

# Summary and conclusions

## Background

After several years of weak financial results, where many Norwegian municipalities were put under direct financial supervision by the county governor, municipal finances are now definitely improving. In the political debate, there now seems to be a certain concern about the fact that the municipalities might use the present strong earnings growth to pay down debt rather than to improve their range of services.

## Mandate/questions

*The mandate (from KS) for the project is as follows:*

- a) To present in an easily accessible way why the municipal sector needs to operate with a "surplus" (i.e. positive net operating result) – and how the term "surplus" should be defined in this context.*
- b) To assess how other indicators/sets of indicators than the net operating result can be employed to reflect the financial situation in the municipal sector as accurately as possible.*

The project was carried out under the leadership of ECON, with Geelmuyden.Kiese as subcontractor.

## Why should municipalities have a financial "surplus"?

In the long run, neither municipalities nor individuals or private companies can have costs that exceed their revenues. The concept of "result" as used in the municipal sector, however, does not manage to capture and reflect all costs as accurately as the results of private companies do. The most important indicator used to measure balance in the municipal finances is the net operating result. This indicator has a major weakness: Not all costs for depreciation in the assets of the municipality – buildings, furnishings, machinery etc. – are subtracted when the net operating result is calculated. This means that the net operating result is "too high" as a measure for the difference between costs and revenue. Therefore the net operating result does not measure the "surplus" in a municipality in a way that guarantees a sustainable economic/financial development. A net operating result of zero in the municipal sector means that the financial situation is not sustainable over time.

In addition, the net operating result is influenced by accidental fluctuations in costs and revenues, and by the fact that a part of the municipalities' income is earmarked for special purposes. This makes it even more problematic to use the net operating result as a measure of financial sustainability for the municipalities. Therefore there is a need for other indicators that can be used as tools to measure financial sustainability.

## The municipal result ("kommunerresultat") – a new auxiliary indicator

As a basis to assess whether a municipality or county is on a sustainable financial trajectory, we would like to introduce the concept of *kommunerresultat*, the municipal result.

### *The municipal result as a new auxiliary indicator*

The main objectives for establishing the municipal result as a new auxiliary indicator are the following:

- Establish a better indicator for the municipalities' financial situation and sustainability than net operating result
- Simplify and improve communication with public opinion and the political environment both within the municipality and in national politics
- Simplify comparisons over time for one and the same municipality
- Simplify comparisons between municipalities.

The municipal result is calculated by adjusting the net operating result:

- **Instalments** will be replaced by depreciation/write-offs
- **Net appropriations to tied-up funds** will be deducted
- **Expenditures that cover previous years excess consumption** will be deducted
- Actual net interest payments (incl. dividends) will be replaced by an estimated average level for this variable
- **Nominal net interest expenditures is replaced by net real interest expenditures**
- Actual income from VAT compensation payments for investments will be replaced by an estimated number for VAT compensation based on an average level for the municipality's investments.

The introduction of the municipal result takes into account some of the objections against the net operating result as an indicator for sustainable financial development in the municipalities. However, an assessment of financial sustainability does of course demand that additional factors are taken into consideration. The new indicator is only meant to be an auxiliary indicator which will be used mainly for purposes of communication, but we believe that it could also be a useful tool for the municipal administration in the ongoing process of monitoring and assessing financial development in the individual municipalities.

The new auxiliary indicator does, however, pose some challenges. It demands some additional calculations on the top of the ordinary procedures for the accounts. The biggest challenge is the lack of data for write-offs/depreciation, which the municipalities need to estimate themselves.

### *Municipal result should be around zero*

The municipal result should be around zero in the long run. To achieve this, the municipalities need to finance all their operating costs themselves, while investments can be financed through loans. This means that increased real capital can be offset by higher debts. We believe that the fact that the municipal result should be around zero makes it easier to see and communicate if a municipality is on a sustainable financial trajectory or not than if other indicators are others.

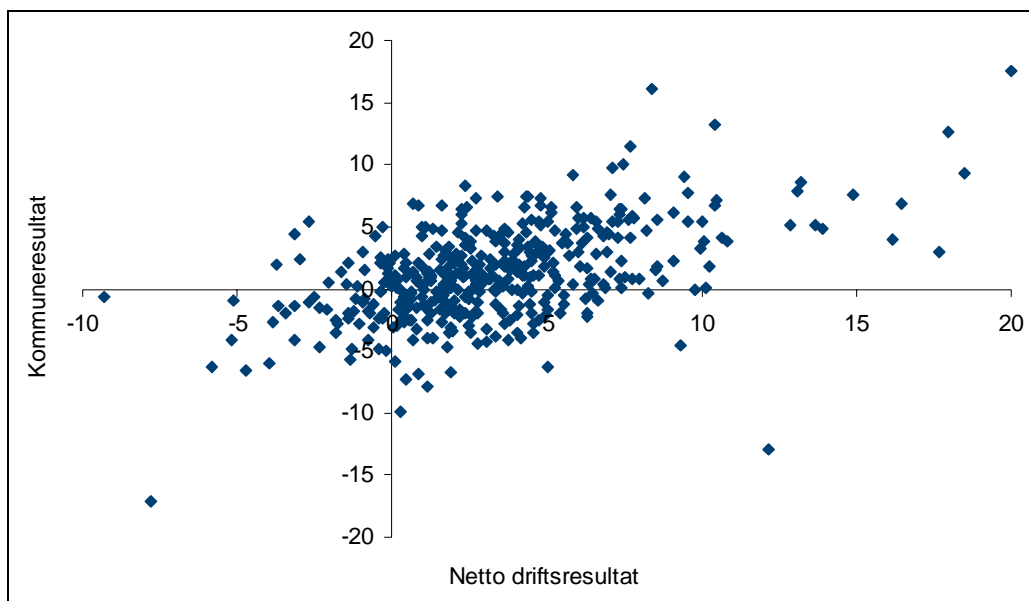
### **Classification of municipalities according to financial balance**

ECON has estimated the municipal result for all Norwegian municipalities on the basis of adjustments to the net operating result, as described above. While the average net operating result in 2005 was 3.9% of revenues, the municipal result was 1.1%. There is a clear tendency

for municipalities with high operating results to have high municipal results, too. However, the material shows that a difference in the operating result between two municipalities of 1 percentage point normally should lead one to expect a difference in municipal results of 0.5 percentage points only.

The correlation between net operating result and municipal result is also far from unambiguous (see figure A). Some municipalities have a high operating result and a low municipal result, while others have a low operating result and a high municipal result. The statistical correlation between those two targets calculated by the correlation coefficient barely reaches 0,4. This means that for individual municipalities, the two indicators can often give differing results.

*Figure A Relationship between net operating result and municipal result in 2005. Percent of gross operating income*



Source: ECON

## **Communication**

Discussions around and objections against the municipalities' financial administration, raise the question of how the municipalities should structure their communication regarding their economic and financial development. Successful communication is of critical importance for most businesses and organizations, also Norwegian municipalities.

We have here emphasized a small number of communication approaches/strategies that can help municipalities in their communication.

### **Strategies and approaches**

#### *Communication in accessible language*

One of the main problems when communicating about municipal finances is that for most of the population, dealing with the necessary numbers and terminology is not something that is required in daily life. This creates distance and makes it difficult to understand the big picture. For successful communication, language and terminology need to be simplified so that the inhabitants can understand what is being communicated.

### *Establishing a communication arena – The yearly meeting of the municipality*

We suggest to establish a new forum for communication, The yearly meeting of the municipality ("årsforsamling"), analogous to annual and general meetings in other sectors. The yearly meeting is meant to be an arena where all relevant interest groups meet; municipal employees, partners/collaborators, users, other inhabitants and the media. The political leadership in the municipality will present key numbers for finances and service levels, report on the status of major projects, and show which new projects and developments are planned for the future.

### *Yearly report by the municipalities*

The municipalities should consider preparing an annual report in a language and form that ensures that it is accessible to everybody who is interested.

### *Structured and planned communication*

Planning and a systematic approach to communication will give the best results. On the background of user studies and other available data, the administration needs to take responsibility for finding the municipality's success stories and plan when these should be presented to the press. News about the activities of the municipality should be communicated several times a year. The municipalities' yearly meeting will be one of the most important communication activities, and other activities should to a large extent be planned depending on the results, both financial and non-financial, that will be presented at the yearly meeting.

### *Communication plan for municipalities*

There is a difference between municipalities that treat communication as an integral part of their strategic planning, and others who employ ad-hoc solutions or leave it to be approached individually. Strategic communication will be very important for modern municipalities. Good communication is an efficient way of handling different interest groups. Both legitimacy and local democracy are strengthened when municipalities communicate efficiently with employees, partners, user groups and inhabitants. All municipalities should have a communication plan which includes, amongst other aspects, a good structure and timing for the yearly meeting, the annual report and other important communication events during the year.