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Local Government Indebtedness and Debt Management in Switzerland

Causes and consequences

SUMMARY: The indebtedness of local governments has the potential to be highly detrimental at both local and central government levels. The objective of the present case study is to present the indebtedness and subsequent restructuring of the municipality of Leukerbad, highlighting the causes leading to the debt, problem management, legislative actions taken in response to the matter and the evaluation of the effectiveness of these measures. The reasons for the indebtedness of Swiss local governments were the soft legal framework and non-adherence to various fundamental statutory regulations. A restructuring concept was developed to settle the debt, according to which the municipality – through an enterprise established for this very purpose – pays 22 per cent of accumulated debt to creditors and holds out the prospect of repaying a further 11 per cent. The majority of creditors ultimately accepted this restructuring concept. Legislators reviewed the Local Government Act of 1980 and drafted a new Act in 2004, as a result of which the financial situation of municipalities of the Canton of Valais improved considerably.

KEY WORDS: local government, public debt, indebtedness, debt management, Switzerland

JEL CODES: H39, H74, H81, H83

There are several public administration models in the world. These all define the number of government levels, as well as their scopes of duties and authorities, differently (thereby indirectly also defining the autonomy of the various government levels). The separation of local government levels from the central government is of considerable significance because the diversified needs of the members of society cannot be efficiently satisfied along the lines of the uniform (“one size fits all”) solutions of the central government (Oates, 2008). In other words: the maximisation of society’s welfare

can only be achieved by satisfying actual social needs, which can be accomplished more efficiently by the local community as they have more information regarding local matters than the central government (Vo, 2010).

According to the Democracy Index (2011) of *The Economist*, Switzerland is the 7th best functioning democracy in the world. This is reflected in state structure as well as even its smallest government divisions¹ have broad autonomy. The independence of local governments can also be observed in their financial management. This provides local administrators of affairs with a high degree of decision-making freedom, which in turn is accompanied by great responsibility as the risks arising from

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bad financial management appear at not just local, but at central government level as well (Rodden, 2002).

By the end of the nineties, debts of local governments in the Swiss Canton of Valais² suddenly became a topical subject. The reason behind this was the fact that in 1998 the news regarding the insolvency of the municipality of Leukerbad³ became public. Leukerbad at the time had 1 700 inhabitants and registered one million overnight stays a year.

The objective of this case study is to use Leukerbad's example to present the measures taken by the Canton of Valais that enabled the settlement of debts accumulated by the Leukerbad local government and prevented the further indebtedness of municipalities of the Canton.

Our article firstly points out the deficiencies of the earlier (1980) regulation which allowed Swiss local governments to set off on the road to indebtedness, after which we will detail the special case of the municipality of Leukerbad along with the solution applied. Subsequently, we will outline the measures (statutory amendments) taken to prevent cases similar to that of Leukerbad, and will also elaborate on the assessment of measures taken to curb indebtedness. The case study ends with a summary.

DEFICIENCIES OF THE LOCAL GOVERNMENT ACT OF 1980 OF SWITZERLAND

Before moving on to presenting the measures that enabled Leukerbad to resolve its seemingly hopeless financial situation and which contributed to calming the financial situation of other municipalities of the canton by 2012, we must first explore the reasons of this indebtedness. In this chapter, we will be elaborating on the related deficiencies of the Local Government Act of 1980 of Switzerland.

The provisions regarding budgetary equilibrium of this Act on the legal standing of local governments that was passed in 1980 were not restrictive. Article 71, for instance, stipulated that “*financial management should enforce the legal, equitable, economic and efficient use of funds as well as strive for budgetary equilibrium*”. Moreover, Article 72 stipulated that “*accounting statements should show a clear, complete and fair view of assets and liabilities*”.

This principle of budgetary equilibrium, however, though certainly praiseworthy, did not represent a binding force to the local authorities and as such, their annual budgets could present deficits and overdrafts. Due to a lack of specific statutory provisions, the deficit increased instead of dropping. The situation was sustained due to the absence of rules within the system establishing the obligation to reduce deficit.

In accordance with Article 74 of the Local Government Act, the accounts of the local authorities were subjected to a fiduciary audit. At the beginning of the given administrative periods, the municipal assembly had to elect an audit body from its own members which reported to the assembly on the accounts. The audits, however, failed to produce the expected results (with respect to budgetary equilibrium and the prevention of indebtedness) as there was no legal obligation to manage local government financial management in deficit.

The most important point of the cantonal-level financial audit was that the local authorities had to submit for approval by the Cantonal Government⁴ all decisions belonging to the competence of the municipal assembly⁵ where (1) loans taken out by the municipality exceeded 10% of the gross income of the previous fiscal year (excluding the consolidation of existing loans); or where (2) the loans granted were not sufficiently covered by guarantees and exceeded 1% of the gross income of the previous fiscal year.

Article 17 of the Local Government Act also

stipulated that the decisions of the municipal assembly, which were subject to the approval of the Cantonal Government, could enter in force only when approved by this authority. The consequences of disregarding this legal provision cannot be underestimated, even if at first glance they do not seem to be very strict. If, for instance, a bank grants a loan to a municipality without the prior approval of the Cantonal Government, said loan agreement is to be considered invalid. As a result, if a bank were to initiate a recovery procedure against the given municipality, there was no valid agreement to rely on and the bank was forced request legal remedy against the municipality on the grounds of illicit enrichment.

Furthermore, the Local Government Act provided for the possibility of placing municipalities under compulsory administration (Article 128). Compulsory administration could be ordered by the Cantonal Government if a municipality put its assets and financial equilibrium at significant risk. In the interest of implementing compulsory administration, the cantonal government raised the prospect of appointing commissioners.

LEUKERBAD

After having reviewed the regulatory deficiencies, let us now take a look at the reasons that led to Leukerbad's debts and what measures were taken to restore the local government's solvency.

Financial situation of the municipality of Leukerbad at the end of 1997 – The reasons of indebtedness

In the span of a few years, Leukerbad had accumulated astronomic debts, amounting to EUR 148 million by the end of 1997. With a population of 1 700 inhabitants, the gross debt per resident amounted to EUR 87 500. In compar-

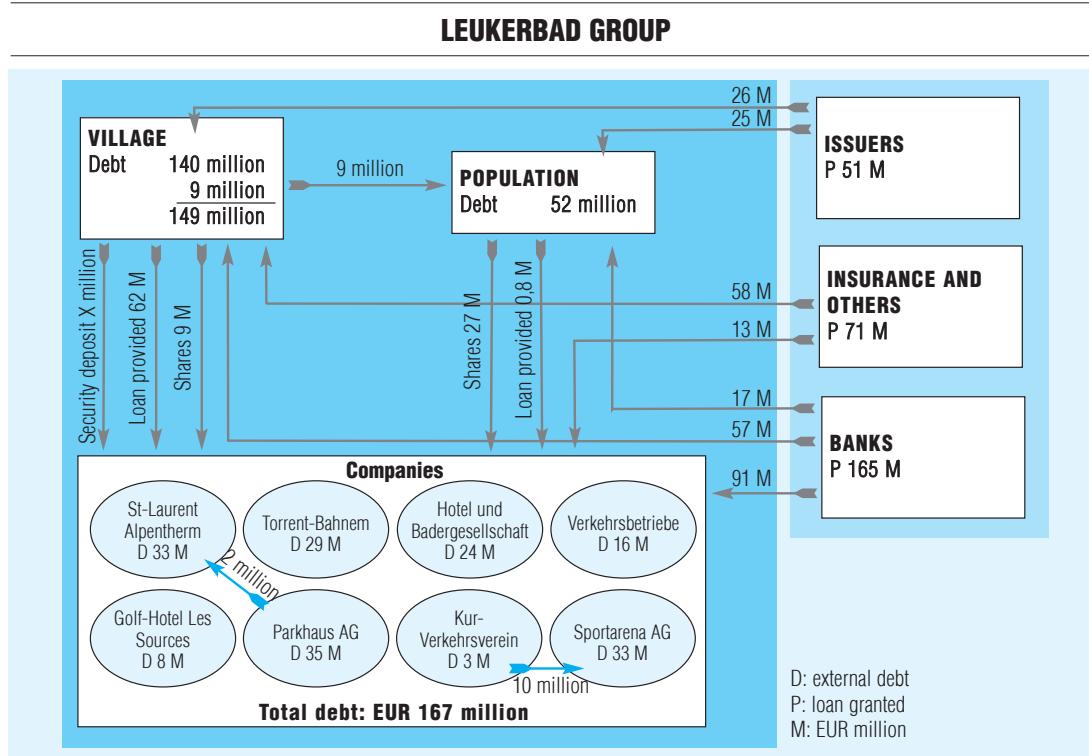
ison, on average, the gross debt per resident of the local authorities in the Canton of Valais at the time amounted to EUR 7 900. The reason for this indebtedness was that the municipality of Leukerbad acquired shares in and provided loans totalling EUR 82 million to joint stock companies in which, for the greater part, it held a majority stake. Due to financial difficulties, these companies were unable to pay the interests charged by the municipality for the loans granted to them. As a result, Leukerbad was forced to take out new loans in order to be able to pay its own creditors. This was allowed to happen because the municipality failed to submit for approval the loans granted to these companies or the loans taken out for itself.

Given the situation at the beginning of 1998, the Cantonal Government appointed the Audit Office of the Canton of Valais to examine and audit the financial situation of Leukerbad. The reports issued by the Audit Office led the government to take measures to resolve the situation. The composition of Leukerbad's debt is shown in *Chart 1*.

Submission of the local authority to compulsory management by the Cantonal Government

After the Audit Office completed auditing of the municipality's finances, the Cantonal Government implemented the measure contained in Article 128 of the Local Government Act, i.e. in October 1998; it placed the municipality of Leukerbad under partial compulsory administration. Commissioners were on the opinion that the municipality was able to assume debts for a maximum amount of EUR 33.3 million. In March 1999, they submitted a restructuring plan to creditors, which featured a waiver of 80 per cent of claims (in a total value of EUR 120.4 million). The creditors rejected this plan.

Chart 1



On a related note, we must mention the Swiss Federal Act of 1947, which regulates legal proceedings against municipalities and other public local governments in case of indebtedness. This act provides for placing a municipality under the care of an administrator if it is expected not to be able to meet its financial commitments in the long-run. This legal measure is applied if the asset management implemented by the canton proves to be insufficient. Until the “special case” of Leukerbad, no other local authority was ever placed under the care of an administrator in Switzerland.

Placement of the municipality under the care of an administrator

In July 1999, at the request of the canton, the Cantonal Court ordered the placement of the municipality of Leukerbad under the care of an administrator in accordance with the federal act

regulating legal proceedings against municipalities and other public local governments. Placement under administration is not a simple measure of supervision, but a legal procedure, the primary objective of which is to protect the interests of creditors.

The problem of placing a local authority under the care of an administrator is that debts remain (and do not cease as a result of the measure), and as such do not become irrecoverable. In light of the statutory provision, there were in fact only two solutions to restore the financial situation of the municipality: (1) the assumption of debts by the canton, (2) or the waiver of claims by creditors.

Indemnity procedures against the Canton of Valais

Four creditors and the municipality of Leukerbad itself lodged complaints with the

Swiss Federal Court accusing the canton of not performing the supervision of the municipality appropriately. The Canton of Valais defended its position on the grounds that it cannot assume responsibility for errors committed by third parties. In its decision of 3 July 2003, the Federal Court rejected liability claims on the grounds that: the culpability of the Canton of Valais cannot be determined with respect to the errors committed by the municipality local government and the financial institutions as the plaintiffs failed to adhere to even the most basic regulations when assessing loan applications.

Restructuring concept

Under the aforementioned circumstances, the administrator came to the conclusion that of its outstanding debt of EUR 151 million, the municipality would be able to repay EUR 33.3 – 22% of the total debt. At the time, the local government had available funds of EUR 12.5 million; therefore, it was forced to have a third party finance a further EUR 20.8 million. On the basis of these facts, the administrator formulated the following restructuring plan.

- ▶ It establishes a joint stock company under the name of “Sanag Leukerbad AG”, in order to settle (purchase) Leukerbad’s debt, while ensuring that all creditors receive equal treatment.

- ▶ The Canton of Valais grants a EUR 25 million guarantee covering the EUR 20.8 million loan the joint stock company has to take out from financial institutions.

- ▶ The joint stock company repurchases the debts of the municipality of Leukerbad.

- ▶ Creditors who accept the restructuring plan are paid a 22% dividend of the value of their claims on repurchase, but not later than 31 December 2003.

- ▶ Provided the sale of the low-voltage electrical network and the St-Laurent water

source⁶ to creditors goes through before 31 December 2023, the creditors accepting the restructuring plan will receive a further 11% on top of the 22% by 31 December, 2023 at the latest.

- ▶ The municipality must commit to separate a minimum amount of EUR 750 000 every year of its operating expenses, which are then to be proportionately divided to decrease transferred (to Sanag Leukerbad AG) and unassumed debts.

- ▶ After the payment of the aforementioned annuity of EUR 750 000, the municipality can use a maximum of EUR 750 000 per year for investments – if the surplus calculated on the basis of gross cash flow exceeds this amount, it shall use the difference to repay debts.

The restructuring plan is shown graphically in *Chart 2*.

Successful restructuring

In its resolution of 4 December 2003, the Parliament of the Canton of Valais agreed to grant a guarantee for the EUR 20.4 million. The guarantee, however, was granted on the condition that the Audit Office of the Canton of Valais be appointed auditor of the financial management of Sanag Leukerbad AG⁷.

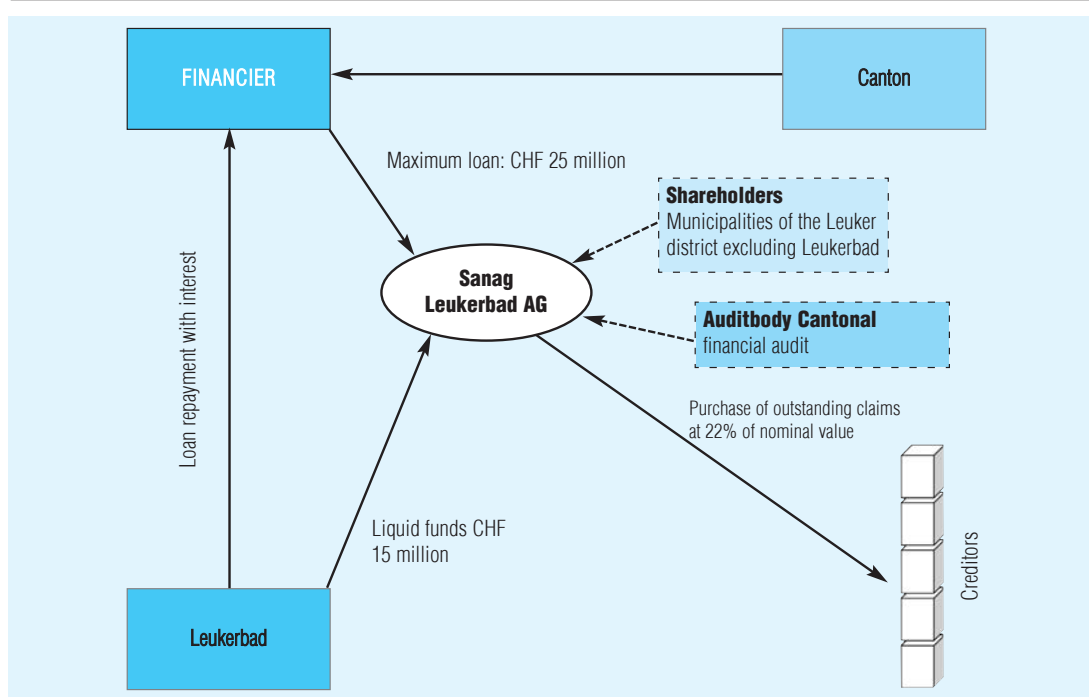
As already pointed out, on 31 December 2003, the administrator acknowledged the debt of EUR 151 million. The creditors waived 97.3% of claims amounting to EUR 147 million. At present, only a debt of EUR 2 million remains that has not been transferred to Sanag Leukerbad AG due to legal proceedings.

The restructuring of the financial situation of Leukerbad is still in progress. At the end of 2003, the amount of debts covered by a state guarantee reached EUR 20 million. By the end of 2011, this amount dropped to EUR 12.4 million.

Without the creditors waiving debts, the recovery of the financial situation of the munic-

Chart 2

COLLATERAL PROVIDED TO SANAG LEUKERBAD AG



ipality would not have been possible, since the volume of loans granted by creditors were disproportionate compared to Leukerbad’s financial capacity. The extension of loan terms or the reduction of interest rates would not have led to such a recovery.

POST-LEUKERBAD

The “special case” of Leukerbad alarmed creditors and as a result they became much more restrictive with regard to financing local governments. They increased the interest rates of loans offered to the municipalities of Valais. These latter also became more cautious and postponed several investments – the situation helped improve municipal finances.

At the same time, however, legislators also acknowledged that the statute in force must be reviewed in order to resolve and eliminate the deficiencies therein. Increasing state centralisa-

tion would have been a simple and obvious solution on the part of decision-making powers and would have entailed weakened autonomy at the local government level. The final solution was the exact opposite of this, i.e. local authorities were given more responsibility while at the same time appropriate regulations were introduced. The new Local Government Act of 2004 reinforced the autonomy of municipalities and at the same time clarified the legal provisions affecting their financial management (among other things, by means of the stricter regulation of measures to be taken in case of budgetary deficit).

The Local Government Act of 2004 of Switzerland – New regulations

The new Local Government Act contained several new elements. Of the measures taken in the interest of maintaining financial equilibri-

um, we have summarised the most important measures as follows.

Standard accounting strategy

The accounting of municipalities must be established in line with the standard accounting strategy, while, thereafter, the principles of financial management will be determined by the government decree on the financial management of municipalities. Within this accounting model, the booking of transactions is made on an accrual basis and no longer on a cash basis.

Valuation of financial assets

In accordance with Article 47 of the Decree on the financial management of municipalities, financial assets must be depreciated if losses or depreciations occurred. The valuation of financial assets thus follows commercial principles.

Valuation of local government assets

The valuation of both loans and shares comprising municipality assets must be performed according to commercial principles. The various asset elements (schools, roads, sports facilities, sewage, drinking water supply, Steps, etc.) are to be depreciated up to 10% of capitalised value. We must note that the total or partial suspension of depreciation is forbidden.

The financial equilibrium of local governments

In case of a balance sheet deficit, the local authority has to formulate a financial plan including financial consolidation measures which must be submitted to the Municipal and Cantonal Assembly. Parallel to this, during the elaboration of the budget, over expenditures can be budgeted only if covered by the net assets of the municipality. Finally, if the municipality's financial equilibrium is not ensured in the long-run, the Canton Assembly shall assign a coach (adviser) to the municipality at

the municipality's cost. The adviser is responsible for drawing up the municipality's financial plan and proposing financial consolidation measures.

THE RESULTS OF THE NEW REGULATION AND FURTHER MEASURES

The new Local Government Act of 2004 increased requirements for audit organisations and has also contributed to increasing the professionalism of audit activity. By fixing the depreciation rate of municipality assets and through the obligation to maintain financial equilibrium, the curbing of indebtedness at the level of municipalities of the Canton of Valais commenced.

After this, on 1 January 2005, the canton armed itself with a demanding instrument that integrates the dual brake aimed at curbing expenditure and indebtedness into the statutes. According to this, neither the budget nor the annual report are allowed in the future to show a deficit and the canton is prohibited from becoming indebted. The capital available to the canton (EUR 1.2 billion) could serve to restructure the pension fund or to cover extraordinary expenditures.

With respect to the aforementioned dual brake, the provision on curbing expenditure and indebtedness also stipulates certain exceptions. In extraordinary cases, the so-called 'Great Assembly' – the organ discharging legislative powers of the Canton – can grant exemption from this requirement. Such extraordinary cases might include a difficult financial situation, natural disaster, occurrence of grave or extraordinary events, or other events that cause unforeseeable welfare loss. The exemption, however, does not give free reign; it does not allow the easing of budgetary discipline as the law obliges cantons to settle the deficit arising out of said exceptional cases

in five years. These five years – in case of an extraordinarily grave situation – can be extended by a further two years.

The dual brake aimed at curbing expenditure and indebtedness is an extremely strict statutory provision. The canton and the parliament are both forced to adjust expenditures to revenues. Without the brake built into the Act, the Government and the Parliament would both find arguments to successfully expand the areas of state collaboration. As a result of the provisions detailed above, however, they are forced to outline their priorities more precisely.

In Switzerland, the majority of cantons have statutory provisions in place that aim to establish budgetary equilibrium, ; this also holds true for the federal state level, where provisions aimed at curbing indebtedness have been in force since 2003. The need to create budgetary equilibrium is also present in the Constitution, and as such has a direct impact on the whole of the financial management of the Federal State of Switzerland. On the one hand, the goal is to prevent the creation of chronic budgetary deficit and the increase of debt, and on the other, to prevent the costs of the present to be shifted to generations of the future.

The Canton of Valais is the only Swiss canton to have introduced the aforementioned dual brake.

SUMMARY

The new Local Government Act has been in force for eight years now. In this regard, we can conclude that the dual statutory requirement regarding depreciation allowance and financial equilibrium proved to be effective in practice. Though the at least 10% depreciation of municipality assets might seem exaggerated, it strongly contributed to restoring the financial position of municipalities. As a result, the

financial situation of municipalities in our canton can currently be considered good, perhaps even great.

Upon seeing the results of the new regulation, we can consider the procedures established for the financial supervision of municipalities effective and correct. The continuous information provided to local governments call attention to the risks arising out of their financial management, thereby contributing to correct decision making.

The finances of the Canton of Valais have also been restored. The new regulation, voted for by the Swiss people, which was enshrined in the constitution in 2001 and which entered into force in 2005 with the act on its implementation, aimed to curb expenditures and indebtedness through the so-called dual brake and in the end did produce the expected results.

A further lesson of this case is that treating financial equilibrium unilaterally is insufficient, particularly if the rate of available incomes is not enough to meet debt service requirements – besides expenditure rationalisation, sacrifices by creditors are also necessary.

The public finance discipline set out by the statutory provisions of the three public administration levels within the Swiss federal system⁸ has proved that it is possible to keep indebtedness in check and that this state of indebtedness can be resolved with the help of available tools.

It is clear that in light of known provisions, decision makers are no longer able to treat each and every project as priority projects to be implemented (as shown by the Leukerbad example) – they are forced to set up an order of priority taking account of available funds.

To act and not subsequently react to events! This is the path that lets us to look to the future with hope and allows us to minimise the chances of unwanted external help that at times could even endanger autonomy.

NOTES

¹ Dorf – village (www.about.ch, 2012)

² Kanton = canton, state

³ Municipality in the southwestern part of Switzerland

⁴ Government division of the given canton

⁵ The general assembly is made up of residents authorised to vote in the municipality. During general assemblies, residents can directly vote on implementing or rejecting a given plan. In the larger municipali-

ties, it is possible to delegate the powers of the assembly to a democratically elected general council.

⁶ A tourism attraction under town ownership.

⁷ As statutory auditor of Sanag Leukerbad AG, the Audit Office of the Canton of Valais checks compliance with the provisions of the restructuring agreement with respect to the various partners.

⁸ the federal state, the canton (state) and the municipalities

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