscal policy' – the yearly agreement of a certain permitted amount for discretionary loans to municipalities constitutes an exception.*

Borrowing restrictions (cf. below) on Danish local governments generally imply current and immediate funding of both operating expenditures and investment expenditures. This may be termed the principle of self-financing of local governments. Although there are significant exceptions to this main rule, naturally, this limits potential discretionary fiscal impulse initiatives from the local governments.

As an exception to the main rule, the Ministry of the Interior grants single municipalities discretionary permission to borrow, within yearly fixed ceilings of the aggregate value of such approvals, so-called loan pools. Assessing the size of the loan pools from 2004 to 2022, we consider the loan pools to be counter-cyclical. As an example, for 2022, where a general upturn of the Danish economy seems to be developing, the loan pools are largely absent.

⇨ *Central government control of municipalities' economy in Denmark is rather extensive, and several different fiscal rules encourage municipalities to promote sound local finances.*

For almost a decade, the central government has made use of a whole range of so-called fiscal rules to promote sound economic behaviour of local governments in Denmark. We identify four such fiscal rules. First, statutory rules exist for the current budget balance as it appears in the yearly budget of single municipalities. Second, the Danish 'budget law' establishes yearly expenditure ceilings for the total local government sector. If ceilings are broken, the central government can impose sanctions on the municipalities via reductions in block grants. Third, increases in local government tax levels for the sector as a whole may also be subject to sanctions. Fourth, strict borrowing restrictions – mentioned above and elaborated on below – also constitute a sort of fiscal rule for the local governments in Denmark.

⇨ *The current financial position of Danish local governments is strong and robust.*

Danish local governments have improved their average net financial position markedly over the last decade. For the sector as a whole, long-term debt has stagnated, while local governments have been accumulating cash balances since around 2013. Consequently, municipalities' income from interests now exceeds interest expenses.

Accumulating cash balances may possibly come to an end in the future, though the finances of local governments as a whole are both strong and robust.

Our analysis of the interest sensitivity of loans of Danish local governments shows a rather modest sensitivity, taking into account the considerable size of the total municipal sector.

3.2 Fiscal policy and international comparisons

As mentioned earlier, we both make comparisons with OECD countries in general and study four specific countries in more detail.

⇨ *The expenditure side of Danish municipalities appears to be more exposed to economic fluctuations than OECD countries in general – the revenue side appears to be more average in this respect.*

The economic significance of the Danish local government sector is rather strong, since the size of the sector in terms of expenditures is more important to the national economy than in most other OECD or EU countries. This stems partly from the fact that Danish municipalities are financially responsible for income transfers to households to a greater extent than in most other countries. Therefore, the Danish municipalities – not taking into account the safety nets mentioned above – are more exposed to cyclical swings than municipalities in most other countries.

On the other hand, when it comes to local governments' revenues the Danish local government sector is close to the OECD average in terms of exposure to cyclical fluctuations. Local taxes do not constitute a large share of total local revenues in Denmark, compared to other OECD countries, but the rather cyclical dependent income taxes is the main tax instrument. Property and land taxes may be more important in certain other countries.

⇨ *The Danish model of neutralising the effects of economic fluctuations on local governments rely on automatic and regulatory measures and mechanisms – in several other countries local governments' own efforts are given higher priority.*

The handling of economic effects on local governments of national economic fluctuations in Denmark rests to a great extent on permanent mechanisms and schemes established by law. This is not what we typically see in other countries. In other OECD countries, discretionary measures are more common, though such measures also exist in Denmark.

Internationally, we regularly observe local governments' use of accumulated cash balances – or so-called RDFs, Rainy Day Funds – to meet economic challenges from cyclical activity levels. This instrument is not normally used in Denmark.

⇨ *Compared to other countries the Danish central government makes intensive use of fiscal rules.*

In general, borrowing restrictions and budget balance objectives (BBOs or deficit rules) are the most frequently used central government measures to obtain sound local finances across OECD countries. On the other hand, expenditure limits are more seldom seen. Some countries, including Denmark, use all three types of fiscal rules simultaneously. In addition to this, Denmark also applies fiscal rules on local taxes. Against this background, the Danish approach to macroeconomic control of local governments seems rather stringent and restrictive.

⇨ *In relation to the four selected countries of comparison, several aspects call for attention, including the Swedish concept for local governments of 'good economic housekeeping' and Rainy Day Funds, and for all four counties the deficit rule named the 'golden rule'.*

Sweden has many similarities with Denmark when it comes to local governments, but makes use of the concept "god ekonomisk hushållning" ('good economic housekeeping'), weighting the local governments' own response to adverse economic conditions more than is the case in Denmark. Sweden, as well as Finland, the Netherlands and Austria, apply the deficit rule known as the ‘golden rule’, implying that current revenues of the local government have to balance the sum of operating expenditures including net interest expenses and depreciation. Consequently, the approach to local borrowing is less restrictive, cf. below. For The Netherlands and Austria, it is noteworthy that the regional/ provincial level has the role of supervising the municipalities, which is not the case of Finland, Sweden and Denmark.

4 Borrowing restrictions on municipalities and related issues

The central government restrictions on local government borrowing is the second main issue of investigation. The issue concerns both direct regulation of local government borrowing and the more indirect way of influencing borrowing and debt behaviour via budget balance objectives (deficit rules). Some aspects have already been mentioned in the previous section. Our primary focus is the institutional description in an international comparative perspective.

4.1 Borrowing restrictions and the Danish case

- ⇨ *In Denmark, local governments' borrowing is primarily regulated by law (i.e. an executive order) – with 'no borrowing' as the starting point.*

An important element of the Danish borrowing restrictions on local governments is the extensive use of a set of rules, i.e. the so-called Executive Loan Order (in Danish "låne-bekendtgørelsen"). The Executive Loan Order is based on the Municipal Government Act.

As already touched upon, local governments in Denmark are subject to a principle of "self-financing". In other words, local government borrowing regulation, in principle, implies immediate yearly funding of local government expenses, i.e. local governments use taxes, grants or user payments to finance the outlays. This applies both to operating and investment expenditures. Put differently, Danish local governments cannot take a loan, unless certain requirements are met.

First and foremost, such a requirement may be that the local government has obtained a specific permission, granted by the Ministry of the Interior. The ministry has the authority to grant such discretionary permissions, primarily covered by the loan pools, i.e. the yearly fixed ceilings of the aggregate value of such approvals.

Secondly, the municipality may have a so-called automatic permission to take on loans in a range of areas, primarily for investment purposes, e.g. investments in public utilities, housing for elderly people, urban renewal, energy saving, housing for refugees and loans for elderly people to pay land taxes.

Normally, any permission for a municipality to take loans is valid for a certain calendar year. Other regulations concern the maximum length of the loan, accepted currencies in which to take up loans and measures to avoid circumvention of the restrictions, e.g. rental arrangements and sale and lease-back activities.

- ⇨ *The customary law in Denmark for handling municipalities in economic and financial crises, which is popularly termed "putting the municipality under administration", has not been used for ten years.*

Since borrowing by local governments inevitably involves a risk for a municipality of not being able to repay future debts, it has been necessary to establish an administrative practice for the central authorities to handle such a situation in an appropriate manner.

The practice is initiated, i.e. the municipality is “put under administration”, if the municipality violates the so-called overdraft facility rule, which stems from the Executive Loan Order. This practice manifests itself in a procedure including meetings with the ministerial representatives, presentation of a recovery plan for the municipality in question and the ministry auditing how the economy develops for a limited future period. From 1988 to 2010, the procedure was activated 30 times, resulting in satisfactory recovery for all the municipalities involved.

However, since 2010 no municipalities have been in a situation where the procedure of “being put under administration” has been necessary. This may partly reflect the improved and strong financial position of the municipal sector mentioned above.

- ⇨ *The Danish municipalities provide guarantees for a considerable and increasing amount of loans, and municipal revenues from guarantee commission have also increased.*

Municipalities in Denmark are allowed to provide loan guarantees for a range of different purposes. This includes social housing projects, urban renewal and loans taken out by municipal owned companies, e.g. certain public utilities.

The guarantees involve an increasing municipal risk exposure in this respect, and the municipalities increasingly charge commission for the loan guarantees and therefore receive increasing revenues from this activity.

4.2 Borrowing restrictions and international comparisons

- ⇨ *Across the OECD countries, borrowing restrictions are frequently used as a fiscal rule. The content and implementation of the rules, however, vary widely between the countries.*

There are several possible approaches to borrowing restrictions and limitation on borrowing by local governments, and the different ways of restricting local governments’ borrowing are widespread in the OECD countries.

The first approach is the liberal version with no limitations on borrowing at all. The second approach is a more indirect way of restricting local governments from borrowing via budget balance objectives and deficit rules, e.g. the ’golden rule’ which allows investment expenditures – but not depreciation – to be financed by loans. As a third approach, the maximum indebtedness of local governments can be fixed by the central government. The fourth approach makes use of specific restrictions and limitations on taking out loans (e.g. the case of Denmark). A fifth approach to regulating loans of municipalities is a requirement of approval of loans from a higher tier in the public sector, e.g. provinces or regions. The sixth and final approach is a general ban on local governments’ borrowing.

Seen across countries, approaches two, three, four and five seem to be the most common, and they are regularly combined in different ways.

⇨ *The way of regulating local government borrowing might be related to the standards of accounting in the country in question.*

Some OECD countries use accrual accounting (sometimes known as cost principles). Here, depreciation appears in the accounts and consequently be financed by revenues for the year in question. This is often the case for countries using the abovementioned 'golden rule' of the budget balance objective. In those countries, we regularly observe no – or only minimal – further borrowing restrictions on local governments.

Other OECD countries uses cash accounting or equivalent accounting standards (or in Denmark so-called expenditure accounting), where no calculated items like depreciation appear. In these situations, borrowing restrictions or regulation may act as a supplement to budget balance objectives.

⇨ *From Denmark and the four countries chosen for comparison, a Danish, a Nordic and a Continental approach to borrowing restrictions and regulation of local government loans might be identified.*

Although it involves some simplification, we find three models or approaches to restriction of municipal borrowing activity when comparing Denmark with the four chosen countries.

Firstly, Sweden and Finland represent a kind of Nordic model with virtually no direct borrowing restrictions, but with rules for the fiscal deficit of the 'golden rule' type that in practice entails some limits on local government borrowing in the long run. In both countries, municipalities that have a budget balance deficit for a certain year have three or four years to correct the imbalance. Consequently, the local governments' own efforts to handle potential imbalances are a vital element.

Secondly, Austria and The Netherlands represent what we call a Continental model of local borrowing. As in the Nordic model, the main instrument for regulating loans at the local level seems to be the budget balance objective of 'golden rule'. There are only a few further borrowing restrictions. However, as already mentioned, a tier of the public sector above the municipalities – provinces in the Netherlands and länder in Austria – has an obligation to supervise the borrowing of the municipalities located within their borders.

Finally, the Danish version of borrowing restrictions also involves limited use of budget balance objectives, but rather strict rules that restrict local government borrowing in a direct way. The starting point in the Danish context is the principle of "self-financing" or "no borrowing". The requirements are softened significantly, however, via so-called automatic or discretionary loan permissions.

5 Content and rationale for the financial institution KommuneKredit seen in an international perspective

Keeping in mind the importance of local governments for the national economy and the national fiscal policy, it seems relevant to look at how the local governments – in a prudent manner – actually take out loans. Against this background, it is relevant to consider the predominant institution in this field in Denmark, namely KommuneKredit, which is a membership association of local government borrowers.

The local governments themselves own the institution KommuneKredit, which was founded more than 100 years ago. But what is the rationale behind this organisation today seen in an international and updated perspective? On our way to answering this question, we first consider alternative ways of credit provision for the local government sector. Next, we set a number of criteria or considerations to apply when before finally making a few evaluating and comparative statements about the KommuneKredit model.

5.1 Different channels, considerations and criteria when selecting a model for provision of credit to municipalities

- ⇨ *Loans to local governments can be organised and provided via the central government, via international banks, by private commercial banks and mortgage institutions, by municipalities' own bond issues or via specialised financial institutions. Danish municipalities mostly use the latter model.*

In principle, several ways or channels to provide loans to local governments exist. Of course, not all the channels may be open for immediate use in all countries and at all times.

Borrowing from the central government (e.g. via the national central bank) may seem like a reasonable way for local governments to borrow money, as the creditworthiness of the central government is naturally high. It might not be self-evident that the central government will offer loans for local governments since the central government may see a risk of confusion of the distribution of responsibilities in the public sector.

Like the central government, international banks may also possess very high credit ratings, which institutions such as EIB, the European Investment Bank and NIB, the Nordic Investment Bank, do. Local governments can also turn to private commercial banks and mortgage institutions when they are in need of loans. Also, the municipalities can issue bonds themselves, i.e. sell bonds on the open markets. This requires it is a cost-efficient manoeuvre for the local authorities, with the potential buyers of bonds being willing to pay a satisfactory price.

Finally, the local governments may jointly set up their own specialised financial institution. KommuneKredit is an example of this kind of financial institution.

When choosing between the different models of organisation, a number of considerations and criteria may be in place. We present three headlines to characterise such criteria.

⇨ *Criteria for selection of the model of organising loans to local governments may include the cost of funding and borrowing, seen from the municipality perspective, the compatibility with the distribution of responsibilities in the public sector and other criteria influencing the societal benefits and costs.*

Firstly, for the municipalities keeping costs related to debt management as low as possible is of course an important criterion, when considering the most appropriate way of taking a loan.

A considerable share of the costs arise from the costs of funding for the institutions providing the loans. These cost depend on the efficiency of the loan markets in general and the leverage efficiency of the institution in case. First and foremost, we expect the perceived creditworthiness of the municipalities and the financial institution itself to influence these costs.

Costs in this respect should be understood in a broad sense. This includes both the degree of stability of loan options when the financial markets are exposed to crisis, and potential administrative costs when taking out and repaying the loans. Furthermore, the calculation of costs should include borrowing fees and the required rate of return (if any) of shareholders in the financial institution.

A second set of criteria concerns the overall compatibility of the model of loan provision with the distribution of responsibilities in the public sector. This involves both the vertical and horizontal division of responsibilities.

The vertical division of responsibilities in the public sector is about the responsibilities of the central government versus the responsibilities assigned to the local government sector. Some models of organising loan provision and the repayment of debt may be more or less congruent with the distribution of responsibilities that apply in general.

The horizontal division of responsibilities for the municipal sector, on the other hand, is about distribution of responsibilities among the individual municipal authorities. Some channels of loan provision may include mutual guarantee arrangements, which may modify the financial responsibilities among the municipalities.

A third set of criteria concerns further societal costs and benefits seen in connection with different organizational models. The need and possibility for central government to implement macroeconomic management and control is one example in this respect. A further consideration concerns a political desire to have uniform costs of local governments' borrowing throughout the country, e.g. the same 'price' for small municipalities in peripheral areas as for large metropolitan municipalities.

Finally, also historical factors and considerations about competition may play a role when comparing organizational models.

5.2 The Danish case of KommuneKredit

- ⇨ *The municipally owned Danish KommuneKredit is a specialised financial institution with its own legal basis, with joint and several guarantees, with no requirement of return to owners and exempted from the EU credit directive.*

In Denmark, the specialised financial institution KommuneKredit is the relevant institution to take as a starting point when considering loan provision to local governments.

The institution of KommuneKredit is a non-profit financial institution founded in the late 19th century. It is a voluntary membership association, but today all Danish municipalities and regions are members and owners.

The central government neither has ownership nor responsibility for the running of the institution. KommuneKredit has its own legal basis, however. Formerly, KommuneKredit was under the supervision of the Ministry of Interior, but as of 2021 the Danish Financial Supervisory Authority is the supervisor. The law about KommuneKredit is currently being revised (autumn 2021) but this does not necessarily imply major changes. The institution is exempt of the EU credit directive.

KommuneKredit provides loans to Danish municipalities and regions, municipally owned enterprises and companies undertaking regional or municipal tasks. The projects financed by loans provided by KommuneKredit must demonstrate a public (municipal) purpose and as such be in harmony with EU state guarantee rules.

The Market share of KommuneKredit in relation to loans to municipalities and regions is close to 100 pct.

As a very important characteristic of KommuneKredit, its liabilities are jointly and severally guaranteed by all members. This means that each member, i.e. each municipality, assumes liability for the entire amount owned by KommuneKredit. The rating of KommuneKredit from rating agencies is very high at the closest proxy to Danish sovereign risk. The equity degree (sometimes reported as the leverage ratio) in 2019 was 3.5 pct.

Historically, the establishment of KommuneKredit must be seen in relation to the Danish cooperation movement (in Danish 'Andelsbevægelsen') of the 19th century.

5.3 KommuneKredit and international comparisons

- ⇨ *In OECD countries, we find financial institutions with great similarities to KommuneKredit, especially in the Nordic countries, though also with differences in their set up and organisation.*

Financial and credit institutions serving municipalities with loan provisions and with clear similarities with the KommuneKredit organisation are to be found in several European countries. Especially in the Nordic countries we find such institutions. Nevertheless, in OECD countries we also find significant deviations from the Danish KommuneKredit model, e.g. central government ownership of specialised financial institutions, the extent of loans to municipalities via commercial banks and mortgage institutions and the occurrence of municipalities issuing bonds.

Municipalities do not issue their own bonds in Denmark nowadays, but they do it regularly at the local government level in countries like Finland, Sweden, Norway, Germany, France, Switzerland and Austria.

- ⇨ *A comparison with specialised financial institutions serving municipalities in four countries reveals that at least three institutions are comparable with KommuneKredit, namely Swedish Kommuninvest, Finnish MuniFin and Dutch BNG Bank, with similarities and differences according to evaluation via preselected criteria.*

In three out of the four countries of comparison, we find financial institutions serving municipalities that occupy a business role comparable to the role of KommuneKredit in Denmark. Those institutions are Kommuninvest in Sweden, MuniFin in Finland and BNG Bank in The Netherlands. For Austria, however, the conditions deviate significantly from the Danish situation. Comparing the three institutions with KommuneKredit reveals, that they all have high credit ratings and a high market share. In Sweden and The Netherlands, the market shares have previously been rising due to the financial market crisis. It is also noteworthy that the financial institutions in countries who are members of the European Bank Union are supervised in accordance with the European Central Bank, ECB, implying some administrative costs.

5.4 Empirical and theoretical literature relevant to evaluation of models for provision of loans to local governments

- ⇨ *In economic literature, we find several aspects of models of credit provision to local governments relevant for an evaluation: the potential value of mutual guarantees, possible gains by transfer of risk to other authorities, importance of specialising and cluster theory in financial services and potential reservations when responsibilities between public sector authorities are not congruent.*

We identify five theoretical aspects of different models of loan provision to local governments, inspired by economic literature. The theoretical considerations are to a certain extent also illuminated by empirical investigations.

As a first consideration, we present mutual guarantees as a sort of public good. Mutual guarantees might be the joint and several guarantee by members known from the KommuneKredit model, but also other organisations of mutual guarantees occur, e.g. the Finnish Guarantee Board.

The idea of this concept rests on the assumption that potential lenders and the participants in the financial markets are somewhat sceptical as to or lack knowledge of the security of municipalities that require loans. Consequently, if the market perception exaggerates the risk in relation to municipal loans, it may be difficult for the municipalities or the financial institutions serving them to obtain a satisfactory price of bonds issued to finance the loans. If, on the other hand, the local governments pool their risks, they may be able to persuade the market of the high level of security of municipal loans and hereby obtain better prices of relevant bonds. Every participant in the mutual guarantee arrangement may exploit this improvement of the market for loans, i.e. it can be seen as a kind of public good.

In Denmark, Sweden and The Netherlands, we see mutual guarantee arrangements between municipalities, which have never triggered a loss to the municipalities, hereby underlining the pubic good character of the guarantees. Also, we have identified some international empirical investigations pointing in this direction.

A second consideration views transfer of risk from municipalities to other authorities, first and foremost the central government, as a way to reduce the costs of loans for the municipalities.

This line of thinking is also known from empirical literature. It should be taken into account that the central government usually has a high credit rating and also has the power and the instruments to provide financial assistance to municipalities that may experience financial difficulties.

A third consideration constitutes an alternative to the security-oriented way of thinking. Here we focus on the necessity and value of professional knowledge about local government economy possessed by the financial agencies providing loans to local governments. Related to so-called cluster theory, we understand the specialised financial agency as an institution with potential in-depth knowledge about local government economy, and especially the economic conditions in the field or area where the municipality in question is located. Such knowledge, cf. the literature, may include not only economical evidence but also so-called soft information relevant in debt relations, about the relationship between tiers of the public sector, regulation etc. The credit institutions referred to in the Nordic countries and The Netherlands possibly possess such knowledge.

Speaking about the influence on the horizontal division of responsibilities from mutual guarantee arrangements, a fourth consideration seem relevant, namely the risk of so-called moral hazard.

If municipalities exhibit moral hazard when covered by a pool of guarantees, they likely weaken their economic discipline and loosen the economic management of the municipality. This may in turn produce unsatisfactory use of economic resources and give a loss to the society. In an extreme situation, the central government might end up “bailing out” seriously distressed municipalities.

Studies from The Netherlands, Sweden and Denmark, however, do not seem to confirm this theoretical argument.

A final and fifth consideration concerns the vertical division of responsibilities among the tiers of government. In theory, a confusion of the division of responsibilities may result from the central government via guarantees, ownership of financial institutions or channelling of loans from the central government to local governments. Such behaviour may make the division of responsibilities for allocative tasks of the public sector unclear to the citizens, and the central government may be considered responsible for bailing out local governments in the event of economic distress.

We do not know of any empirical studies on the effects of confusion regarding responsibilities between the tiers of public sector, but find that such a phenomenon should be understood with classical fiscal federalism literature in mind.

5.5 Evaluating remarks about the KommuneKredit model

- ⇨ *The KommuneKredit organisation has parallels to organizational models in other countries, but nonetheless it is unique and tailored to Danish conditions.*
- ⇨ *The market share of KommuneKredit is very high when it comes to loans to municipalities and regions.*

We observe that the KommuneKredit model of provision of loans to local governments has parallels in other OECD countries, especially in some Nordic countries. Yet, differences also exist.

This is the case when it comes to the competitive position of KommuneKredit, which seems to be very strong as KommuneKredit has a marked share of loans to municipalities and regions of almost 100 pct., i.e. more than that of parallel institutions.

Even though such a very strong market position always gives rise to critical awareness about how it unfolds, the competitiveness and increasing market share over the years probably mirrors the economic advantages for the members of the association of KommuneKredit. It should also be taken into consideration that the Danish local governments are by no means forced to use KommuneKredit to obtain loans.

- ⇨ *Even though one should always be aware of dominant market positions and the theoretical potential challenges of a horizontal division of responsibilities, based on an overall assessment, the KommuneKredit model is doing well according to most of the pre-established criteria.*
- ⇨ *The joint and several guarantee of all members of the association and very strong local government finances in Denmark, including close monitoring and control by the central government, all contribute to the perception of security of loans funded by KommuneKredit.*
- ⇨ *The shielding of Danish municipalities from economic fluctuations adds security and stability to the local government finances.*

An assessment of the KommuneKredit model must be based on the assessment of the individual pre-established criteria.

One of those criteria concerns the members' joint and several guarantee for the obligations of KommuneKredit and how this guarantee is perceived by the lenders. We find it likely to be a crucial element for limiting the cost of funding for the financial institution, in harmony with a very high credit rating by the credit rating agencies.

Of course, the high level of creditworthiness also is due to sound local government finances and a remarkably strong financial position of the average Danish municipality. The "safety nets" stretched under the municipalities to protect their economy from the effects of economic fluctuations and the rather strict central government control of local governments' economy also play a role in this regard.

- ⇨ *Irrespective of the ongoing revision of the Act on KommuneKredit, the organisation will still not be legally obliged to make credit evaluations of individual municipal members since loans to municipalities and regions are perceived as risk free.*
- ⇨ *The absence of central government ownership of KommuneKredit and no requirement of rate of return to owners seems to be in harmony with the general division of responsibilities in the Danish public sector.*
- ⇨ *The pricing policy of KommuneKredit implies uniform cost of borrowing for all municipalities, regardless of size, geographic location etc.*

The insight that the KommuneKredit staff have in the local government economy and the municipal tasks and borrowing restrictions determined by the central government adds to the relevance of the KommuneKredit model.

The model of KommuneKredit also satisfies the national political aim of a uniform pricing policy in relation to the single municipalities, regardless of their size, geographical location and other external conditions for the local authorities. The historical background of the institution should also be taken into account here.

The KommuneKredit organisation does not involve central government ownership – nor full or partial ownership. This seems to tie in well with the general division of responsibilities in the Danish public sector. Moreover, it does not imply any possible requirement of return to owners.

The ongoing revision of the law regarding KommuneKredit may imply some costs of supervision from the Danish Financial Supervisory Authority. However, the situation however still deviates from the conditions for some of the parallel institutions in other OECD countries.

5.6 Final remarks

- ⇨ *In the coming years, a continuation of the accumulation of municipalities' cash balances stemming from central government "over-financing" may, in isolation, result in a declining demand for loans from KommuneKredit, though this demand also depends on need for investment, unknown future borrowing restrictions etc.*

As a closing remark, we observe that yearly central government over-financing of the municipal sector, followed by increasing cash balances, may result in a declining demand for municipal loans. However, this is seen in isolation and does not take into account possible increasing needs for investment, e.g. a "green transition" in the public sector. Also, any future changes of the rather restrictive Danish borrowing rules for local government is an unknown factor.

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