SECTOR COMMENT

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Norwegian counties face financial strain amid rising costs

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Rising wages and expenses over the past two years have weakened the financial position of Norwegian local and regional governments, with cost inflation reducing operating margins and higher rates adding to the interest burden. In addition, following subdued investment during the Covid-19 pandemic, Norway's local and regional governments have increased their capital expenditure, which has contributed to a modest rise in the gross debt burden.

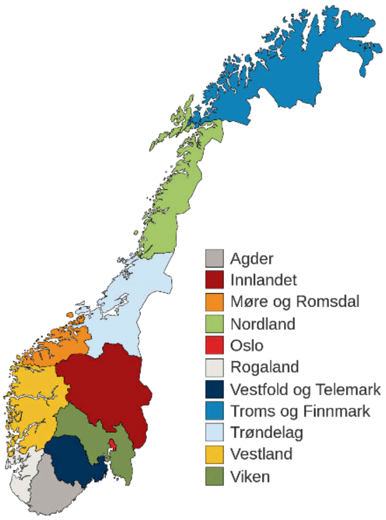
We believe higher costs and the need to provide essential services to residents will add pressure to local and regional governments' budgetary processes in 2024. Non-essential services are likely to be subject to cost cuts during these more economically challenging times, while essential services will be prioritised within tight budgets. Although we expect lower operating margins in 2024, general funds are strong following recent gains and should remain at current levels or decrease to cover additional costs, repay debt or finance investment.

Norway's institutional framework for local and regional governments is strong, with an equalisation system that mitigates wealth differences among counties and municipalities. However, there are still differences in operating performance between counties, in terms of operating margins, as well as in the size of financial reserves. Local and regional governments also have variations in demographic and geographical factors that influence the prioritisation of responsibilities.

This article takes a deep dive into the issues faced by Norway's regional governments (counties; *fylkeskommuner*). Nordic Credit Rating (NCR) published its final methodology for local and regional governments on 14 February 2024. The methodology defines NCR's approach to analysing the institutional framework and entity-specific factors for local and regional government entities that determine issuer ratings.

NORWEGIAN REGIONAL GOVERNMENTS

As of 1 January 2024, Norway comprises a total of 15 county governments. The increase from 11 counties in 2023 follows the division of Viken back into the counties of Akershus, Buskerud and Østfold. In addition, the counties of Vestfold and Telemark have divided into separate counties, as have Troms and Finnmark. All three divisions reverse the 2020 mergers of these counties.

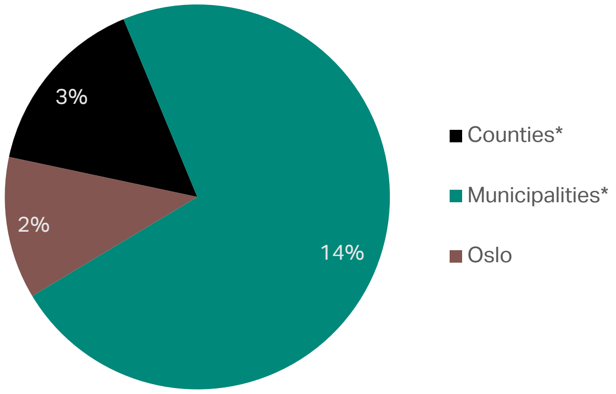


The expansion to 15 counties has created a need to reconsider the equalisation system and the calculation used to distribute funds to the counties. In addition, discretionary grants to the counties will be replaced by a standard grant per inhabitant, benefitting counties with a higher population density at the expense of less populous counties. A compensation and transition scheme will be used to ease the transition, but the impacts will be felt as early as 2024.

County governments have wide-ranging responsibilities in Norway, with transport, secondary education and dental health care among the main responsibilities. However, county governments' priorities vary, due to differences in demographics and size. The capital, Oslo, is the county with the highest population density, while Troms, Finnmark and Nordland, in the north, have the lowest.

The local and regional government sector is a significant part of Norway's economy, with total income of just under 20% of mainland GDP. The strong link between the performance of the Norwegian economy and the local and regional economies emphasises the importance of solid local governance and financial management. The pandemic and geopolitical instability of recent years have created uncertainty in both the Norwegian and the global economy. This continued into 2023, and inflationary pressure and heightened interest rates remain in 2024.

Figure 1. Income as a percentage of Norway mainland GDP, 2022



Source: Statistics Norway (SSB), NCR. *Excluding Oslo.

NOTE: Due to Oslo's status as both a municipality and county, we have excluded the capital from most figures in this article.

Interest costs for the counties increased by 48% between 2021 and 2022. Given the increases in market rates in 2023 and our expectations for 2024, we believe debt-heavy counties will continue to face an increased financial burden. However, consensus is that the policy rate will be lowered by Norway's central bank during 2024, which could provide some financial relief.

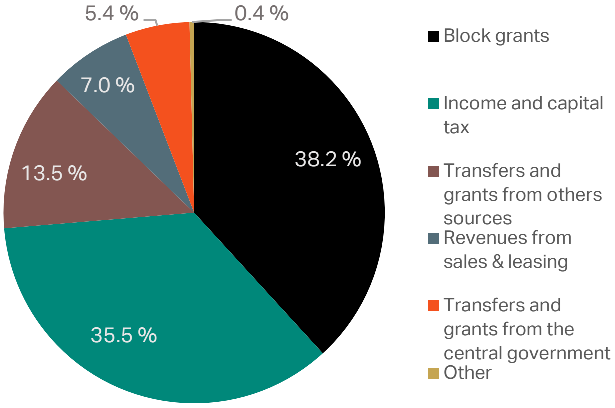
Norway has a far-reaching financial equalisation system that compensates counties with an adverse cost structure or a less favourable demographic profile, evening out per capita differences in local tax bases. Through block grants, involuntary differences in costs are fully equalised, whereas tax revenues (income and wealth tax on individual taxpayers and the natural resource tax on power companies) are partially redistributed. In our view, Norway's equalisation system is a strong framework for reducing wealth differences among county governments, but allows for some differences and limits flexibility to some degree.

HIGHER COSTS TO PRESSURE BUDGETS

According to the most recent data, total operating revenue for counties amounted to NOK 103bn in 2022, a 5% increase on 2021 as a result of low unemployment and a strong economy. Income and capital tax and block grants were the main sources of revenue, which are 'free' funds that the counties can prioritise based on local needs. Income and capital tax and block grants accounted for 74% of total operating revenue in 2022, in line with historical levels, and we expect the aggregated share to continue at this level.

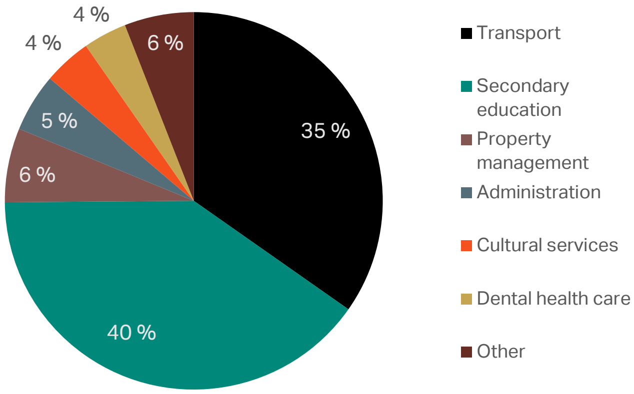
According to the national budget for 2024, these 'free' revenues will increase by 5.1% nominally from 2023 for counties. However, the increase in funds does not automatically result in increased policy flexibility, as the sector is subject to demographic changes and increased pension liabilities, as well as tighter economic constraints due to increased costs and interest expenses.

Figure 2. Counties' sources of revenues*, 2022



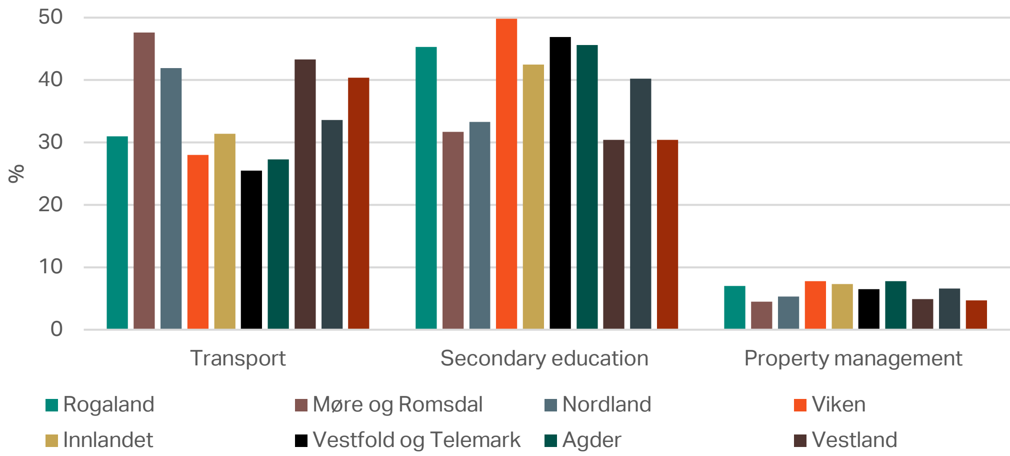
Source: Statistics Norway (SSB), NCR. *Excluding Oslo.

Figure 3. Counties' expenditure by responsibility*, 2022



Source: Statistics Norway (SSB), NCR. *Excluding Oslo

Figure 4. Counties' share of total operating expenditure by type, 2022



Source: Statistics Norway (SSB), NCR.

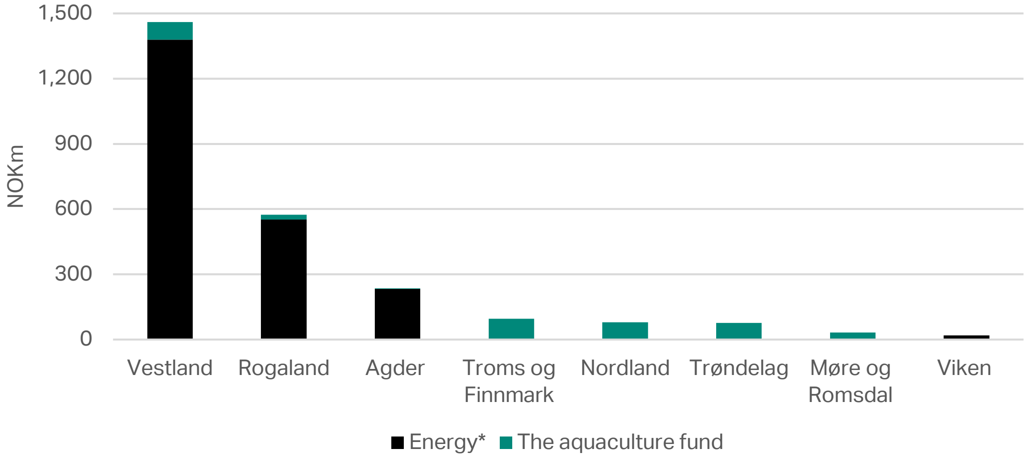
The figures in this report include the former counties of Troms og Finnmark, Vestfold og Telemark and Viken.

Total operating expenditure increased by 6% in 2022 and is expected to increase further for 2023 and 2024. The local and regional sectors wage and price deflator is estimated to show a 4.3% increase for 2024 in the national budget, with a 4.9% rise for wages and 3.4% price increase. The increased cost base is putting pressure on county budgets, and we consider it likely that some counties will have to implement material cost cuts or use a portion of their financial reserves in 2024.

SOME COUNTIES STRENGTHENED BY ADDITIONAL REVENUES

As taxation is largely decided by central government, tax flexibility at county level is somewhat constrained. As mentioned above, income and capital tax are also partially equalised. However, some county governments are better positioned to derive income from sources beyond traditional taxes and grants. We believe that counties with additional revenue streams, such as energy and aquaculture, have less financial pressure, enabling greater investment in residents' needs. County governments that host or have ownership stakes in power companies received additional revenues due to higher energy prices in 2022. Energy prices also remained high in 2023, albeit lower overall than the historical high of the previous year. Agder, Rogaland and Vestland were the counties with the highest share of their income derived from energy concessions, energy/power licences and other energy for resale.

Figure 5. Counties' income from energy and the central government aquaculture fund, 2022



Source: Statistics Norway (SSB). *Energy concession,energy/power licence and other energy for resale. Oslo, Innlandet and Vestfold ogTelemark excluded due to zero income.

The local and regional government sector received total income of over NOK 3.1bn from the aquaculture fund in 2022, including NOK 387m in disbursements to seven counties. The newly implemented resource rent tax on the sea-phase production of salmon and trout will provide host counties with increased and more stable revenues going forward (see relevant research). The central government has stated that local and regional governments should benefit from the revenues generated in the fish farming industry, which uses public resources along the coast. A budgeted increase in 2024 could enable those counties that receive income from the aquaculture fund to invest more in key services for residents.

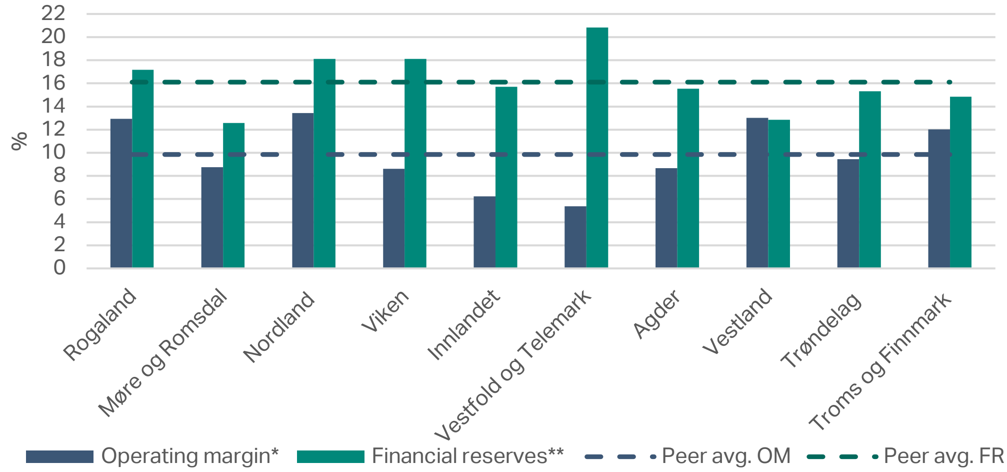
SOLID FINANCIAL RESERVES OFFSET POTENTIAL BUDGET DEFICITS

Solid operating margins in recent years have enabled counties to accumulate large financial reserves. However, we believe it is likely that the pressure on operating margins was greater in 2023, though we expect the counties to report solid results overall. Margin pressure is likely to continue in 2024 before receding due to reduced inflationary pressure and lower interest rates. We expect the counties to have lower operating margins at year-end 2023 and 2024, and allocations to general funds will not necessarily be the main priority.

NCR's assessment of financial reserves and operating margins are conducted in tandem, recognising that existing reserves can serve to offset any potential deficit in operating results. If there is a negative accumulated operating result that exceeds 3%, or is not covered within two years, the county may be added to the ROBEK registry. The ROBEK registry identifies municipalities and counties that are in financial imbalance or have not met specific deadlines. While no counties are currently included on the ROBEK list or had accumulated deficits in 2022, 13 municipalities are registered on the list as of 6 Feb. 2024.

Based on the latest available figures, the average county operating margin (excluding depreciation) was 9.8%. The average share of financial reserves in relation to total operating income was 16.1%. Rogaland, Nordland, Viken and Vestfold og Telemark had strong financial reserves, while Rogaland and Nordland were among the counties with the highest operating margins. Vestfold og Telemark had the lowest operating margin in 2022, though its large financial reserves serve as a solid liquidity buffer.

Figure 6. Operating margins and financial reserves as a share of operating income, 2022



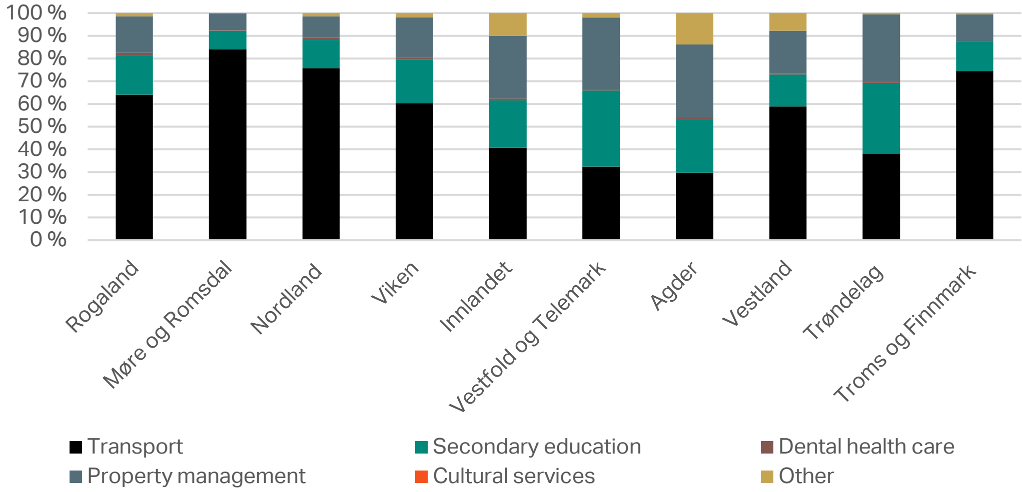
Source: Statistics Norway (SSB), NCR. *Excluding depreciation and interest costs. **Includes general funds and accumulated operating result.

SIGNIFICANT NEED FOR FURTHER TRANSPORT INVESTMENT

Counties' total gross investment expenditure increased by 6% in 2022 compared with 2021, when the level of investment decreased during the pandemic. Transport, secondary education and property management were the largest areas of investment, in that order. Investment related to transport has risen over the past 10 years, while investment in secondary schools and cultural services has decreased. In 2022, a significant portion of transport investments was associated with county roads, as well as environmental and traffic safety measures. We believe, this, along with other future investment needs, will remain elevated.

Norway's road network consists of both national and county roads, and budgetary responsibility is divided between the central and county governments. The Norwegian Public Roads Administration estimates the total maintenance backlog for county roads at up to NOK 100bn. While the current central government proposal includes around NOK 10bn for the operation and maintenance of the national road network in 2024, only an additional NOK 415m has been earmarked in grants for the maintenance of county roads. As a result of the significant maintenance backlog for county roads, it has been widely discussed whether central government should grant more earmarked funds to the counties or bring county authority roads under central government responsibility. To compensate, some county governments might use their financial reserves to cover increased investment expenditure, which implies a potential decrease in financial reserves going forward, or the need to access external financing.

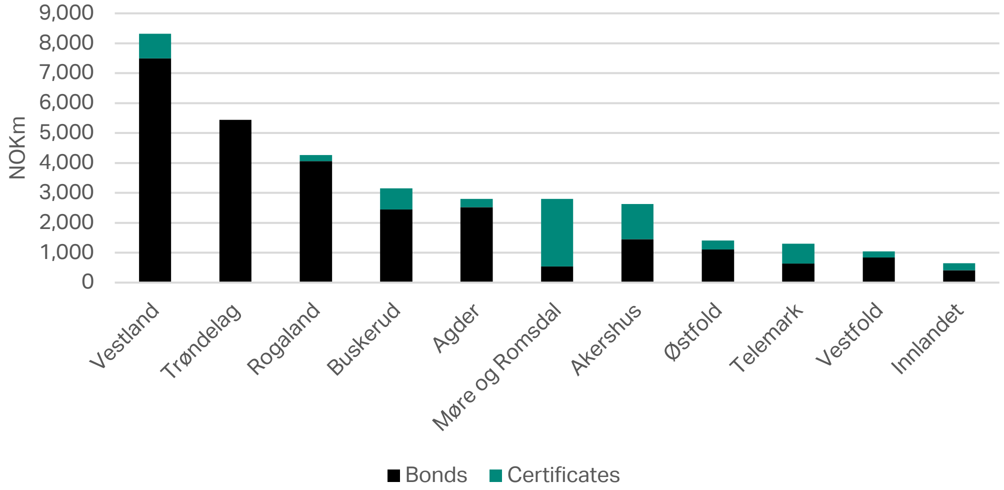
Figure 7. Counties' gross investment expenditure by area of responsibility, 2022



Source: Statistics Norway (SSB), NCR

We expect the debt burden for some counties to increase due to elevated investment needs, coupled with somewhat weaker revenue growth due to a slowdown in economic activity. Local and regional governments have access to both government-backed funding and the capital markets. There has been a steady increase in the number of local and regional governments tapping into the bond market, and about 40% have outstanding bonds. As of 8 Feb. 2024, the total outstanding amount for Norway's local and regional government sector is NOK 242bn. Some 12 out of 15 counties are utilising the bond market, with a total outstanding amount of NOK 86bn; NOK 51bn from Oslo and NOK 34bn from the other counties.

Figure 8. Counties' outstanding amounts in the capital markets, 8 Feb. 2024



Source: Stamdata, NCR

EXTREME WEATHER COULD INCREASE INVESTMENT NEEDS

We have also recently seen an increase in extreme weather events, likely due to climate change, which are expected to continue to pose a challenge and require further investment. Storm Hans in 2023 did major damage to infrastructure and housing across Norway. The central government has thus far supported local and regional governments with NOK 704m of funding to compensate for increased costs related to Storm Hans, including significant disbursements to the counties of Innlandet and Viken of NOK 250m and NOK 100m, respectively. This highlights the growing need for robust preparedness for flood and landslide protection, which are likely to increase in the foreseeable future, and we also expect investments in this regard to rise. In general, we expect natural disaster relief funding to continue to come from central government, but the impact of climate change and increased weather volatility will require new criteria for urban planning and difficult decisions about which areas to avoid and which to reinforce. The related implications and infrastructure investment are likely to be costly for the counties.

RELEVANT RESEARCH

(i) Local and Regional Government Rating Methodology, 14 Feb. 2024
(ii) Norway salmon farms face sharp tax hike, 29 Mar. 2023

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