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Research

Basel-Country (Canton of)

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ISSUER CREDIT RATINGS

Basel-Country (Canton of)

Issuer Credit Rating AAA/Stable/A-1+

Basellandschaftliche Kantonalbank

Issuer Credit Rating AAA/Stable/A-1+

AFFIRMED RATINGS

Basellandschaftliche Kantonalbank

Certificate Of Deposit AAA/A-1+

Sr unsecd debt

Local currency AAA

Issuer credit rating history:

Nov. 21, 2001 AAA/A-1+

Major Rating Factors

Strengths:

- Good financial performance, with operating surpluses and slight deficits after capital expenditures on average over the past five years;
- Highly sophisticated management, committed to implementing a necessary savings program;
- Net contributor to the Swiss fiscal equalization system;
- High wealth levels by national and international comparison; and
- Increasingly diversified economy with good growth prospects.

Weaknesses:

- Weakening trend in budgetary performance; and
- Limited revenue-raising flexibility on tax side owing to tax competition between cantons

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■ Rationale

The ratings on the Canton of Basel-Country, which belongs to the Swiss transjuristic region of northwest Switzerland (0.5 million inhabitants), are supported by its good financial performance, highly sophisticated management, and only moderately high debt levels. The canton also benefits from its diversified economy and high wealth levels. The positive rating factors are mitigated by the negative trend in budgetary performance and limited tax-raising flexibility. In the past, budgetary performance has been consistently good, with operating surpluses averaging 5.6% of operating revenues and deficits after capital expenditures of 1.1% of total revenues over the past five years (including 2004 estimates).

Nevertheless, budgetary performance has started to come under pressure, and can only be maintained in the future if the government's proposed consolidation program is approved for implementation by parliament and taxpayers. Approval of this program would demonstrate that the canton has the financial flexibility to improve budgetary performance. Currently, revenue-raising flexibility is limited, as it would be difficult to raise tax levels.

Besides improving annual budgetary performance, the consolidation program would also benefit debt levels. Debt is currently moderately high at an estimated 48% of operating revenues in 2004, and will only stabilize if consolidation measures are implemented. The commitment to implement consolidation measures, additional control systems, and the newly defined group function for its separated entities demonstrate the high level of sophistication of the cantonal administration.

Basel-Country's economy developed positively in 2004 compared with the confederation as a whole. The economic structure is highly diversified, with some dominance in chemicals and pharmaceuticals production, as well as in mechanical engineering products. Owing to the neighboring important urban center, the output structure has a higher secondary output (41%) than the Swiss average (27%). Wealth levels in Basel-Country are above Swiss and EU15 averages, with cantonal income per capita 111% of the Swiss average. Generally, unemployment levels are low by Swiss and international comparison, currently at a stable 3.4% (compared with 3.9% for Switzerland).

■ Outlook

The stable outlook reflects Standard & Poor's expectation that the Canton of Basel-Country will manage to improve budgetary performance by increasing budget consolidation and bringing future operating expenditures under control. We expect that the government will show ongoing commitment to restructuring public services and will implement sizable cost-saving measures, which should continue good budgetary performance. Furthermore, the trend toward debt reduction should continue. The rating would be negatively affected if the canton does not manage to reduce inflationary demand for public services.

■ Comparative Analysis

Basel-Country's economy is small compared with most of its peers but, like the Regional Municipality of Halton (AAA/Stable/--) in Canada, it benefits from its proximity to an urban center and from the domination of one or two sectors or employers. The canton's budgetary performance is weaker than peers in Table 1. German peers have a similar burden of contingent liabilities from public sector banks and pressure from unfunded pension liabilities, although Basel-Country's pension fund covers 82% of actuarial pension obligations.

Table 1 Canton of Basel County Peer Comparison 2003

	Basel-Country (Canton of)	Alberta (Province of)	Bavaria (State of)	Halton (Regional Municipality of)	Upper Austria (State of)	Zurich (Canton of)
Issuer credit rating*	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/--	AAA/Stable/A-1+	AAA/Stable/--
<i>Three-year averages, using actual results only</i>						

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Operating balance (% of operating revenues)	5.4	17.2¶	5.7	23.9	17.8§	7.0
Balance after capital expenditures (% of total revenues)	(1.1)	9.1¶	(5.0)	3.8	5.0§	1.2
Capital expenditures (% of total expenditures)	8.0	8.8¶	13.4	30.8	18.6§	9.6
Transfers received (% of total revenues)	17.7	10.4¶	7.4	9.3	44.5§	25.3
2003 (mil. €)						
Total revenues	1,221.1	15,255.7¶	31,872.5	275.0	4,127.5§	5,411.4
Modifiable revenues (% of operating revenues)	85.2	88.6¶	10.9	88.9	3.0§	72.8
Direct debt (at year-end)	619.3	3,435.1¶	22,303.0	70.3	0.0	4,038.5
Direct debt (% of operating revenues)	51.8	22.5¶	72.6	29.1	0.0	78.0
Tax-supported debt (% of total revenues)	99.6***	44.7¶	139.5	7.1	N.A.	207.9
Interest (% of operating revenues)	2.1	1.1¶	3.4	1.7	0.2§	3.4
Debt service (% of total revenues)	10.6	1.1¶	9.0	4.5	9.2§	15.8
Cash (% of debt service)	37.1	1,917.0¶	0.0	2,013.3	N.A.	114.1
Population	264,400.0	3,164,400.0	12,397,400.0	390,389.0	1,382,000.0**	1,245,683.0
Unemployment rate (%)	3.4¶	5.1	6.9¶	7.6	4.7§	4.6
GDP (nominal)	9,224.9¶¶	103,701.8	371,256.0	N.A.	33,431.30¶¶	N.A.
GDP (real) growth (%)	1.6	2.7	0.2	N.A.	0**	(0.4)
Total revenues (% of GDP)	14.8¶¶	14.7¶	8.6	N.A.	11.1¶¶	N.A.

*At Feb. 16, 2005. ¶Figures for 2004. §Figures for 2002. **Figures for 2001. ¶¶Figures for 2000. ***Figures for 1999. N.A.--Not available.

■ System Support and Predictability

Net contributor to fiscal equalization system.

Switzerland has a financial equalization system with vertical and horizontal components, which redistributes revenues from the financially stronger and wealthier cantons to the financially weaker ones, thereby compensating for the varying levels of financial and economic strength among the 26 cantons. Based on specific parameters, an index of financial strength is derived for each canton. In addition to revenue equalization ("direct equalization"), the federal government participates proportionally in certain expenditure items ("indirect equalization").

The index of financial strength is recalculated every two years and thereby redefines contributors and beneficiaries of the equalization scheme. The current index is valid for 2004/2005 and for Basel-Country is 116 (the Swiss average being 100), representing a decline from 120 for the previous period. Basel-Country ranks seventh out of the 26 cantons in the index.

As the confederation has implemented a consolidation program, the canton's accounts will be burdened as of 2005 by different measures and will also receive some additional--but not compensating--revenues.

Implementation of reformed equalization system expected 2008

The underlying principles of the Swiss cantonal equalization system have been renegotiated, as the current scheme has not sufficiently reduced the disparities between the cantons; set wrong incentives,

as parts of it are expenditure-based (indirect equalization); and is considered to be too complex. The new system will be based on tax potential rather than tax revenues, allowing for more flexibility and higher efficiency for cantons on the expenditure side. The new equalization system, which is planned to go into effect in 2008, will result in increased equalization compared with the current system. This is expected to burden the Canton of Basel-Country by Swiss Franc (SFr) 45 million (\$37 million) per year as of 2008, so that it will still be a contributor to the system.

Under the new equalization system, the Canton of Basel-Country and the Canton of Basel-City (AA+/Negative/A-1+) will further develop their cooperation. They will coordinate their health and hospital sector planning, education sector (university and colleges), infrastructure (public transport, airport, river harbors), and cultural affairs.

Redistribution of responsibilities between canton and municipalities.

In August 2003, Basel-Country implemented a new municipal equalization system, based on a redistribution of responsibilities between the canton and municipalities. With the exception of a onetime effect in the 2003 accounts owing to a change in accounting practice, these new tasks and the municipal equalization system have had a neutral effect on the canton as of 2004. Municipalities must balance their accounts within the next five years. Municipal supervision is strict. The canton can nullify illegal acts by municipalities (this has only happened once), issue instructions, or suspend local self-administration. A special equalization fund amounting to SFr5 million is set aside to provide last-resort assistance to municipalities.

■ Economy

The canton's economy is integrated in the Swiss economy nationally and integrated internationally into the Upper Rhine Euro Region, consisting of two million inhabitants including German region of southern Baden and the French southern Alsace region. The canton benefits from excellent access to national and international traffic, as it is a gateway to Germany and France (highways, railways, airport, Rhine river shipping). Nevertheless, its close interrelation and interdependence with the city of Basel is important in a regional perspective.

Strong population characteristics.

With 264,000 inhabitants, Basel-Country represented 3.6% of the Swiss population at year-end 2003. Forming a belt to the nearby city of Basel, population increases in the canton have averaged 0.4% per year over the past five years, owing to natural growth and inward migration, although the latter is on a declining trend.

The age structure reflects the Swiss average, showing a slightly aging trend, with 17% older than 65 in 2003. The dependent population represents 38%, which corresponds with the Swiss average.

Prospering wealth and leading economic growth area.

In 2002, Basel-Country's cantonal income per capita declined to SFr51,140 from SFr51,853, which is 5% above the Swiss average. Over the past five years, Basel-Country increased its relative wealth position continuously compared with its Swiss peers, ranking it seventh out of 26.

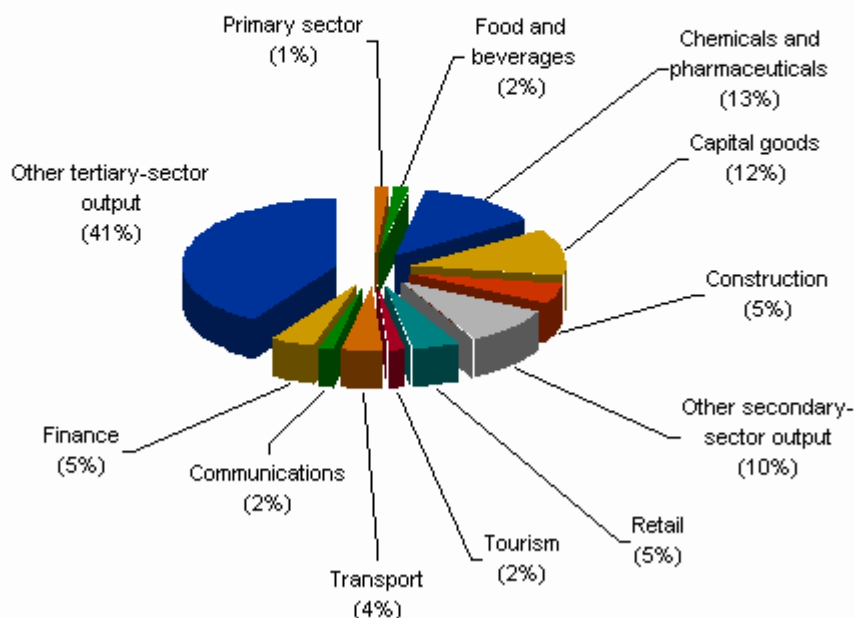
After a weak 2003, the Swiss GDP growth rate for 2004 is estimated at 1.8%, following improved domestic and international economic conditions. It is expected to slow to 1.5% in 2005. Basel-Country is expected to be among the growth leaders in Switzerland, benefiting from the cyclical-resistant structure of the cantonal chemical-pharmaceutical sector. Real GDP growth should average 2.3% until 2007.

Diversified economic structure.

The economic structure of Basel-Country is evenly balanced, although there is some dominance in the chemical and pharmaceutical sector. The canton has a higher degree of industrialization than the Swiss average, with a secondary sector output of 41% and tertiary sector output of 57%, compared with 27% and 71% nationally. This structure is partly the result of a shortage of areas for manufacturing sites in the neighboring Canton of Basel-City as well as the lack of a large agglomeration in the Canton of Basel-Country, which attracts business-oriented and financial services only to a limited extent.

Chart 1

Canton of Basel-Country - Economic Structure By Sector Contribution To Gross Value Added 2001



The chemical-pharmaceutical industry plays a key role in northwestern Switzerland. Its products contribute 12.7% to gross value added in the canton and 17% of gross value added to northwest Switzerland, with the trend increasing. Capital goods have an 11.8% (northwest Switzerland 6.3 %) share in gross value added, although its importance is declining. Therefore the chemical-pharmaceutical sector, in combination with the capital goods sector, represent both a strength and a weakness for the cantonal economy, but is better balanced than in the neighboring canton Basel-City.

Low unemployment levels.

Employment distribution by sector is 3% primary, 33% secondary, and 64 % tertiary. It is not concentrated to single employers. Only 17% of the workforce is employed in plants with more than 200 employees (representing 48 plants).

Unemployment in Basel-Country has consistently been below the Swiss rate, but increased again in 2004 to 3.4% (from a low 1.9% in 2002), compared with a national average of 3.9%. A large portion of residents of the canton (12%) commute to work in neighboring France and Germany.

Economic policy, which is stability-oriented, aims at further diversifying the economic structure. Furthermore, Basel-Country and Basel-City together promote the life sciences industry and related services.

■ Management Capacity and Institutional Legitimacy

Consensus-based democracy.

The cantonal parliament consists of 90 members (Landrat) and is elected every four years. The last elections in April 2003 reelected a right-wing majority. Six parties are represented. Although there was a slight move in favor of right-wing parties, stability and consensus in parliamentary sessions will be

maintained.

The government (Regierungsrat) is directly elected by the people for a four-year term. The last elections were also in April 2003. It consists of five, mostly right-wing members, each heading a department of cantonal administration.

The cantonal parliament has, in particular, to approve annual budgets, including a three-year financial plan as well as annual accounts.

Compulsory and facultative referenda and initiatives are held several times per year concerning cantonal or federal matters.

Restructuring of administration.

The cantonal administration is in the process of restructuring. Service mandates will be implemented for all sectors, with explicitly defined goals, indicators, and standards, accompanied by a systematic controlling process.

Parliament has to approve the government plan at the beginning of the governing period. The most prominent government proposals are the general review of responsibilities and services, the implementation of a specific control system, and group function responsibilities for separated entities.

With the implementation of the new equalization system between confederation and cantons, which will also include a redistribution of responsibilities, the cantonal administration will review internally all respective areas for efficiency gains.

■ **Financial Flexibility**

Below-average tax burden compared with competitors.

Although the canton has tax-rate-setting rights for income and wealth as well as for corporate profit and capital taxes, tax competition among the cantons make it difficult to increase the tax multiplier. In 2003, the tax index for individuals (94.6%, compared with the Swiss average of 100%) was the eighth lowest, but for corporate taxes it was sixth highest (116.8%). The overall tax index ranking for Basel-Country is ninth at 98.2 %. One political aim is to optimize the tax burden so as to remain competitive compared with its neighboring cantons.

Implementation of new financial strategy to consolidate budgetary performance.

The cantonal government has begun a general review of responsibilities and services over and above an ongoing restructuring of the cantonal administration that aims to exploit the existing potential for rationalization by concentrating support functions, prioritizing investments, and optimizing administrative processes. The current proposal should save an accumulated SFr135 million in the operating account by 2007. SFr80 million of this sum however, will depend on being accepted by parliamentary decision. Revenues should contribute 35% and expenditures 65% in the consolidation program. All responsibilities and services are under review for sustainable relief of operating accounts on the expenditure side (e.g. reduction of social subsidies, outsourcing of road construction and maintenance, outsourcing of office cleaning services, reduction in personnel). Revenue-raising potential is also expected to be examined (such as a cancellation of the rebate on vehicle tax, an increase in personnel for tax collection, and a refund for police services to municipalities). Tax increases would only be considered as a last resort. For 2005, the government has budgeted savings of SFr19 million.

Alongside its general review of responsibilities and services, the cantonal administration is also discussing setting fixed parameters concerning budgetary performance and debt levels by braking the increasing expenditure trend. This would achieve a balanced account in accrual terms. Debt levels and equity would

be stabilized. To meet this requirement, a control system based on several ratios with alternative paths of action is expected to be implemented. Parliamentary approval and a referendum for these proposals are planned for 2005, with implementation in 2007.

The canton has additional room for financial maneuver in its capital expenditures. In the near future, these are expected to stabilize at about 7%-8 % of total expenditures, or SFr150 million. Capital expenditures would only be cut, if needed. If the financial situation requires, capital expenditures could easily be postponed, as the canton's infrastructure is on highest standards.

■ Budgetary Performance

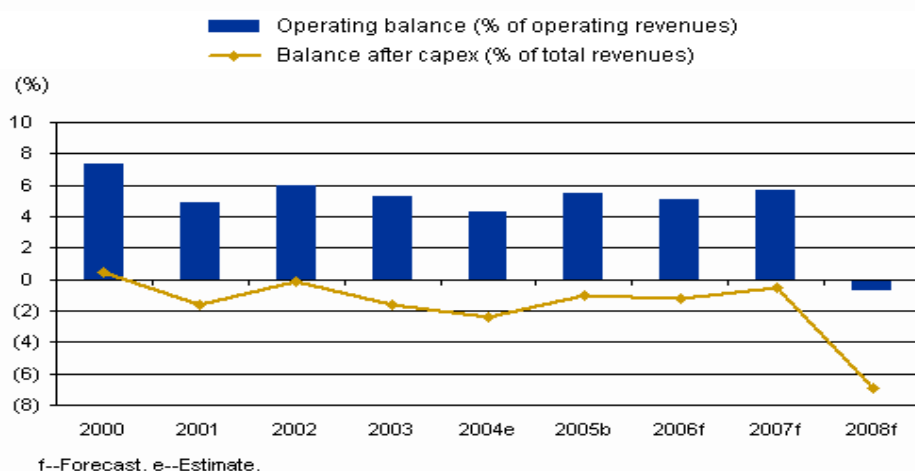
Continued challenge to improve financial performance.

Basel-Country has a proven track record of sound budgetary performance, with operating surpluses averaging of 5.6% of operating revenues, and deficits after capital expenditures of 1.1% of total revenues on average over the past five years (including 2004 estimates). Budgets have mostly been outperformed in year-end accounts, except in 2004. The canton has recognized this weakening in budgetary performance and has proposed measures to consolidate its accounts. The current financial plan (until 2008) shows that the operating accounts will be increasingly pressured, and only the proposed additional consolidation measures will result in a consolidation in financial performance. Usually, the canton sets conservative budget plans.

Actual results for 2004 are estimated to be slightly weaker than budgeted, with an operating surplus of 4.3% of operating revenues compared with 4.5% budgeted, and a deficit after capital expenditures of 2.4% of total revenues compared with a budgeted 2.3%. Although revenues came in higher than budgeted, expenditures also exceeded budgeted levels.

Total revenues increased by 2.5% on average over the past five years, but total expenditures have grown by 3.1%, thereby demonstrating the need for structural change. Therefore, the canton faces the challenge of improving operating and capital expenditure results by implementing and even extending the proposed measures, as ongoing deficits after capital expenditures are planned until 2008, accompanied by debt increases. Standard & Poor's, however, expects that the cantonal parliament and the taxpayers will approve the proposed measures.

Chart 2
Canton of Basel-Country Budgetary Performance



■ Liquidity and Debt Management

Comfortable liquidity position.

The canton has implemented rolling liquidity planning. It has regular payment streams on the expenditure side (such as wages), but revenues culminate at the end of January (vehicle tax), March (direct federal tax), and September (state taxes). To balance its liquidity position, the canton has access to a committed credit line of SFr50 million and an uncommitted SFr100 million. Financial assets (cash and equivalents) amounted to SFr69 million or 6% of operating expenditures at year-end 2003. This translates into 37% of 2003 debt service (no data available for 2004).

Moderate debt service levels.

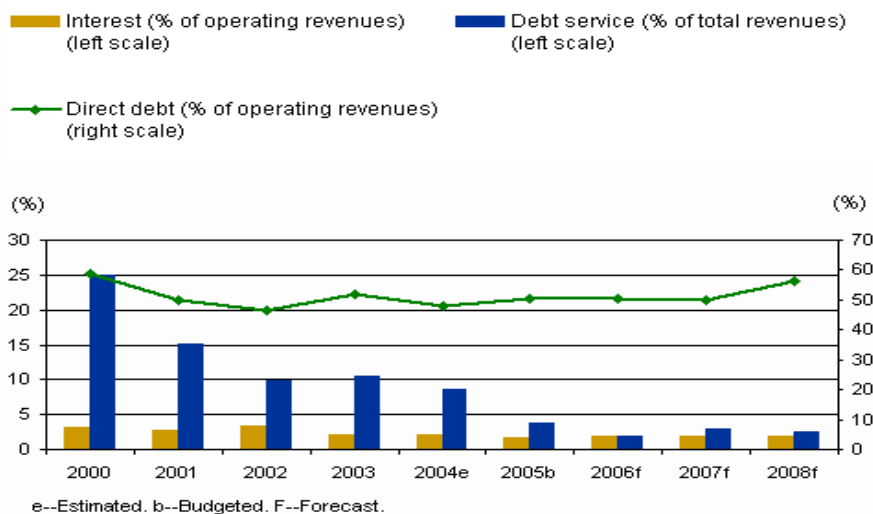
Debt management is conservative, with currently no use of floating-rate funds or derivative instruments. Authorizations exist for both, of SFr100 million each. Debt service hovers at about 10% of total revenues, not including any prepayments of debt. Interest payments account for a low 2%-3% of operating revenues.

■ Debt Burden

Having reduced nominal debt levels in the late 1990s, the canton only managed to stabilize its debt over the past two years at an estimated SFr1,061 million or 48% of operating revenues in 2004 (down from 52%). If the proposed measures were implemented, projected relative debt levels would show only a stabilizing trend. Nominal debt is projected to increase further, which could harm the rating on the canton. This debt level is moderately high compared with national and international peers.

Debt figures include equity contributions of SFr180 million to Basellandschaftliche Kantonalbank (AAA/Stable/A-1+). The bank has to refund the canton for the full interest service of the equity contribution. At year-end 2004, about 60% of Basel-Country's outstanding debt was in public bonds, the remainder being insurance and bank loans. The canton has no foreign-currency denominated liabilities. The federal parliament's decision to distribute the central bank's gold reserves will alleviate the canton's debt position, as it will receive SFr371 million, which is expected to be used to reduce the debt burden.

Chart 3
Canton of Basel-Country - Debt Burden



■ Contingent Liabilities

The canton's largest contingent liability is Basellandschaftliche Kantonalbank. In addition to the capital stock already brought into the bank, the canton is legally required to guarantee all of its liabilities.

Further contingent liabilities stem from legally required guarantees and accounted for 2% of its operating revenues. In addition, the canton guarantees the actuarial underfunding of its pension fund, which is currently 18% below actuarial liabilities and represents 54% of total cantonal revenues. The canton's operating accounts are not burdened by additional contributions to the fund's annual pension payments.

Besides Basellandschaftliche Kantonalbank, Basel-Country has several interests in public and private companies (transport, university, colleges, hospital). For public companies, it is the canton's intention to operate via defined service contracts, contributing to operating expenditures.

Participations in private companies are only held if its operations are of regional importance and affect the canton's economy and finances.

■ Financial and Economic Statistics Tables

Table 2 Canton of Basel Country - Financial Statistics									
	--Year ended Dec. 31--								
(Mil. SFr)	2008f	2007f	2006f	2005b	2004e	2004b	2003	2002	2001
Operating revenues	2,441.0	2,408.0	2,367.0	2,305.0	2,209.0	2,189.5	2,110.0	2,270.8	2,035.2
Operating expenditures	2,459.0	2,271.0	2,246.0	2,179.0	2,114.0	2,090.6	1,999.0	2,136.1	1,936.6
Operating balance	(18.0)	137.0	121.0	126.0	95.0	98.9	111.0	134.7	98.6
Operating balance (% of operating revenues)	(0.7)	5.7	5.1	5.5	4.3	4.5	5.3	5.9	4.9
Capital revenues	N.A.	N.A.	N.A.	70.9	64.4	64.4	45.0	36.7	28.4
Capital expenditures (capex)	150*	150*	150*	221.2	214.0	214.4	190.1	175.1	159.9
Balance after capex	(168.0)	(13.0)	(29.0)	(24.3)	(54.6)	(51.1)	(34.1)	(3.7)	(32.9)
Balance after capex (% of total revenues)	(6.9)	(0.5)	(1.2)	(1.0)	(2.4)	(2.3)	(1.6)	(0.2)	(1.6)
Debt repaid	15.0	25.0	0.0	50.0	150.0	150.0	185.0	150.0	256.9
Net budget loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance after debt repayment and onlending	(183.0)	(38.0)	(29.0)	(74.3)	(204.6)	(201.1)	(219.1)	(153.7)	(289.8)
Balance after debt repayment and onlending (% of total revenues)	(7.5)	(1.6)	(1.2)	(3.1)	(9.0)	(8.9)	(10.2)	(6.7)	(14.1)
Gross borrowings	183.0	38.0	29.0	75.0	204.0	226.0	270.0	150.0	200.0
Balance after borrowings	0.0	0.0	0.0	0.7	(0.6)	24.9	50.9	(3.7)	(89.8)
Balance after borrowings (% of total revenues)	0.0	0.0	0.0	0.0	0.0	1.1	2.4	(0.2)	(4.4)
Modifiable revenues (% of operating revenues)	79.3	79.8	80.4	80.6	81.6	81.1	85.2	80.0	81.0
Capex (% of total expenditures)	5.8	6.2	6.3	9.2	9.2	9.3	8.7	7.6	7.6
Operating-revenue growth (%)	1.4	1.7	2.7	4.4	4.7	3.8	(7.1)	11.6	(3.0)
Operating-expenditure growth (%)	8.3	1.1	3.1	3.1	5.8	4.6	(6.4)	10.3	(0.4)

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Direct debt (debt outstanding at year-end)	1,371.0	1,203.0	1,190.0	1,161.0	1,061.0	1,214.1	1,092.9	1,055.1	1,014.2
Direct debt (% of operating revenues)	56.2	50.0	50.3	50.4	48.0	55.5	51.8	46.5	49.8
Interest (% of operating revenues)	1.9	1.9	1.8	1.7	2.1	2.1	2.1	3.4	2.7
Debt service (% of total revenues)	2.5	2.9	1.8	3.8	8.6	8.7	10.6	9.8	15.1
Cash plus committed facilities (% of operating expenditures)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	5.9	7.8	8.0
Cash (% of debt service)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	37.1	77.9	40.5

f--Forecast.b--Budgeted.*Net capital expenditures. N.A.--Not available. SFr--Swiss franc.

Table 3 Canton of Basel-Country Economic Statistics								
	--Year ended Dec. 31--							
	2004	2003	2002	2001	2000	1999	1998	1997
Population	N.A.	264,400.0	263,194.0	262,934.0	262,165.0	261,380.0	259,485.0	257,822.0
Population growth (%)	N.A.	0.5	0.1	0.3	0.3	0.7	0.7	N.A.
Unemployment rate (%)	3.4	2.9	1.9	1.4	1.4	1.8	2.6	3.7

N.A.--Not available.

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