Fiscal policy audit report

Steering of local government finances

6/2018

Fiscal policy audit report

Steering of local government finances

Translation of fiscal policy audit report 6/2018

Helsinki 2018

Photos
Section 1 and 3: photographed by Elina Keckman, NAOF
Section 2, photographed by Ville-Veikko Heinonen, NAOF

Fiscal policy audit report of the National Audit Office

Registry no. 121/51/2017

The National Audit Office has conducted an audit of the steering of local government finances, which is included in its audit plan. The audit was carried out in accordance with the fiscal policy audit guidelines issued by the National Audit Office.

On the basis of the audit, the National Audit Office has issued an audit report, which will be submitted to the Ministry of Finance, the Ministry of Education and Culture and the Ministry of Social Affairs and Health. Copies of the report will also be submitted to the Parliamentary Audit Committee and the Government Financial Controller's Function for their information.

Before the issuing of the audit report, the Ministry of Finance, the Ministry of Education and Culture, the Ministry of Social Affairs and Health, Statistics Finland and the Association of Finnish Local and Regional Authorities were provided with an opportunity to ensure that there are no factual errors in the report and to give their views of the opinions of the National Audit Office contained in the report.

In the audit follow-up, the National Audit Office will determine which measures have been taken on the basis of the opinions presented in the audit report. The follow-up will take place in 2020.

Helsinki 22 March 2018

Marko Männikkö
Deputy Auditor General

Ville Haltia
Principal Fiscal Policy Auditor

Conclusions

Conclusions

Steering of local government finances has a significant role in ensuring the sustainability of public finances. In 2015, the overall steering of local government finances (macroeconomic steering) was reformed as part of changes to the general government fiscal planning. The aim of the reform was to meet the requirements laid down in the EU Budgetary Frameworks Directive. The system of central government transfers and the provisions of the Local Government Act steering the finances of individual municipalities (microeconomic steering) have also been revised.

The objective of the audit was to assess whether the Ministry of Finance is coordinating the steering of local government finances in an effective and efficient manner, as well as to ensure transparency of the steering of local government finances. Furthermore, the aim was to assess the changes made to the steering mechanisms, as well as the reliability of the knowledge base for steering of local government finances.

Overall, the measures taken to reform the steering of local government finances have been effective

On the basis of the audit, it can be stated that the steering system for local government finances mostly functions well. Communication between the different parties has improved along with the introduction of the new steering model for local government finances, and the further needs for development have been well identified.

The budgetary position in ratio to GDP target separately set in the General Government Fiscal Plan for local government finances (the budgetary position target) and the limit for expenditure arising to municipalities from central government measures (the expenditure limit) connect the steering of local government finances as part of the overall steering of general government finances. The Programme for Local Government Finances drawn up in connection with the General Government Fiscal Plan has also provided a deeper view of the state of local government finances and factors affecting it.

The reform of the Local Government Act also involved amendments to the provisions concerning local government finances. The new provisions steer the finances of individual municipalities more clearly towards the budgetary position target set for the entire local government sector. Another decision that has improved the efficiency of the steering of local government finances is that now corrections to the division of costs between central and local government, which is part of the system of central government transfers, are made annually.

The monitoring of the implementation of the expenditure limit and the principle of adequate financial resources is lacking

Setting a separate expenditure limit for the local government sector has improved the transparency of the funding of the basic services imposed by the state on municipalities. It has also become an important addition to the range of tools facilitating the achievement of the local government budgetary position target. However, the expenditure limit cannot alone guarantee that all central government measures targeted at the local government sector are in line with the objective of achieving the local government budgetary position target. Reduction in expenditure does not improve the local government budgetary position if revenues are also reduced at the same time.

Indeed, the expenditure limit is better suited to reflect the potential for savings in municipalities enabled by central government measures than actual reductions in the level of expenditure. On average, the savings impacts of measures performed to achieve the expenditure limit have been over-estimated. The audit revealed that the justifications for the expenditure limit set, the monitoring of the implementation of the expenditure limit, and the related impact assessments are not reported in a systematic and open manner. Furthermore, the justifications for the expenditure limit do not specify the uncertainties related to the impact assessments performed or contain any impact assessments on alternative measures.

The Programme for Local Government Finances provides information about the financial position of municipalities, but the practical impacts of the programme on the steering of local government finances and on local government decision-making remain limited. The Programme for Local Government Finances also covers the implementation of the principle of adequate financial resources. The principle of adequate financial resources means that the state must ensure that the financing issued to municipalities to perform their statutory duties is adequate. However, the analysis provided in the Programme of the implementation of the principle of adequate financial resources is rather mechanical and does not take a clear stand on the question whether the principle of adequate financial resources is followed.

Microeconomic steering could better support the achievement of the macroeconomic targets

The budgetary position target set for the local government sector is determined on the basis of the concept of net lending according to National Accounts, while the thresholds for the steering of local government finances are based on the concepts of municipal accounting. The differences between these two accounting systems reduce the transparency and efficiency of the system for the steering of local government finances. Instead of deficit,

a threshold determined on the basis of cash flows from operations and investments would be more compatible with the concept of net lending according to National Accounts, and its adoption would clarify the overall steering of local government finances. Cash flows from operations and investments has already been introduced as one of the key indicators in connection with the organisation of the steering of the regional government sector.

It seems that a group of municipalities of major economic importance still remains outside the scope of the microeconomic steering, although including them would be important in terms of the achievement of the macroeconomic steering targets. The purpose of the financial steering criteria laid down in the Local Government Act is to identify the municipalities in which the provision of the basic services is compromised. The criteria emphasise the need to cover any deficit in the municipality's balance sheet, which does not provide a sufficiently comprehensive view of the budget balance of the municipality. For example, depreciations have systematically been lower than what is recommended, which consequently has reduced the deficit. At the same time, investments in the local government sector have exceeded depreciations, which has enabled indebtedness to grow without breaching any thresholds set out in the Local Government Act.

The state contributes to the financing of basic services by means of central government transfers. The significance of central government transfers as the source of income for municipalities varies greatly: the significance is higher in municipalities with a higher need for services and a more limited revenue base. The system of central government transfers has been generally utilised in the practical implementation of adjustments to the financial relationship between central and local government, for example, to compensate municipalities for loss of tax revenue. Measures supporting the achievement of the macroeconomic steering targets, such as cuts in central government transfers or the incorporation of performance incentives into the system of central government transfers, could undermine the overall effectiveness of the system and have unintended consequences in municipalities.

The information base for local government finances and the steering processes do not support knowledge-based management

The efficiency of the steering of local government finances could be enhanced by developing the underlying information and its efficient and timely use. There is still room for improvement in terms of the comprehensiveness and comparability of data collected for the needs of municipal steering. The creation of standardised data specifications within the framework of the Local Government Data Programme (Kuntatieto-ohjelma) has enhanced

the quality of the knowledge base, but more attention should be paid to making the specifications binding. In the steering processes, the focus of analyses is on the ex-post assessment of decisions and on the transfer of data between different actors.

Abolishment of the misaligned incentives between central and local government finances was one of the objectives of the reform of the system for the steering of local government finances. It is essential to take account of the overall situation of general government finances in order to achieve the national budgetary position targets. Consequently, it is also important to coordinate the steering of local government finances outside the influence of representation of interests of individual subsectors of general government finances. Otherwise, the risk for over-emphasising the interests of central government finances increases in the preparation of measures targeted at the local government sector. Furthermore, attention should be paid to ensuring the independence of the party responsible for the coordination of general government finances.

Recommendations of the National Audit Office

Based on the audit, the National Audit Office recommends that the Ministry of Finance:

1. enhance the transparency of the justifications for the expenditure limit set, as well as the monitoring of its implementation;
2. further develop the comprehensiveness of the assessment of the implementation of the principle of adequate financial resources provided in The Programme for Local Government Finances;
3. enhance the coordination of the microeconomic and macroeconomic steering systems, improve the transparency concerning the differences between the systems, and further coordinate the rules steering general government finances. The budget balance requirement set for individual municipalities should be specified so that it can better steer the municipality towards the macroeconomic balance targets;
4. further develop the contents of the information base according to the needs of the local government steering. The rules and guidelines governing the data contents should be made more binding.

Contents

1 Scope of the audit

Steering of local government finances can be divided into macroeconomic steering targeted at the entire local government sector and the steering of the finances of individual municipalities, i.e. microeconomic steering. Macroeconomic steering is composed of the financial framework for local government finances, which is specified in the General Government Fiscal Plan (GGFP). The financial framework for local government finances specifies the Government policy decisions on the budgetary position target and expenditure limit for the local government sector, as well as the central government measures targeted at local government finances and the estimated impacts of these. Macroeconomic steering also covers the Programme for Local Government Finances, which elaborates the local government section of the GGFP and examines local government finances and impacts of central government measures by municipality categories and regions. The Programme for Local Government Finances also includes an assessment of the achievement of the principle of adequate financial resources. The effectiveness of the macroeconomic steering and achievement of the targets set for the macroeconomic steering are discussed in Section 2.

Microeconomic steering is based on the objective of balanced local government finances specified in the Local Government Act. An important tool in microeconomic steering is the assessment procedure for municipalities in a very difficult financial position, which is based on margins determined on the basis of the final accounts of municipalities, joint municipal authorities, and local authority corporations. If the margins are not observed, decisions are made under the procedure on the measures required to steer the finances of the municipality back on a sustainable path. In addition to microeconomic and macroeconomic steering, the audit focused on the system of central government transfers and its incentive impacts as a tool for the steering of local government finances. The effectiveness of the microeconomic steering and its compatibility with the macroeconomic steering, as well as the steering effects of the system of central government transfers are discussed in Section 3. In the audit, particular attention was paid to the reliability of the information base utilised in steering.

The steering system for local government finances refers to an entity composed of procedures, systems and practices supporting financial management, as well as related documentation. For the purposes of the present report, 'incentive' refers to procedures targeted at local government finances, which involve clearly set objectives. In terms of the overall steering system, incentives can also relate to other factors, such as selected data collection methods, data transfer processes, and practices of and between different parties.

The Ministry of Finance is responsible for the steering of local government finances as part of the overall steering of public finances. The Budget Department of the Ministry of Finance is responsible for the drafting of the General Government Fiscal Plan. The economic forecasts and trend projections for local government finances utilised in the steering of local government finances are drafted in the Economics Department of the Ministry of Finance. The Programme for Local Government Finances

is prepared by the Department for Local Government and Regional Administration of the Ministry of Finance, together with the Ministry of Social Affairs and Health, the Ministry of Education and Culture, the Ministry of the Environment, the Ministry of Transport and Communications, the Ministry of Economic Affairs and Employment and, if necessary, other ministries. The Association of Finnish Local and Regional Authorities also participates in the preparation of the Programme for Local Government Finances in its role as the representative of municipalities. Matters that have impacts on local government finances are also discussed in the Advisory Committee on Local Government Finances and Administration (Kuthanek). Provisions on the Advisory Committee are laid down in the Local Government Act.

The reformed model for the macroeconomic steering of local government finances was adopted in 2015, along with the new Government Programme and the first actual General Government Fiscal Plan. Prior to that, the overall steering of local government finances was primarily executed through the basic public services programme. The objective of the new macroeconomic steering system is to ensure the achievement of the principle of adequate financial resources and long-term sustainability of local government finances. The reformed Local Government Act entered into force in the same year. The reform involved, among other things, amendments to the provisions concerning local government finances. The reform of the system of central government transfers was implemented at the beginning of 2015.

In addition to the development measures implemented in recent years, the currently ongoing reforms will also have impacts on the steering of local government finances. For example, the information base for the steering of local government finances is undergoing a reform within the framework of the Local Government Data Programme (Kuntatieto-ohjelma) headed by the Ministry of Finance. The Local Government Data Programme focuses on the development of financial information, financial statistics and data management in the local government sector. It also aims to improve the production of financial information required in the drafting of the General Government Fiscal Plan and the Programme for Local Government Finances and in municipal decision-making, as well as access to such data. Another objective of the Local Government Data Programme is to improve the functional and information compatibility within general government. Furthermore, the programme aims to promote the development of data production and reporting so that the required information would be available to decision-makers at the right time and in a transparent, sufficiently extensive, and comparable manner.

The health, social services and regional government reform is estimated to transfer a significant proportion of the overall expenditure of the local government sector from municipalities to counties from the year 2020 onwards. At the same time, a corresponding amount of revenues will also be transferred from municipalities to the level of counties. The impacts of the regional government reform on local government finances are still partly clouded. The debt level of municipalities is estimated to remain at the current level, while municipal revenues and expenditure are expected to decrease. At the same time, the growth of municipal expenditure is also expected to slow down and its predictability to improve, which would make it easier for municipalities to plan their finances and implement investments.

The greatest investment pressures will be transferred from municipalities to counties. On the other hand, municipalities' financial leeway to balance their budget will be restricted. The budgetary constraints and financial management of counties, which rely on state funding, are foreseen to be stricter than those concerning local government finances.

The measures carried out over recent years to develop the steering of local government finances have provided this opportunity to assess the effectiveness of the current regulations and procedures, their potential impacts on local government finances and sustainability of public finances, as well as the achievement of the set targets. In addition, this audit could also have impacts on the management of risks involved in the ongoing reforms, and it could also reveal related opportunities and needs to develop the steering of local government finances.


VALTIOVARAINMINISTERIÖ
FINANSMINISTERIET
MINISTRY OF FINANCE

2 Does the macroeconomic steering of local government finances support the achievement of the objectives set for the overall steering of general government finances?

Overall, the reform of the system for the macroeconomic steering of local government finances has achieved the set objectives. The macroeconomic steering increases the information available about the local government sector and local government finances as part of the overall public finances. Communication between the different parties has also improved. However, the incentives involved in the macroeconomic steering of local government finances are target-driven, and the steering cannot guarantee the achievement of the set budgetary position target. The justifications for the setting of the expenditure limit and monitoring its implementation are not specified in an open and transparent manner, and the assessment of the achievement of the principle of adequate financial resources is superficial. There is also room for improvement in the impact assessments of the measures implemented. The reform of the information base will improve the conditions for the steering of local government finances. On the other hand, the health and social services reform will restrict the scope of the steering and municipalities' financial room for manoeuvre.

2.1 The macroeconomic steering system for local government finances strengthens the perspective of overall general government finances in policy-making

The macroeconomic steering of local government finances is based on the Decree on the General Government Fiscal Plan (120/2014[1]; 601/2017[2]). The decree transposes the key provisions of the Budgetary Frameworks Directive (2011/85/EU), which in addition to the requirements for budgetary frameworks also contains provisions on the requirements for budgetary reporting of Member States, drafting of economic forecasts, and applicable fiscal policy rules. In terms of the steering of local government finances, the most important provisions are laid down in Article 13 of the Budgetary Frameworks Directive, which stipulates that Member States shall establish appropriate mechanisms of coordination across subsectors of general government to provide for comprehensive and consistent coverage of all subsectors of general government in fiscal planning, country-specific numerical fiscal rules, and in the preparation of budgetary forecasts. Furthermore, in order to promote fiscal accountability, the budgetary responsibilities of public authorities in the various subsectors of general government shall be clearly laid down.

The EU Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) plays a key role in the achievement of the objectives set for the macroeconomic steering of local government finances. In Finland, the Fiscal Compact was transposed in 2013 through the Fiscal Policy Act (869/2012). The objective of the Fiscal Compact is to reinforce the budget discipline and coordination fiscal policy and to enhance financial steering and governance in the European Union and in the euro area. According to the Fiscal Compact, Member States must incorporate into the national legislation provisions concerning the medium-term objective (MTO) set for the general government structural balance and correction mechanism related to the achievement of the MTO.

The macroeconomic steering of local government finances is part of the European economic governance system.

The steering of local government finances is composed of several subsystems

The steering system for local government finances is formed of several components. Figure 1 provides an overview of the steering system for local government finances and its main elements.

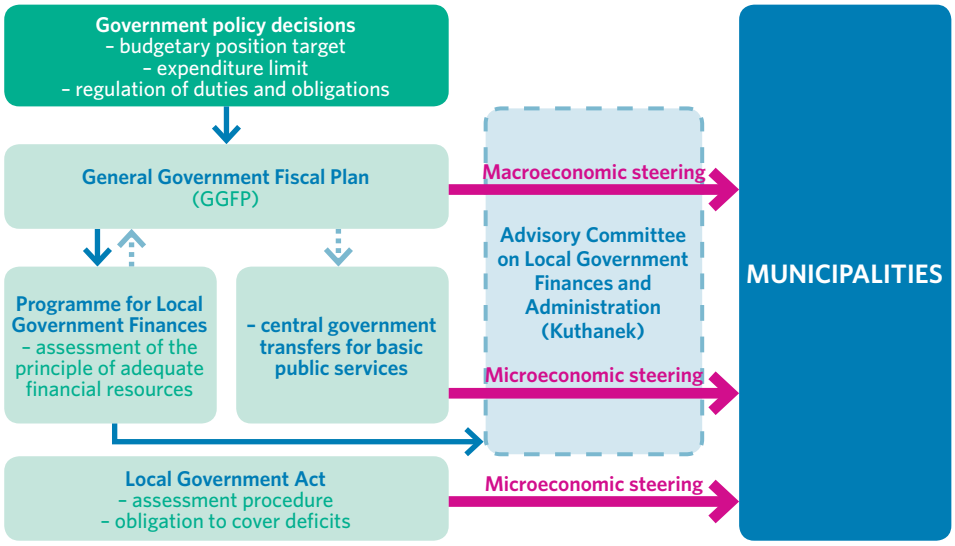

Figure 1: The steering system for local government finances (Source: NAOF)

The Government makes policy decisions, on the basis of economic forecasts and preliminary impact assessments, on the budgetary position target for the local government sector, the local government expenditure limit, and changes to the duties and obligations of municipalities required to achieve the targets.

The Government implements its policy decisions through the General Government Fiscal Plan (GGFP), which contains a section on local government finances. The section specifies the budgetary framework for local government finances. The Government publishes the GGFP at the beginning of the parliamentary term, and the plan is revised once a year in spring. The measures specified in the GGFP targeting the duties and obligations of municipalities are implemented through government proposals prepared by the sectoral ministries. Concrete tools for the macroeconomic steering of local government finances include changes specified in government proposals to duties of municipalities and state funding, which involve

Government policy decisions are implemented through the General Government Fiscal Plan

impacts on the revenues and expenditure of municipalities. Another way to impact municipal revenues is to make adjustments to the taxation or payment criteria or to change the calculation principles of index-linked revenues and expenditure.

The drafting of the Programme for Local Government Finances (PLGF) takes place in parallel with the revision of the GGFP in spring, as well as in autumn in the context of the drafting of the state budget. The PLGF increases the openness and transparency of the impacts of central government measures on the different municipality categories. On the basis of the audit, the PLGF has hardly any impact on the contents of the GGFP, and its purpose is to elaborate the measures specified in the GGFP and their impacts on local government finances. A central purpose of the PLGF is to assess whether the principle of adequate financial resources is achieved.

The Advisory Committee on Local Government Finances and Administration (Kuthanek) operates under the Ministry of Finance. In addition to the preparation of the PLGF, the Advisory Committee provides another forum for the negotiation process between central and local government. The task of the Advisory Committee is to discuss the contents of government proposals concerning local government finances and administration prior to their discussion in the Government. In addition, the Advisory Committee is responsible for discussing matters concerning the division of costs between central and local government, as well as other significant matters concerning local government finances and administration. The section of the GGFP covering local government finances and the PLGF are also discussed in the Advisory Committee.

The main source of information for the steering of local government finances is the various data materials collected by authorities (Figure 2). Statistics Finland collects information about activities and finances of municipalities, joint municipal authorities, municipally owned companies, and local authority corporations and prepares National Accounts. The National Institute for Health and Welfare produces information about, for example, health and social services spending, and the National Board of Education collects data about the education sector. The cornerstones of the information base for the steering of local government finances include the forecasts and trend prognoses for public finances prepared by the Economics Department of the Ministry of Finance and assessments of the sectoral ministries and the Ministry of Finance on the impacts of central government measures on local government finances.

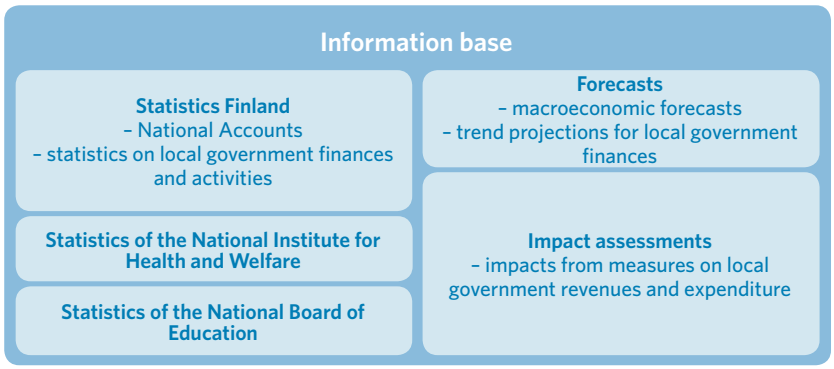

Figure 2: Information base for the steering of local government finances (Source: NAOF)

The macroeconomic steering of local government finances is based on the General Government Fiscal Plan

The macroeconomic steering of local government finances is implemented as part of the General Government Fiscal Plan. The Government drafts the General Government Fiscal Plan for the entire parliamentary term and sets budgetary position targets for general government finances and its subsectors. The budgetary position targets are set so that they, taking into account the forecast of the Ministry of Finance, enable achieving the medium-term objective (MTO) set for the general government structural balance. The purpose of the General Government Fiscal Plan is to support policy-making in the area of public finances and to achieve the general government MTO. The Budget Department of the Ministry of Finance is responsible for preparing matters concerning the General Government Fiscal Plan.

The Budget Department of the Ministry of Finance is responsible for the drafting of the General Government Fiscal Plan

To support the achievement of the budgetary position target, the instrument called 'expenditure limit' was introduced to curb the growth in expenditure arising to municipalities from central government measures. The expenditure limit for local government finances refers to a cap (in euros) set for changes in local government expenditure arising from central government measures.

As part of the overall steering of general government finances, the General Government Fiscal Plan is revised annually for the next four years. In the revision process, forecasts concerning local government revenues and expenditure are updated, the adequacy of measures decided at the beginning of the parliamentary term to achieve the budgetary position target is assessed, and possible further measures are decided.

The Programme for Local Government Finances is prepared in a negotiation process between central and local government

The preparation of the PLGF takes place in the negotiation process between central and local government. The PLGF covers the section of the General Government Fiscal Plan concerning local government finances. The purpose of the process is to generate versatile, up-to-date and high-quality information for local government decision making within the framework set in the GGFP.

The PLGF assesses the achievement of the principle of adequate financial resources, i.e. the adequacy of funding for meeting the duties of municipalities. The PLGF also contains an assessment of changes in the municipalities' operating environment and demand for services and in the functions of local government, and provides a projection of the trend in local government finances. Local government finances are assessed as a whole, as part of general government finances, as well as by municipality categories. The assessment also distinguishes between the statutory and other functions of municipalities and assesses the cost-effectiveness of the activities of municipalities. (410/2015)[3]

The Programme for Local Government Finances assesses the achievement of the principle of adequate financial resources

The Department for Local Government and Regional Administration of the Ministry of Finance is responsible for the preparation of the PLGF. The economic forecasts and trend projections for local government finances used as a basis for the PLGF are drafted in the Economics Department of

the Ministry of Finance. Experts from the main sectoral ministries and the Association of Finnish Local and Regional Authorities also participate in the drafting of the programme.

The Association of Finnish Local and Regional Authorities also often participates in the drafting of legislation concerning municipalities, which has improved the collaboration between central and local government, taking the perspective of municipalities better into account. Although municipalities have now better opportunities to influence policy-making already at earlier stages, the role of the Advisory Committee on Local Government Finances and Administration as a platform for the negotiation process still remains essential. Information channels or negotiation platforms based on law cannot be replaced by changing unofficial working methods.

Currently, the Advisory Committee has three subcommittees. On the basis of the audit, the functions of these subcommittees should be clarified to reduce the number of overlapping activities with other working groups and the secretariat for the Programme for Local Government Finances.

Overall, the measures taken to reform the steering of local government finances have been effective and the current system functions well

On the basis of the audit, the macroeconomic steering of local government finances has better incorporated local government finances as part of public finances and has improved the optimisation of policy-making in terms of overall public finances compared to the previous system. Furthermore, the macroeconomic steering has enabled identifying well those areas in the steering of local government finances and in the relationship between central and local government that impede the management of overall public finances. Better awareness of the different interests supports decision-making that emphasises the perspective of general government as a whole.

Macroeconomic steering has better incorporated local government finances as part of overall public finances

The organisation of the macroeconomic steering of local government finances involves several elements that support exchange of information, and based on the audit, communication between the different parties has improved and the risk for sub-optimisation has decreased. The General Government Fiscal Plan and the Programme for Local Government Finances have increased the transparency of the monitoring of the budgetary position of local government finances and measures having an impact on it, which supports the achievement of the budgetary position target for general government finances.

Setting a separate budgetary position target for the local government sector is necessary in terms of the management of overall public finances. It has helped to steer Government actions and has contributed to the improvement of the quality of economic impact assessments. The local government expenditure limit set by the Government in the General Government Fiscal Plan is another important steering instrument, which helps to achieve the budgetary position target set for general government finances. On the basis of the audit, the General Government Fiscal Plan, which examines general government finances in a comprehensive manner and also by subsectors, has proven to be a useful tool for both central and local government.

Coordination of the steering of local government finances is weak

The audit revealed that it is not fully clear, based on the administrative structures or power relationships, which party is responsible for the coordination of the steering of local government finances. In drafting, views of the Budget Department of the Ministry of Finance, which are motivated by the management of the state budget and overall budgetary framework, are emphasised. The possibilities and incentives of the Budget Department to utilise the data available from the macroeconomic steering of local government finances could be improved.

The sectoral ministries and the different departments of the Ministry of Finance each have their own perspectives and interests concerning the steering of local government finances. According to the rules of procedure of the Ministry of Finance, in the decision-making of the Budget Department and the Economics Department, it is of primary importance to examine the impacts of the steering activities from the financial perspective. However, in the Department for Local Government and Regional Administration and in the decision-making of the sectoral ministries, the focus is on securing local self-government and on functional aspects. Deficiencies in the coordination of these different perspectives could lead to the deterioration of service quality or to the increased indebtedness of municipalities due to steering measures.

Not taking all the perspectives on general government finances adequately into account in decision-making may lead to placing disproportionate emphasis on a single perspective. On the basis of the audit, the General Government Fiscal Plan has expanded the perspective of the Budget Department and changed its practices so that the impacts on local government finances are now better taken into account in decision-making. However, the state budget still remains the Department's first priority.

The sectoral ministries and the different departments of the Ministry of Finance each have their own roles in the steering of local government finances

One example of the differing perspectives of sectoral ministries and the Ministry of Finance and dysfunctional steering process is the case concerning the processing of applications for exemption from the scope of application of the Act restricting municipalities' and joint municipal authorities' outsourcing projects and investments in health and social services in 2016 and 2017. The process failed to consider to an adequate extent the monetary targets set by the Ministry of Finance for local and regional government finances. Investment permits were granted on the basis of functional reasons alone, which from the perspective of the steering of local and regional government finances led to over-investments and contractual arrangements between municipalities, joint municipal authorities and private service providers that can be considered unfavourable from the perspective of the future health and social services reform.

Attempts have been made to secure the independence and neutrality of decision-making in the Budget Department by emphasising its autonomy from other departments of the Ministry of Finance and from other ministries. Although, these structures facilitate decision-making concerning the state budget, they cannot be directly applied to decision-making concerning overall public finances. Even though the new steering system for local government finances has already established new administrative structures between the different parties and improved communication, the barriers between the parties should be further lowered to expedite an exchange of information and to promote better utilisation of data.

From the perspective of an efficient economic steering of overall public finances, the most optimal scenario would be that an autonomous body that is fully independent of the subsector-specific general government decision-making was responsible for the steering of general government finances. This coordination function could be established in connection to existing structures, such as the Ministry of Finance, provided that its organisational independency and advisory and decision-making powers are safeguarded to ensure the best interest of overall public finances. Alternatively, the transparency of activities and division of responsibilities in the existing organisational structures should be clarified.

The coordination of general government finances should be entrusted to an independent body

Macroeconomic steering of local government finances cannot guarantee the achievement of the budgetary position target

The macroeconomic steering of local government finances is primarily target-driven and as such cannot guarantee that the local government sector could achieve the budgetary position target set for it. Consequently, the macroeconomic steering of local government finances has only a limited impact on the achievement of the medium-term objective (MTO) set for the general government structural balance.

The budgetary position set for the entire local government sector does not restrict the decision-making of individual municipalities, but rather steers it indirectly. The most important element of the macroeconomic steering is regulating the number of the statutory duties and obligations of municipalities. A key element of this regulation is whether the potentials for saving can be implemented at the municipal level, since due to the strong self-governance of municipalities, it is left for municipalities to decide to what extent they wish to utilise the provided savings potentials. Whether the intended steering effect can be achieved by regulating the number of duties and obligations of municipalities depends on how realistic the related impact assessments are.

The budgetary position set for the entire local government sector does not restrict decision-making of individual municipalities

Achievement of the principle of adequate financial resources is only assessed mechanically in the Programme for Local Government Finances

The Programme for Local Government Finances (PLGF) assesses the achievement of the principle of adequate financial resources, i.e. the adequacy of funding for meeting the duties of municipalities. The principle of adequate financial resources may refer to whether a specific municipality or municipal sector has sufficient revenues to perform its duties or to the general principle of adequate financial resources applied to the relationship between local and central government. The philosophy behind the principle is that the state must secure adequate funding for the functions it has imposed on municipalities. The aim is to prevent situations where the state would impose certain duties on municipalities without providing municipalities with sufficient financial leeway or resources to perform those duties. In recent years, the state has aimed to ensure the achievement of the principle of adequate financial resources by fully covering any new functions imposed on municipalities through central government transfers.

At the macroeconomic level, the achievement of the principle of adequate financial resources is very difficult to assess. The PLGF is missing criteria for assessing the achievement of the principle or clear conclusions on its achievement from various perspectives. On the basis of the audit, the achievement of the principle of adequate financial resources is not thoroughly discussed in connection with the drafting of the PLGF, and the conclusions are made on the basis of a mechanical analysis in which the pressures to adjust local government finances are assessed by performing various calculations.

Previously, the Constitutional Law Committee has assessed the achievement of the principle of adequate financial resources after extensive measures that have involved impacts on municipal revenues and expenditure. The Committee has emphasised the need for a regularly performed comprehensive analysis on the assessment of the achievement of the principle (see, e.g. PeVL 34/2013)[4].

The Programme for Local Government Finances should clearly comment the achievement of the principle of adequate financial resources

Based on the audit, in order to improve the transparency of the steering of local government finances and the quality of impact assessments, the PLGF should more clearly comment on the achievement of the principle of adequate financial resources. The achievement of the principle, should be one of the elements considered when deciding on central government measures that aim to achieve the set budgetary position target. It would be possible to develop more extensive indicators than an economic analysis to support the assessment of the achievement of the principle of adequate financial resources by combining the activity information provided in the report analysing the status of basic public services by the subcommittee for the assessment of economic impacts of the Advisory Committee on Local Government Finances and Administration with financial data.

The drafting of the PLGF is carried out with a strict timetable because the process is linked to the preparation of the General Government Fiscal Plan, spending limits negotiations between the sectoral ministries and the Ministry of Finance, and the schedules concerning the drafting of statistics and forecasts. In the current format of the PLGF, only impact assessments of measures already decided and specified in the General Government Fiscal Plan are discussed. To increase the weight of the PLGF in the steering of local government finances, in addition to municipal category-specific examinations, the programme should place stronger emphasis on sensitivity analysis of the impacts of competing measures on local government finances. The PLGF could also discuss measure-specifically about the potential issues that measures decided in the General Government Fiscal Plan for the entire local government sector may cause to different municipality categories.

On the basis of the audit, the PLGF and its drafting process can be considered efficient tools for dissemination of information between the ministries participating in the steering processes of local government finances and the Association of Finnish Local and Regional Authorities.

2.2 Data should be available to decision-makers participating in the steering of local government finances at the right time

Already during the early stages of the steering process for local government finances, the parties commit to the limits set in the Government Programme and in the General Government Fiscal Plan. Therefore, it is essential that already during the drafting stage of the Government Programme, decision-makers would have access to a variety of high-quality information and experts. Since the Government Programme drafting process is carried out with a strict timetable, the information based utilised in the process should be expanded and prepared in good time already during the previous parliamentary term. In practice, this means a continuous impact assessment of central government measures targeted at the local government sector and monitoring of other areas of the operating environment.

The data collected must be available in the right place at the right time to be useful in decision-making. It is also necessary to specify a clear need for information. A vast amount of information is collected in municipalities, but only a small proportion of this data is utilised in the macroeconomic steering of local government finances. On the basis of the audit findings, parties responsible for data collection and data management require more specific information than currently available about the data that is utilised in the steering process, so that they could collect, process and deliver such data to the right place at the right time. In practice, the existing processes do not support knowledge-based management in an efficient manner. The exchange of information between experts functions well, but information does not necessary travel all the way up to decision-makers.

Reformed information base should be efficiently utilised

The reform of the information base enables development of the steering of local government finances

If the Local Government Data Programme (Kuntatieto-ohjelma) is implemented as planned, it will provide a higher-quality information base for the steering of local government finances than presently. For example, the enhancement of the quality of cost information concerning municipal service production will enable making more accurate analyses and assessments on the impacts of central government measures on local government finances. The conditions for the monitoring of cost-effectiveness will also considerably improve.

Expediting access to information will improve conditions for management based on access to timely information in decision-making affecting local government finances. Comparability of municipal data will also improve. Enhanced comparability of data helps to better identify the areas and services which involve a potential to enhance cost-effectiveness and consequently to make savings. Enhanced comparability also enables targeting individual and category-specific steering measures to specific municipalities.

The Local Government Data Programme provides an opportunity for different parties to develop their data processing and analytics practices. The programme will also improve the identification of issues, as well as the monitoring and comparison of economic efficiency. In order to fully utilise the data collection reform, the steering processes for local government finances should be critically assessed and the need for information should be more specifically defined.

The macroeconomic steering processes should take into account the accelerating production of data and the improved quality of information and try to take full advantage of the possibilities brought by these both in the development and impact assessments and in the indicators used in the monitoring of local government finances. In addition, data collection should be further expanded so that all possible data needed in the steering of local government finances could be collected in a centralised manner.

The processes of the steering of local government finances does not support knowledge-based decision-making in an optimal manner

The readiness of an organisation to utilise data in decision-making can be estimated on the basis of the matrix presented in Figure 3. The matrix has been prepared by combining the key elements of performance management identified in the study by Aho (2011)[5] with development stages reflecting organisational maturity.

The matrix specifies five organisational maturity levels from a silo organisation to a knowledge-managed organisation on the basis of how the organisation operates in terms of data, processes, technologies and human resources. The matrix also lists indicators reflecting organisational maturity in each of the abovementioned subareas, which are adapted from the framework presented by Aho.

Steering processes require further development to enable full utilisation of the reformed information base

	1. Silo organisation	2. Understanding organisation	3. Data-driven organisation	4. Analytical organisation	5. Knowledge-managed organisation
Information	▪ Poor quality and dispersed data ▪ Lack of shared structures and basic data ▪ Limited access to data	● ▪ Overlapping and partially dated data ▪ Value of high-quality data is acknowledged ▪ Guidance information is collected	▪ Information architecture ▪ Shared concepts and understanding of knowledge capital ▪ Data is automatically collected throughout the organisation	▪ High-quality data and information ▪ Quick and open dissemination of information ▪ Selective use of data	▪ Fully integrated data ▪ Information is highly appreciated ▪ Organisation-wide picture
Processes	● ▪ Decision-making based on insufficient information ▪ Vague setting of targets ▪ No official strategy planning process ▪ No clear and consistent picture of the organisation	▪ Process-specific solutions ▪ Monitoring of activities based on standard-form reports	▪ Monitoring and implementation of the strategy ▪ Indicators steer activities ▪ Simulations and scenario analyses	▪ Rolling forecasts ▪ Simulation and analysis of efficient performance ▪ Deeper understanding about activities	▪ Continuous strategic planning ▪ Strategy is linked to operational activities ▪ Automated decision-making
Technologies	● ▪ Local solutions ▪ Ad-hoc solutions ▪ Data analysis based on spreadsheets	▪ Operational information systems ▪ Local storages ▪ Interactive reporting systems	▪ Centralised data reserves ▪ Outturn reporting using advanced tools	▪ Predictive analytics ▪ Visual reporting ▪ Importance of analytics is highly appreciated throughout the organisation and functions	▪ Analytics is integrated in the basic infrastructure ▪ Strategies, people, processes and information are more closely linked to technologies
People / Competencies and resources	▪ Extensive use of resources on the generation of information ▪ Success relies on individual persons	▪ Lack of support from the senior management ▪ Success is based on previous experiences	● ▪ Data-driven organisational culture ▪ Steering of operations based on data and facts ▪ Data ownership is specified	▪ Data is used in a planned and controlled manner ▪ Predictive analytics is used to solve problems ▪ Data is used in accordance with the control strategy	▪ One official body controls the functions throughout the organisation ▪ Operations are based on the ability to learn faster and better than competitors ▪ Knowledge-based management creates new operating models

● Steering of local government finances

Figure 3: Steering of local government finances (green dot) in the organisational maturity matrix (Source: NAOF, adapted from Aho, M. 2011)

The audit interviews and observations were utilised to assess the level of maturity of the steering of local government finances at the Ministry of Finance against the framework presented above. The average maturity level of the steering of local government finances is indicated in the matrix with a green dot. The conclusion of the assessment was that overall, the maturity level of the steering system for local government finances is somewhere between levels 2 and 3, i.e. between understanding and data-driven organisation. In some subareas, the indicators reflecting the organisational maturity show that the steering system has already achieved the level of analytical organisation, which can be considered to be quite good. In addition, it is likely that the reform of the local government data collection will considerably improve the quality and timeliness of the data.

The weakest subareas were processes and technologies. The technologies subarea will also improve towards the end of the Local Government Data Programme. Processes, on the other hand, require active development to ensure full utilisation of the improved information base. Specific process descriptions that specify what data is used at which stage of the steering process for local government finances should be utilised in the development work.

2.3 The monitoring of the calculation and implementation of the expenditure limit requires development

The Government sets the expenditure limit for local government finances. According to the Decree on the General Government Fiscal Plan (120/2014), the section concerning local government finances must set a cap (in euros) for changes in local government expenditure arising from central government measures that is in line with the budgetary position target set for local government finances. This expenditure limit determines to what extent may central government measures increase the net spending of municipalities or how much should central government reduce the spending of the local government sector. The expenditure limit applies to both new and existing duties.

The expenditure limit curbs the growth in expenditure arising to municipalities from state measures

The purpose of the expenditure limit is to curb the growth in expenditure arising to municipalities from central government measures. The expenditure limit for local government finances should be determined based on the financial leeway established in the trend projection for local government finances prepared by the Ministry of Finance before parliamentary elections or based on the fiscal adjustment required to achieve the budgetary position target. At the time when the expenditure limit is set, there already exists an indicative picture of what the required measures are. The expenditure limit is adjusted once a year in connection with the revision of the General Government Fiscal Plan.

The General Government Fiscal Plan of 28 September 2015 confirmed the Government decision according to which the net impact of the measures established in the plan will help to reduce local government operational expenditure by a minimum EUR 540 million by 2019, compared with the technical GGFP prepared in spring 2015, which was used as the basis for the Government Programme. Thus the set expenditure limit is consistent with the budgetary position target, according to which the budgetary position of the local government sector should improve by approximately one billion euros by 2019, compared with the situation forecasted in 2015 (Ministry of Finance, 2015)[6], assuming that the national economy grows as predicted. Consequently, it has been estimated that the contribution of expenditure limit measures to the achievement of the budgetary position target for local government finances by 2019 accounts for nearly 50%. In other words, implementation of the expenditure limit as estimated is alone not enough to achieve the budgetary position target; it will also require expenditure cuts from municipalities or measures that support growth in municipal revenues.

Expenditure limit measures are only one example of central government measures targeting the local government sector

The expenditure limit cannot alone guarantee that central government measures are consistent with the budgetary position target, because state measures also have impacts on municipal revenues. If it is deemed necessary to steer the achievement of the budgetary position target for local government finances more strictly in the Government Programme, a limit should be set for total net impacts arising to municipalities from all central

government measures implemented during a parliamentary term. Even this could not guarantee the achievement of the budgetary position target due to the municipal self-government.

Table 1 illustrates the development of the expenditure limit, impacts on municipal revenues from central government measures and net impacts of central government measures according to calculations performed in connection with the drafting of the General Government Fiscal Plans for 2015-2017. The expenditure limit set in the General Government Fiscal Plan only covers the four years following the publication year

The expenditure limit cannot alone guarantee positive developments in the budgetary position

Table 1: Estimated impacts from central government measures on local government finances in 2015-2017, EUR million. Figures that have not been previously published are indicated with light blue. (Source: Ministry of Finance)

Time of calculation	2016	2017	2018	2019	2020	2021
Expenditure limit						
GGFP 2015	-160	-340	-460	-540		
GGFP 2016	-160	-560	-690	-770	-840	
GGFP 2017	-167	-538	-720	-453	-467	-467
State funding cuts and index freezes						
GGFP 2015	-71	-160	-295	-384		
GGFP 2016	-70	-177	-269	-332	-340	
GGFP 2017	-80	-171	-216	-138	-152	-152
Taxation and payment criteria adjustments						
GGFP 2015	207	280	305	330		
GGFP 2016	207	274	299	324	324	
GGFP 2017	185	260	285	310	310	310
Net impacts						
GGFP 2015	269	460	470	486		
GGFP 2016	297	657	720	762	824	
GGFP 2017	272	627	789	624	625	625

As the table indicates, the expenditure limit is only one central government measure that involves net impacts on local government finances. The real impacts of measures required to implement the expenditure limit are difficult to assess. Instead, revenue cuts implemented through cuts in central government transfers and index freezes can be estimated relatively accurately in advance.

Impacts from taxation and payment criteria adjustments, on the other hand, largely depend on to what extent municipalities are willing to implement the tax or payment increases they are permitted to execute. The assumed savings impacts from taxation and payment criteria adjustments account for a significant proportion of the estimated net impacts indicated in the table. For example, of the savings estimated to incur to municipalities from central government measures in 2019, revenue increases from taxation and payment criteria adjustments account for approximately half. However, it is not realistic to expect that all municipalities will fully utilise these savings potentials. Local decision-makers have strong incentives to restrict the growth in customer fees and tax rates because their position depends on the voters. The same also applies to voluntary spending cuts achieved by scaling down services.

Impacts of fiscal adjustments have been over-estimated

In summer 2017, the Ministry of Finance and the Association of Finnish Local and Regional Authorities conducted a survey[7] among municipalities, joint municipal authorities and health care districts on the impacts of the main fiscal adjustment measures targeted at local government finances. According to the results (see Table 2), the impacts of the fiscal adjustments in 2018 seem to remain just over one-third of the target. For example, according to the results, increasing the social services and health care customer fees will increase municipal revenues in 2018 by only EUR 105 million, while the estimated savings impact according to the General Government Fiscal Plan is EUR 150 million. Achievement of this target would require increasing all the fees specified in the relevant decree to the fullest permitted extent. Similarly, on the basis of the responses, increasing the customer fees of morning and afternoon activities for school children will accumulate a total of EUR 4.4 million in savings in 2018, while the estimated impact for 2018 according to the Ministry of Finance was EUR 20 million.

Municipalities implement only part of the savings potentials and customer fee increases permitted by the state

Based on the survey results, municipalities are planning to implement (of the estimated savings) a proportion that is even smaller than the customer fee increases. According to the survey, municipalities estimate that in 2018, they will cut their operational expenditure arising from the measures specified by approximately 25% of the savings estimated by the Ministry of Finance. This more or less corresponds to the currently valid central government transfer percentage. Thus, it seems that in 2018, municipalities have reacted to the central government measures examined in the survey on average so that the expenditure savings achieved would match the state funding cuts arising from these expenditure limit measures. On the basis of this kind of calculation it can be assessed that the net impact of expenditure limit measures on the budgetary position of local government finances would be neutral in the year under review. The calculation does not take into account the fact that the implementation of central government measures aiming to achieve savings also typically involves substantial change costs to municipalities.

Table 2: Results of the survey by the Association of Finnish Local and Regional Authorities (Source: Ministry of Finance, 2017)[8]

	Government estimate (million euros)	Achieved result (million euros)	Percentage
Competitiveness Pact			
Increase in working hours	190	56.7	29.8%
Social services and health care			
Increase of social services and health care customer fees	150	105.3	70.2%
Replacing elderly care services with informal care and family care	135	29.2	21.6%
Day care and education			
Limiting the subjective right to child day care	41	9.9	24.1%
Loosening the personnel requirements in day care	54	9.3	17.2%
Increasing the customer fees of morning and afternoon activities for school children	20	4.4	22.0%
Total	590	214.8	36.4%

On the basis of the audit, it seems that costs are systematically underestimated and revenue increases from payment criteria adjustments overestimated in impact assessments utilised in the steering of local government finances. Furthermore, it is typically estimated that the savings targets from individual changes to the duties of municipalities can be achieved earlier than they actually are. Due to this, the steering of local government finances seems to be more effective according to calculations than it actually is. However, it is still possible that the intended savings impacts are achieved over longer term than originally estimated, due to which the assessment of the actual savings impacts of expenditure limit measures requires long-term and systematic monitoring of these impacts. Accumulation of relevant data and improvement of the quality of impact assessments will enable more accurate specification and dimensioning of expenditure limit measures in the future. Assessments on the breakdown of the impacts by the different years of the spending limit period should be improved.

In calculations, the expenditure limit seems to be more effective than it actually is

The monitoring of the implementation of the expenditure limit is inadequate

The final report of the working group established to improve the macroeconomic steering of local government finances (Ministry of Finance, 6/2014)[9] states that the expenditure limit needs to be supported by improved assessment of expenditure and other impacts and effective monitoring methods. These conclusions presented by the working group four years ago are still valid. The Budget Department of the Ministry of Finance is monitoring the implementation of the Government Programme from the perspective of local government finances. However, the results of this monitoring are not currently reported in an open manner and so that they would provide a clear picture of whether expenditure limit measures can achieve the targets set for them.

To be useful as the steering instrument it was intended to be, the expenditure limit needs to be supplemented, for example, with an evaluation framework to monitor the savings achieved. The calculations utilised when setting the expenditure limit should be presented as transparently as possible so that external experts could repeat them where necessary. The notes to the General Government Fiscal Plan could, for example, discuss details about the impact assessments on the basis of which the expenditure limit was set. More detailed monitoring of the implementation of the expenditure limit would also support the assessment of the achievement of the principle of adequate financial resources.

Expenditure limit calculations should be transparent and easily available

The strong upward trend in local government finances has weakened the monitoring and adjustment of expenditure limit measures

According to the spring 2017 General Government Fiscal Plan, the expenditure limit cannot be relaxed from the level set in the first General Government Fiscal Plan of the Government. The limit is tightened each year as the preparation of the measures agreed in the Government Programme that are not yet specified in detail progresses. Based on the interviews

conducted in the audit, the improvement in the general economic situation has diluted the interest in the implementation of the expenditure limit. New measures intended to provide additional savings were not decided in the autumn 2017 budget proposal, even though the analysis of the results of the survey conducted by the Ministry of Finance and the Association of Finnish Local and Regional Authorities indicate that the savings for 2018 will remain clearly below the level estimated in 2017. According to the audit interviews, decision-makers consider it sufficient that local government finances remain on a path that enables the achievement of the budgetary position target in 2019 at the latest according to trend projections. The reliability and effectiveness of the expenditure limit as a steering tool will suffer if compliance with it is not required in favourable economic climate and its implementation is not adequately monitored.

2.4 The quality, uniformity and transparency of impact assessments need further development

According to the Decree on General Government Fiscal Plan (120/2014), the plan shall specify the required measures and their estimated economic impact on the achievement of the budgetary position target set for the local government sector. In other words, the provision requires the specification of legal amendments that will have impacts on the revenues and expenditure of the local government sector and any other future measures required to achieve the budgetary position targets and the evaluation of their economic impacts. For each measure, an economic impact assessment (in euro terms) must be presented with justifications.

The decision on what is deemed as a sufficient impact assessment for a measure to be included as part of the expenditure limit set is made in the Budget Department of the Ministry of Finance. The impact assessments presented in the General Government Fiscal Plan are based on the impact assessments prepared with a strict timetable in connection with the drafting of the Government Programme (2015)[10]. According to the audit interviews, the expertise of the sectoral ministry responsible for the administrative branch targeted by the relevant measure was not utilised in all impact assessments. On the other hand, there may not be sufficient incentives to adjust the impact assessment because this could lead to additional savings measures.

Impact assessment development needs have been identified

The Advisory Committee on Local Government Finances and Administration established in September 2013 a subcommittee responsible for the assessment of economic impacts. The task of the subcommittee was to assess and develop the assessment methods and operating models concerning economic impacts from legislative projects targeted at municipalities. In its report (Ministry of Finance, 2015)[11], the subcommittee considered that the sectoral ministries' own assessment know-how should be reinforced, both through training and through recruitment. Furthermore, the competencies

of various research institutes, universities and ministries should be utilised more in the design and implementation of the assessments. According to the report, both the preliminary and the ex-post evaluation of the impacts on local government finances should be improved. Furthermore, sufficient time and resources should be reserved for the impact assessments, and the plan to assess the economic impacts of a legislative project should be made at an earlier stage than presently.

Sufficient time and resources should be reserved for impact assessments

According to the subcommittee, an independent party should also perform an annual evaluation of the impact assessments on the most significant legislative projects. The Finnish Council of Regulatory Impact Analysis established under the Prime Minister's Office in spring 2016 has partly responded to this need. The Council is independent of all political actors, administrative branches and societal interest groups and their special interests. The task of the Council is to give statements about impact assessments. In addition, the Council may make initiatives to improve the quality and assessment activities involved in legislative drafting and particularly impact assessments. After a regulation has entered into force, it can also assess whether its legislative impacts comply with those estimated. (1735/2015)[12]

According to preliminary details, the new report by the assessment subcommittee of the Advisory Committee (Ministry of Finance, 2018)[13] will mostly contain similar conclusions as the previous report. In addition to the need to develop the information base and to increase cooperation and openness, another development area identified is the need to assess the impacts from the behaviour of municipalities or customers, as well as dynamic impacts. To this end, it could be useful to utilise more agile data collection methods than traditional research, such as surveys. Furthermore, the draft report emphasises the need to change the organisational culture of the entire policy-making system in terms of, for example, scientific information and ex-post monitoring.

According to the Council, there are deficiencies in impact assessments

According to the 2016 Annual Review of the Finnish Council of Regulatory Impact Analysis[14], a considerable proportion of the draft government proposals analysed have been fairly deficient in terms of impact assessment. The Council specifies augmentation and elaboration of quantitative assessments, cost/benefit analysis, description of impact mechanisms and methods of calculation, and consideration of alternative means of implementation as the most important areas for development. The list of most common deficiencies also includes 'regard for regional impacts', which according to the Council has involved deficiencies in almost every other government proposals assessed in 2016.

On the basis of both the Annual Review of the Council and the interviews performed during the present audit, it can be stated that the work of the Council has improved the quality of the impact assessments included in government proposals. However, as the Council concluded in its Annual Review, it is of course obvious that the Council's monitoring of the quality of law drafting will have to be complemented by ongoing law-drafting quality assessment and development also by other parties such as the ministries, other experts and the research community, and Parliament.

The development of the impact assessment included in the drafting process of government proposals is considered challenging particularly because the resources available are insufficient considering the given timetable. According to the audit, the subcommittee for the assessment of economic impact of the Advisory Committee on Local Government Finances and Administration mainly discusses impact assessments that are already completed. Therefore, its contribution to the development of the impact assessments inevitably remains at commenting on the assessments retrospectively.

The steering of local government finances should be supported with more effective assessment of financial impacts than presently

Based on the audit, attention should be paid in the steering system for local government finances to the development of particularly those impact assessments relating to the expenditure limit. In addition, the impact assessment performed in the connection of legislative drafting could be promoted by ensuring open exchange of information between the parties and by openly discussing differences revealed in the impact assessments and causes for these.

Furthermore, in terms of the steering of local government finances, the ex-post assessment should be developed towards a more systematic direction so that more realistic impact assessments can be made in the next Government Programme and the related General Government Fiscal Plan. The cost impacts involved in changes to tasks or obligations should be assessed in a transparent and comprehensive manner and by utilising the best available expertise. At present, the ex-post assessment of the cost impacts of measures is mainly the responsibility of the sectoral ministries, which perform this duty with varying success. According to the audit, the unwillingness of the sectoral ministries to adjust their impact assessments may be affected by the concern that savings estimates adjusted downwards will cause additional savings measures. Realistic and high-quality impact assessments have also significance for the predictability of municipal revenues because they impact the central government transfers paid to municipalities and the adjustments to the division of costs between central and local government.

The uncertainty involved in impact assessments should be more clearly specified

In addition to the expenditure limit for local government finances and the measures selected to implement the limit, the General Government Fiscal Plan and the Programme for Local Government Finances should support decision-making by also providing alternative policy measures and related impact assessments, as well as by comparing selected measures with impacts from previous measures. The uncertainty involved in impact assessments should be indicated, for example, specifying the range within which the economic impacts are likely to settle.

2.5 The quality of the information base must be continuously improved

The effectiveness and efficiency of the macroeconomic steering of local government finances ultimately depend on the quality of the information used in the steering and abilities of decision-makers to utilise the information. The Local Government Data Programme (Kuntatieto-ohjelma) aims to improve the production of financial information required in the fiscal steering, as well as the availability of the data. The objective is to produce

in municipalities compatible and structured information to ensure that the same information can be utilised in the internal steering of municipalities, in the central government steering of local government finances, as well as for the needs of other parties.

Another objective of the Local Government Data Programme is to improve the functional and information compatibility within general government. Furthermore, the programme aims to promote the development of data production and reporting so that the required information is available to different decision makers at the right time and in a transparent, sufficiently extensive and comparable manner.

The Local Government Data Programme provides different parties with an opportunity to develop their data processing and analytics practices. Overall, the improvement of the information base should lead to a faster detection of problems and more accurate dimensioning and targeting of the steering measures. On the basis of the audit, the greatest challenge in terms of the efficient utilisation of the information base is in the adoption of new information and new working practices in the central and local government sector. The macroeconomic steering processes should take into account the accelerating production of data and the improved quality of information and try to take full advantage of the possibilities brought by these both in the development and impact assessments.

The remit of the local government sector in Finland is exceptionally wide, and it will remain so also after the regional government reform. In addition, the planned structural changes also cause needs to develop the steering system for local government finances. This means that the information base utilised in the steering of local government finances must also be continuously developed. The organisation responsible for the Public Administration Recommendations (i.e. JHS Recommendations) has established a subgroup responsible for the continuous updating of the recommendations according to changing data needs.

There is not yet a known solution for all the deficiencies in the information base

The recent measures to develop the information base have improved the conditions for the steering of local government finances. For example, the data concerning the final accounts of local authority corporations collated by Statistics Finland since 2015 have enabled preparing more extensive analyses of the status and development of local government finances. Additional data on the most significant cash flows between municipalities and their corporations in terms of the general government deficit and debt reporting (EDP reporting) (Ministry of Finance, 2015)[15] will be collected for the first time in spring 2018 for the reference year 2017. The data will be available for the drafting of National Accounts in June 2018. The information base has also been enhanced by the joint data collection activities between local authority corporations and their parent municipality. This has improved the comparability of data with the external final accounts.

Key information required in the macroeconomic steering of local government finances that are not yet extensively collected include details on transactions between municipalities and joint municipal authorities or municipalities and their subsidiaries (consolidated data). Based on the

audit, the same deficiency will also concern counties and the corporations and service centres owned by them. At present, the Local Government Data Programme does not include any solution concerning the availability of such data. These data would primarily be utilised in the drafting of statistics concerning the local government sector of National Accounts, as well as the upcoming regional government sector. Absence of such data could weaken the information base used in the drafting of National Accounts and the related EDP reports and forecasts. In addition, another area of which data is not yet systematically collected is municipalities' fiscal planning. In this area, data has so far been collected upon temporary assignments. High-quality data about fiscal planning performed in municipalities could improve, for example, the information base of public investments which are difficult to predict.

2.6 The health, social services and regional government reform weakens the ability of local government finances to adjust to shocks

If the health and social services reform is implemented as planned, it will cause significant changes to the macroeconomic steering of local government finances. The weight of local government finances in the overall public finances will considerably decrease as more than half of municipalities' operational expenditure is transferred to counties. The impacts of the reform on the steering systems, such as the system of central government transfers, have been assessed relatively well in connection with the related drafting.

After the reform, the most important duty of municipalities will be the provision of education services. On the basis of the audit, the trend projections for local government finances will be easier to predict as the health and social services, which are difficult to predict, are transferred to counties. At the same time, the biggest growth pressures in expenditure are also transferred from the local government to the regional government sector. This will also impact the budgetary position target set for the local government sector, which will likely be tightened from the present level. On the other hand, the considerable repair backlog in the education services sector will remain at the hands of municipalities.

After the reform, municipalities' possibilities to implement their own measures to balance their finances will be limited as the significance of the municipal tax as a source of income decreases. The relative indebtedness of municipalities will significantly increase as the revenues decrease while debts still remain at the responsibility of municipalities. The majority of municipal debt is linked to variable reference rates. High relative indebtedness, combined with the predicted upward turn of reference rates can weaken municipalities' debt sustainability.

The decreasing financial leeway of municipalities must be taken into account in the macroeconomic steering, which is largely dependent on municipalities own savings measures. The monitoring and analysis of the key performance indicators utilised in the steering must be enhanced in connection with the reform. If necessary, the Ministry of Finance should be prepared to support municipalities facing financial problems over the transitional period.

Municipalities' decreasing financial leeway should be taken into account in the macroeconomic steering

The reform enables building the information base for the steering system for regional government finances from scratch in accordance with the needs of the system. According to the Ministry of Finance, knowledge-based management will have a key role in the county administration and in the steering of regional government finances. Organisationally, it should be ensured that the steering of regional government finances is coordinated together with the steering of local as well as general government finances so that the administrative burden does not become too heavy and that the steering system does not become fragmented and thus weaken the overall steering of public finances.


KUNTALAKI
– Tausta ja tulkinnat
Heikki Harjula
Kari Prättälä

3 Does the microeconomic steering of municipalities improve the sustainability of local government finance and achievement of the macroeconomic targets?

The objective of the microeconomic steering of local government finances, i.e. fiscal steering targeted at individual municipalities, is to secure basic public services for the residents of municipalities. The main steering instrument is the requirement to cover any deficit in the municipality's balance sheet. However, there is considerable uncertainty involved in the information base concerning deficit. Nevertheless, the assessment procedure improves the credibility of the microeconomic steering because municipalities make a real effort to comply with the criteria for the procedure. The microeconomic steering affects municipalities unevenly. This is particularly highlighted in the system of central government transfers, the main purpose of which is to reduce differences among municipalities in terms of municipal expenditure, service needs and revenue base. Introducing other objectives to the system of central government transfers could weaken the efficiency of the entire system. Achieving the objectives of the microeconomic steering of local government finances will not alone ensure the achievement of the targets of the macroeconomic steering. The link between the budgetary position target for the local government sector and the budgetary position of individual municipalities is weak. Instead of a deficit, a better key performance indicator for the microeconomic steering would be cashflow from operations and investments, since this indicator is compatible with the objectives of the macroeconomic steering.

3.1 Microeconomic steering involves important incentives in terms of achieving the budgetary position target in terms of achieving a balanced budget

The main instruments in the microeconomic steering of municipalities are the Local Government Act and the system of central government transfers for basic public services. However, the microeconomic steering is also affected by normative steering, i.e. requirements concerning, for example, personnel resources or the amounts of customer fees, applied to services produced by municipalities.

The main instruments in microeconomic steering are the Local Government Act and the system of central government transfers for basic public services

The provisions of the Local Government Act concerning microeconomic steering emphasise the importance of covering deficits

Pursuant to the Local Government Act, the main steering instrument applied to individual municipalities is the procedure by which a deficit in the municipality's balance sheet is covered. A deficit in the balance sheet should be covered within four years. The measures for covering the deficit should be specified in the financial plan of the municipality. The financial plan must be in balance or in surplus. If the balance sheet result is in surplus or if the result is at balance even for one year, the obligation to cover the deficit is considered fulfilled.

The obligation to cover a deficit steers municipalities' finances towards a balanced direction. However, deficit and surplus are not direct measures of the operational efficiency of municipalities, as the measure simply gives indirect information about the municipality´s revenue/expenditure ratio (Sinervo, L.-M., 2011)[16]. The indicator reflecting the surplus/deficit is the sum of a number of different accounting elements. To balance its finances, a municipality should aim to specify, typically through collecting data other than accounting data, the factors that have affected the accumulation of deficit in order to select the measures that enable achieving the budget balance again. The obligation to cover a deficit may, however, be met by implementing solutions that do not improve the long-term sustainability of the municipality's finances or that can deteriorate the cost-efficiency or quality of the municipality's services.

The obligation to cover a deficit can also be met with solutions that do not improve the long-term sustainability of the municipality's finances

The obligation to cover a deficit is also applied to joint municipal authorities. Furthermore, consolidated financial statement of a municipality may show a deficit per resident of at least EUR 1,000 (and the preceding financial statements a deficit per resident of at least EUR 500) before the assessment procedure is initiated. Monitoring the deficits of joint municipal authorities and local authority corporations also decreases the incentive to transfer deficits between different accounting units, which decreases the possibilities to utilise accounting measures to cover deficit. In general, monitoring the finances of also joint municipal authorities and local authority corporations is a clear improvement towards a more holistic view of the factors affecting the budgetary position of municipalities.

Despite the extension of the obligation to cover deficit, the incentives related to deficit seem to be relatively weak. The majority of municipalities don´t have deficit — both in terms of their number and their economic impact. According to the final accounts for 2016, a total of 36 municipalities had accumulated a deficit in their balance sheet. This represents 12% of all municipalities. Of the 36 municipalities, 25 municipalities had also accumulated a deficit during the previous year. Of the total number of municipalities which had accumulated a deficit in their balance sheet in 2015, 21 municipalities managed to achieve a result in surplus or a balanced result in 2016.

The obligation to cover debt only concerns a relatively small number of municipalities

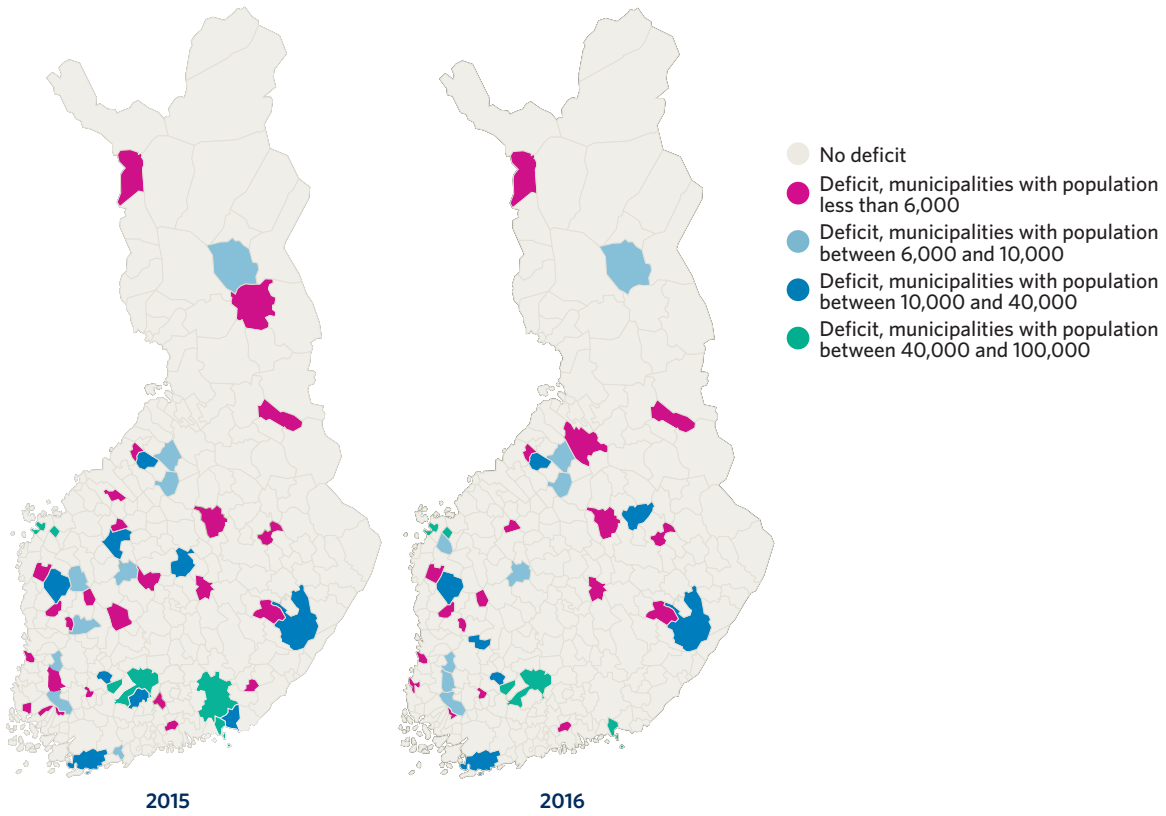

Figure 4: Municipalities with an accumulated deficit in their balance sheets in 2015 and 2016. The different colours indicate the size of the municipality in terms of population. (Source: Statistics Finland)

The majority (18) of the municipalities that accumulated deficit in 2016 are small municipalities with a population of less than 6,000. The fact that mainly small municipalities accumulate deficit may relate to the overall financial leeway available to those municipalities. This seems to be supported by the fact that of the municipalities in deficit in 2016, in 11 municipalities more than 40% of their revenue came from central government transfers.

A municipality in deficit can waive the obligation to cover a deficit for a period of at least four years with a balance sheet in surplus even for one year. As an indicator of the budgetary position, a deficit and surplus can only provide an insufficient picture and, therefore, it cannot be ruled out that the related incentives can also lead to unintended consequences. Section 3.2 discusses in more detail the information conveyed by the concept of surplus/deficit.

The objective of the assessment procedure is to secure access to basic public services

Section 118 of the Local Government Act contains provisions on the assessment procedure for municipalities in a very difficult financial position. The assessment procedure can be started if a municipality has not covered the deficit in its balance sheet within the period. The assessment procedure may also be started if the latest financial statements of the local authority corporation show a deficit per resident of at least EUR 1,000 and the preceding financial statements a deficit per resident of at least EUR 500, or if

the financial key figures for finance adequacy or solvency of the municipality and the local authority corporation have reached the following limits for two successive years:

1. the annual contribution margin of the local authority corporation is negative;
2. the municipality's rate of local income tax is at least 1.0 percentage point higher than the weighted average rate of local income tax of all municipalities;
3. the local authority corporation's debt per resident exceeds the average debt for all local authority corporations by at least 50 per cent; and
4. the local authority corporation's relative indebtedness is at least 50 per cent.

The purpose of the assessment procedure is to secure adequate basic public services for the residents of the municipality. Therefore, the procedure should be targeted at municipalities where there is still a possibility that the municipality can balance its finances through internal measures despite the clear risks related to the financial sustainability. In most municipalities that have previously been subject to the assessment procedure, the challenge has been the decreasing and aging population and thus the reduction in the revenue base. Other challenges reported concern the dimensioning of services relative to the service needs and preparing for and implementing investments.

The assessment procedure has been in place since 2007. Since then, a total of 35 municipalities have been subject to the procedure, of which four in two separate occasions. In general, the assessment procedure has been considered an effective form of cooperation between central and local government. The majority of the participant municipalities have managed to balance their finances through internal policy decisions since the procedure, which indicates that the criteria set for the procedure help to identify the right municipalities at a sufficiently early stage. The measures agreed in the assessment procedure are selected based on the circumstances of each municipality, but typically they involve spending cuts and reorganisation of the service system. One off measures are not favoured in the assessment procedure.

The assessment procedure is a credible instrument for microeconomic steering

The power of the Government to decide on changes to municipal borders has improved the credibility of the requirements set by central government for local government finances

The credibility of the assessment procedure as an instrument for microeconomic steering is based on the power of the Government to decide on the merger of municipalities, if it deems that the ability of a municipality to provide basic public services to its residents is jeopardised (HE 53/2013)[17]. The Government has exercised this power a few times. In 2014, after conducting the assessment procedure, the Government decided in three cases to change the municipal borders. On the other hand, the decision to merge the municipalities of Rääkkylä and Kitee made in 2016 was later repealed in the Supreme Administrative Court. The Supreme Administrative Court concluded that it had not been not established to a sufficient extent that the municipality of Rääkkylä can no longer secure the statutory public services for its residents after the implementation

of the health, social services and regional government reform (Supreme Administrative Court 2016)[18]. The decision by the Supreme Administrative Court means that to exercise its powers to decide on changes to municipal border, the Government must now conduct a more extensive assessment on the related economic impacts until the implementation of the health, social services and regional government reform.

The power of the Government to decide on and implement changes to municipal borders in municipalities in financial crisis has improved the credibility of the requirements set by central government for local government finances. However, changes to municipal borders are not an effective an effective steering instrument, in general it has been difficult to demonstrate the actual savings impacts from these measures in municipalities (VATT, 2017)[19].

Typically, the assessment procedure is initiated on the basis of the deficit criterion. Only in a few cases, the other criteria may also have been met. The health, social services and regional government reform will not cause any great needs to change the current criteria for the assessment procedure; only criterion 4 concerning the relative indebtedness of a local authority corporation (50%) must either be adjusted or completely reassessed.

Based on the audit, the assessment procedure acts as a preventive measure, i.e. municipalities try to avoid meeting the criteria for the procedure through forward looking planning. The number of municipalities entering the assessment procedure has continuously decreased. The preventive element could be significant in terms of the macroeconomic steering of municipalities, if it was possible to establish that the budgetary position of municipalities that do not meet the criteria for the procedure is also balanced according to the criteria of the macroeconomic steering. Then again, a deficit does not seem to be a sufficient criterion in terms of the macroeconomic steering and achieving the budgetary position targets (see section 3.4).

The threat of being placed into the assessment procedure prevents municipalities from ending up in financial crisis

The effectiveness of the assessment procedure for counties cannot be deduced directly based on experiences gained from the assessment procedure for municipalities

A mechanism similar to the assessment procedure is also planned to be incorporated in the steering of regional government finances. In the assessment procedure for counties, the state and county would together assess the financial conditions of the county to perform its duties. The objective of the procedure would be to encourage counties for effective financial management. The procedure could be initiated if the four criteria specified in the Act on Regions are met or if the ability of the county to provide health and social services is deemed jeopardised. The criteria for the procedure includes, for example, cash flow from operations and investments, which could not be negative for two consecutive years.

The steering of regional government finances differs considerably from the steering of local government finances, which means that the experiences gained from the assessment procedure for municipalities cannot be used when assessing the effectiveness of the procedure in the case of counties. In counties, the state has a more direct responsibility to ensure adequate finances for counties, and therefore the possibilities of counties to impact the balance of their finances are significantly more limited compared to municipalities.

3.2 The significance of the system of central government transfers in the steering of local government finances should be examined

The state uses the system of central government transfers for basic public services to participate in the financing of services and to equalise differences between municipalities

Central government transfers to municipalities for basic public services forms the most significant element of the system of central government transfers, as well as one of the largest expenditure items in state budget (approximately EUR 8.9 billion in 2017). The state contributes to the financing of basic public services through the system of central government transfers. The central government transfer percentage for basic public services provided by municipalities reflects the division of costs between central and local government. The system has also been used to achieve other objectives, such as to pay compensations to municipalities arising from tax cuts or encouraging municipalities towards cost control by making universal cuts in the level of central government transfers. Based on the audit interviews, the system of central government transfers for basic public services has become a practical tool to manage changes in the financial relationship between central and local government.

The system of central government transfers for basic public services is used to equalise the cost and need differences between municipalities, after which the differences in the revenue base of municipalities are also equalised. The system can be considered to be an important microeconomic steering instrument for the state. However, there is scarce information available on the incentive impacts of the system of central government transfers for basic public services. According to the VATT Institute for Economic Research, regionally allocated central government transfers favour living in low-productivity areas, which means that people are not relocating to areas where they could be more productive members of society (VATT, 2015)[20]. Indeed, one of the objectives of the system of central government transfers is to support the existing municipal structure and enabling equal access to municipal services throughout Finland.

Imputed costs of central government transfers are used to steer municipalities towards cost control

The system of central government transfers for basic public services is used to pay compensations for imputed costs. This means that the level of central government transfers is not based on the total service expenditure of any single municipality. It is also not affected by how the municipal services are organised or by the scope or quality of the services provided. The level of the imputed costs is determined for each year separately in the adjustment procedure concerning the division of costs between local and central government. The data collected by Statistics Finland of the costs actually incurred to municipalities form the information basis for the procedure. Of the adjusted costs, the state contribution covers the amount corresponding to the central government transfer percentage and the municipalities cover the rest. The imputed costs are divided between municipalities according to criteria that take into account factors such as the age structure of the municipality, morbidity rate, remote location, etc.

The system of central government transfers for basic public services has been considered to encourage municipalities towards cost control, because it is profitable for individual municipalities to not exceed the level of imputed compensation. In practice, determining the amount of central government transfers received for specific service expenditure is very difficult, which means that it is unlikely that imputed costs could have any incentive impacts on specific services. Central government transfers are paid to municipalities without earmarking them for specific purposes, so municipalities may independently decide how to allocate them. It should also be noted that if the actual costs used as a basis for determining the imputed costs decreased throughout the local government sector, this would also decrease the total amount of central government transfers in the following year. Consequently, the incentive impacts involved in imputed costs are complicated at best, and information about how to best utilise them may not always be available in the right place at the right time. Therefore, it seems likely that the effect of the incentive to not exceed the imputed costs is weak.

It is profitable for individual municipalities to not exceed the level of imputed compensation

The significance of central government transfers as a source of revenue for municipalities varies

Central government transfers form a significant source of income for the local government sector, and the overall level of the transfers has important financial impact at the level of individual municipalities. The share of revenues from central government transfers of the total revenues of municipalities and joint municipal authorities has been approximately 18.2% in 2010-2016 (Association of Finnish Local and Regional Authorities, 2017)[21]. The share varies between individual municipalities. At the highest, central government transfers can account for in excess of 60%, and at the lowest they can be 2% of the total revenues of an individual municipality. In municipalities with a population of less than 2,000, the revenues from central government transfers on average exceed the tax revenues. (HE 15/2017)[22]

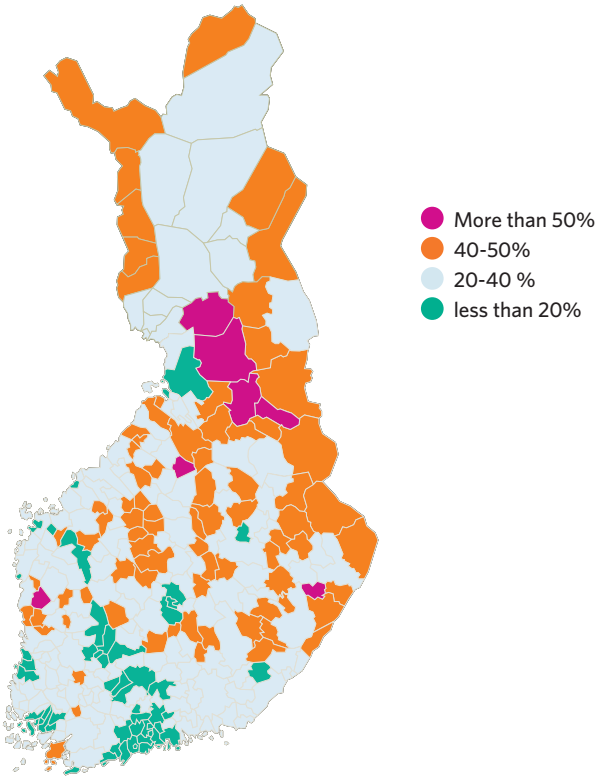

Figure 5: Share of central government transfers for basic public services of municipal revenues in 2016 (Source: Statistics Finland, NAOF's calculations)

The idea behind the steering impact of the level of revenues from central government transfers is that if the level of these revenues is decreased, it encourages municipalities to implement cost control measures and, correspondingly, if the level of central government transfers is increased, it encourages municipalities to increase their spending. Since the annual fluctuation in central government transfers is difficult to predict, this may also encourage municipalities to implement short-term spending cuts. The use of the system of central government transfers to promote general cost control in municipalities is incompatible with the main objective of the system. Changes to the level of central government transfers have more significant impacts on municipalities in which central government transfers account for a larger share of the total revenues. These municipalities often also have higher than average costs and service needs and a weaker tax base. The financial leeway of these municipalities is typically already narrow, and the municipalities have fewer means to adjust to revenue cuts so that they can still maintain their ability to provide basic public services. Due to these uneven impacts, cuts in central government transfers are more likely to deteriorate the service quality, increase indebtedness and jeopardise the achievement of the principle of adequate financial resources compared to other revenue cuts.

Changes to the level of central government transfers have stronger impacts on municipalities in which central government transfers are an important source of income

Central government transfers are paid to municipalities as compensations for tax cuts

The system of central government transfers is also used for the practical implementation of adjustments to financing between central and local government. One example of this is compensations paid to municipalities for tax cuts. These are paid so that central government would not deteriorate the budgetary position of municipalities through its decisions. Particularly changes made to income taxation are also reflected in municipal tax revenues.

Compensations for tax cuts have been paid to municipalities since around 2003. For a short period compensation measures have been implemented within the tax system or by adjusting the central government transfer percentages. Compensation measures implemented within the tax system are in principle problematic because they reduce the transparency and openness of the tax system. On the other hand, compensation measures implemented through adjusting the central government transfer percentage cannot be directly targeted to cover losses in tax revenues incurred by an individual municipality. The compensation measure implemented through a separate appropriation included in the system of central government transfers was introduced in 2010. The appropriation ensures that the compensation is implemented in a transparent and open manner and that it can be targeted specifically to the relevant municipality.

Share of compensations for tax cuts has increased

The compensation is paid to municipalities once a year through the system of central government transfers. The total amount of compensations in 2017 is already quite substantial, namely EUR 1.6 billion.

The overall level of central government transfers for basic public services has remained relatively steady while the share of compensations for tax cuts has increased from 5% to 19% of the total central government transfers. Figure 6 illustrates the development in the share of tax-cut compensations of the total central government transfers.

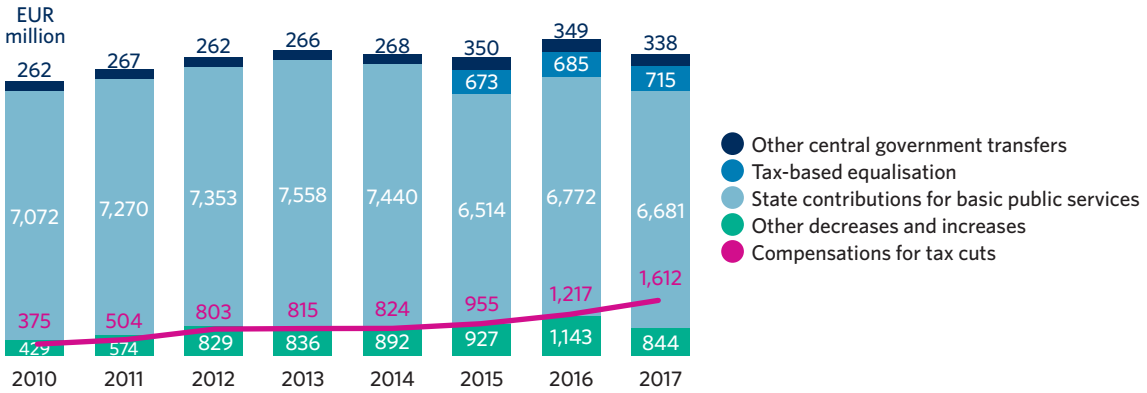

Figure 6: Development of certain items included in central government transfers for basic public services in 2010-2017, EUR million (Source: Ministry of Finance)

The system of central government transfers is not particularly well suited for the payment of compensations for tax cuts

An expenditure item within a system that grows continuously and serves purposes other than the system in general can jeopardise the sustainability of the entire system. The use of the system of central government transfers for practical financial arrangements between central and local government further increases the complexity of the system. For the system of central government transfers to function efficiently and according to its purpose — which is to equalise differences in the revenue base and expenditure level between municipalities — adding elements to the system that are redundant in terms of the basic purpose of the system should be avoided. Furthermore, it should be noted that tax compensation measures that are based on a separate appropriation narrow municipalities' possibilities to impact their own revenues through taxation.

Regional financing will change the system of compensations for tax cuts. Approximately 70% of the existing compensation payments will be transferred as part of regional financing, which will significantly decrease the significance of the share of compensations still paid to municipalities. However, it is important to reassess the tax-cut compensation model once the major changes to the system of regional and local government financing are completed.

Adding elements to the system that are redundant in terms of the basic purpose of the system should be avoided

Regional financing will change the system of central government transfers

Regional financing cause considerable changes to the system of central government transfers. According to the government proposal concerning the establishment of counties (HE 15/2017), the state contribution to municipalities for basic public services would cover a total of EUR 5.8 billion of the functions transferred from municipalities to counties. The remaining costs would be covered by cutting municipal tax revenues by approximately EUR 11.14 billion. Thus, the changes made to the system of central government transfers would also indirectly impact the system of equalisation of tax revenues. The threshold for the equalisation of tax revenues between municipalities will decrease, which will also affect the amount of tax revenues offset in the system. However, the aim is to limit the impact of any changes on individual municipalities and to secure the budgetary position of municipalities and the achievement of the principle of adequate financial resources even after the reform. Approximately 70% of the imputed costs of the system of central government transfers for basic public services would be transferred to counties.

The central government transfers paid to municipalities will be supplemented with a top-up earmarked for the promotion of health and welfare. The purpose is to encourage municipalities to implement preventive measures that increase the health and welfare of their residents. The effectiveness of the incentives added to the system of central government transfers should be closely monitored.

The use of the system of central government transfers as an incentive system should be carefully assessed

Creation of an effective incentive system would require clarifying the division of powers and responsibilities between central and local government

The questions concerning the division of powers and responsibilities between local and central government are complicated. The state makes policy-decisions concerning central government transfers paid to municipalities and the municipal tax base and service level. The state can impact the achievement of the targets set for local government finances and therefore, indirectly, also the effectiveness of the related steering. For the incentive system to be effective, the perspective of the overall public finances should be emphasised in the steering of local government finances. The central government steering targeted at municipalities, as well as any incentives set for municipalities can be affected by deficiencies in the information base, risks related to measuring, and ensuring that the subjects of the incentive measures have powers and responsibilities in respect of the encouraged behaviour.

In the mid-term review, the Government proposed an investment in the range of EUR 100 million in an incentive system for municipalities targeting their operational expenditure. VATT has initiated a research project which examines the conditions for the creation of an incentive system. The results will be reported in spring 2018. The aim of the project is to investigate if it is possible to measure differences between municipal expenditure by also taking differences in service quality and service needs into account, as this would enable assessing the cost-efficiency of the services. Generation and utilisation of this type of information is important, even if it was not linked to the incentive system. Incorporating the incentive system into the system of central government transfers should be critically assessed because the objectives of the incentive system may not be in line with the other objectives of the system of central government transfers. The other elements of the system of central government transfers and its complexity may dilute the impact of the incentives, and the system may not provide equal incentives to municipalities. Furthermore, it should also be noted that municipalities already have an incentive to improve the cost-efficiency of their services since cost-efficiency itself is a beneficial objective for municipalities. In terms of the effectiveness of both the incentive system and the system of central government transfers, it is important that the systems operate in a clear and easy-to-understand manner.

3.3 The reform of data collection practices enables better targeted microeconomic steering

The information base utilised in the microeconomic steering of local government finances is mainly composed of the local government finances statistics maintained by Statistics Finland. The statistics on local government finances describe data on Finnish municipalities', joint municipal authorities' and their corporations' final accounts, as well as on their operational economy and investments. The quality of the information base collected depends on the quality requirements applied to the data on municipalities'

final accounts and financial planning, as well as on the data required in the calculation of the level of central government transfers, i.e. data on the actual costs incurred from services eligible for the system of central government transfers to local government. The information base is designed to meet information needs concerning accounting and expenditure.

Municipalities' internal and many service-specific information needs are often met using separate data gathering outside from the information base used in the microeconomic steering of municipalities. Municipalities generate a lot of information about their activities and related costs, but this data is often dispersed and only serves a specific information need. The Local Government Data Programme aims to improve the timeliness, comparability and accessibility of the information base from the perspective of the data needs of both local and central government. According to the audit, particularly timeliness and to some extent also comparability of data has improved, but a real effort must still be made before all data needs of municipalities and the state can be specified and covered.

The Local Government Data Programme will considerably improve the timeliness of the information base

Collection of data on municipalities should also serve municipalities' own data needs

The aim of the Local Government Data Programme is to improve the timeliness, openness, extensiveness and comparability of information. Another objective is to ensure availability of data from the perspective of the data needs of both local and central government. Particularly good results have been achieved in the area of data collection, to which the Local Government Data Programme is bringing considerable improvements. Automated data collection enables updating the information base concerning local government finances four times a year, which is a significant step forward compared to the present situation. Automated data collection will also reduce the administrative burden involved in the current data collection practices.

Automation of the collection of local government data and its transfer from Statistics Finland to the State Treasury will include some risks linked to the change. In the current model, Statistics Finland is responsible for the coordination of the collection of local government data, serving the needs of the different users, and performing quality assurance on the statistical data. Statistics Finland has also accumulated considerable expertise capital concerning the collection of local government data. In connection with the transfer of the data collection function to the State Treasury, it must be ensured that expertise accumulated is also transferred to the State Treasury, that the coordination of data collected from the local government sector is appropriately organised, and that the quality assurance process functions appropriately. On the basis of the audit, this change involves a risk that the automated quality assurance processes are not adequate to ensure the accuracy of the collected data. Furthermore, in legislative drafting, attention should be paid to the fact that it is now possible to prepare extensive online reports about the operations and finances of municipalities. During the transitional period, it is important to also ensure that all responsibilities within the areas of data collection and quality assurance have been clearly specified to avoid overlapping data collection practices and needs. At present, the reformed information base is foreseen to be in operation in 2020.

Another aim of the Local Government Data Programme was to develop data specification so that the coverage and comparability of the data collected would improve. Creating standardised data specifications provides a solid foundation for high-quality data collection, and the achievement of the target has been one of the most important successes of the programme. Despite the standardised specifications, it is still necessary to pay more attention to making the specifications binding. Specifications based on voluntary adoption do not guarantee comparability of data.

Changes in the data collection system also require investments in quality assurance

Data collection has been expanded to also cover the financial data of local authority corporations and financial planning in municipalities, which will also expand the coverage of the information base. The data collected under the management of the State Treasury are intended to be freely available to all relevant parties. Data collection should also be purposefully expanded, so that all possible data needed in the steering of local government finances could be available in a centralised manner.

The guidelines governing the collection of local government data should be made more binding

In adjustments to the division of costs, data providers have a major responsibility to provide high-quality information

Data about the costs incurred to municipalities from services eligible for central government transfers, i.e. actual costs incurred, are utilised when calculating the imputed costs used in the determination of the level of central government transfers. Actual costs incurred are revised annually in connection with the adjustments to the division of costs between local and central government. The required data are retrieved from the local government finances statistics maintained by Statistics Finland. The data concerning actual costs incurred should be extensive, accurate and timely to ensure that the level of central government transfers can be correctly determined. Municipalities are likely to report their actual costs incurred correctly and in a timely manner because any missing or incorrect data will reduce the amount of central government transfers paid to them. However, joint municipal authorities may not have a similar incentive because the reporting of costs has only indirect impacts on their financing. It is possible that the information concerning expenditure is also revised after the calculation of central government transfers. In exceptional circumstances, this could also require adjusting the level of central government transfers.

Automation of data collection improves the timeliness of data, which can considerably improve the quality of data collected on costs actually incurred. At present, based on its quality assurance activities, Statistics Finland sends requests for information to municipalities and performs the required corrections based on the received replies. In some years, the sum of the absolute values of the corrections made has been in the range of billions of euros. In automated data collection, particular attention should be still paid to verifying the correctness of data, particularly during transitional periods, when it is no longer possible to verify data by comparing them against data from previous years due to the changes in the data collection system. Furthermore, it would be important to examine the incentives of municipalities and other reporters of data to improve their responsibility for data accuracy.

Municipalities should have an incentive to report their actual costs incurred correctly and in a timely manner

Current microeconomic steering targets municipalities in an uneven manner

At present, the microeconomic steering targets municipalities in an uneven manner. Overall, it seems that the steering is not compatible with the objectives of the macroeconomic steering. The potential incentives contained in the system for central government transfers mainly affect municipalities in which central government transfers account for a larger share of their total revenues. The incentive provided in the Local Government Act concerning keeping the municipal budget in balance, i.e. covering any deficit accumulated in the balance sheet, from time to time affects only a relatively small group of municipalities.

The purpose of the microeconomic steering is to provide support for municipalities with poorer possibilities than on average to increase their revenues and curb their spending, as well as to identify those municipalities which are unable to achieve budget balance without jeopardising their provision of basic public services. In practice, microeconomic steering cannot reach a financially significant group of municipalities, whose indicators describing their budgetary position are within acceptable limits and for which central government transfers are not a particularly significant source of income. However, the role of these municipalities in the achieving of the budgetary position target is decisive.

Municipalities outside the reach of the microeconomic steering involve the greatest potential to achieve the targets of the macroeconomic steering

3.4 The macroeconomic and microeconomic steering of municipalities are not mutually compatible from the perspective of the budgetary position target for general government finances

The Decree on the General Government Fiscal Plan (120/2014) requires that that the budgetary position targets are set by using the concepts of national accounting. Consequently, the basis for the macroeconomic steering of local government finances is net lending according to National Accounts. The criteria laid down in the Local Government Act, which are used as the basis for the microeconomic steering, have been specified, using the concepts of municipal accounting, and therefore the key indicator used is a surplus or deficit accumulated in the balance sheet. The Programme for Local Government Finances, which elaborates the local government section of the General Government Fiscal Plan, also examines local government finances, using the concepts of municipal accounting. The concepts and book-entry practices used in municipal accounting are governed by Finnish accounting legislation. Instead, the collection of fiscal statistics on National Accounts is based on Regulation (EU) No 549/201 and the related (Eurostat, 2016)[23], as well as other applicable guidelines.

A major difference between the local government sector of National Accounts and municipal accounting is the way they define sectoral boundaries. Municipalities' external final accounts concern municipalities, joint municipal authorities and corporations of these. Instead, the accounts of

local authority corporations cover, in addition to the units referred to above, also subsidiaries of the parent municipality, whose share of the total finances of the corporation can be considerable, particularly in large municipalities.

In national accounting, the local government sector covers the non-market activities of municipalities and joint municipal authorities, which are primarily funded through taxation and compulsory charges. Unlike in the financial and operational statistics of municipalities, in national accounting, some municipally owned companies are categorised outside the local government sector to the corporate sector. Instead, municipally owned companies that are considered units that primarily serve the parent municipality are classified in national accounting to the local government sector.

The local government sector according to National Accounts and local government finances according to municipal accounting differ from one another

The boundaries of the local government sector in both municipal and national accounting keep moving. When examining local government finances in the light of the financial and operational statistics of municipalities, it is necessary to remember the impacts of corporatisation measures that have been implemented over years.

The categorisation of the sectors of National Accounts is also reviewed regularly. Statistics Finland reports any changes to the categories and the classification of new units on its website.[24] The differences between the local government sectors in municipal and national accounting is one reason why the indicators calculated based on final accounts data and the indicators calculated based on National Accounts differ from each other.

There are also differences in the concepts used by these to accounting systems. These differences reduce the effectiveness of the steering of local government finances. Based on the audit interviews, not all decision-makers are fully aware of the incompatibility of the indicators concerning macroeconomic and microeconomic steering.

Annual margin has not been sufficient to cover net investments

In the monitoring of local government finances performed in municipal accounting, it is customary to examine the development of the annual margin indicated on the profit and loss account. Annual margin indicates the amount of revenue available for investments and repayment of loans. The rule of thumb rule that if the annual margin equals to the depreciation according to plan deducted from the annual margin, the income financing of the municipality is sufficient. However, this also requires that the total depreciations correspond to the average level of investments eligible for depreciation.

Balanced results have not been enough to prevent indebtedness in the local government sector

Local government finances are in surplus if the profit according to the profit and loss account for the financial year exceed the net change in cumulative accelerated depreciation, reserves and funds. Based on this indicator, in recent decades, local government finances have been in surplus, with the exception of a few exceptional years. Since depreciation almost always remains smaller than net investments, balanced results have not been enough to prevent indebtedness in the local government sector. The development of net investments, annual margin and depreciation according to plan in the accounts of municipalities is illustrated in Figure 7.

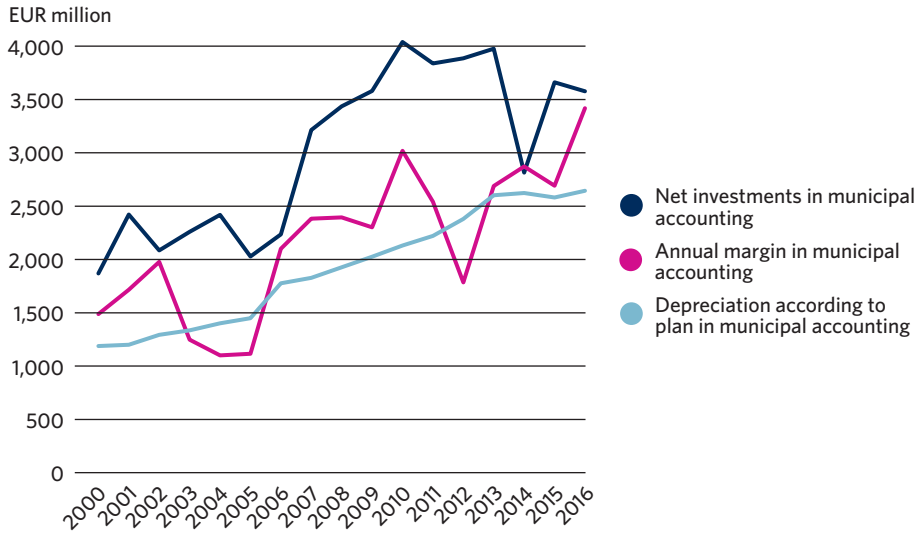

Figure 7: Development of net investments, annual margin and depreciation according to plan in the accounts of municipalities and joint municipal authorities in 2000-2016 (Source: Statistics Finland)

Deficits entered in books do not provide an adequate picture of the budgetary balance of local government finances

The uncertainty involved in final accounts data is reflected in the figure describing deficit accumulated in the balance sheet. Of the factors affecting deficit, there is considerable uncertainty involved in the treatment of investments and the level of related depreciation. Part of the uncertainty is due to municipal-specific solutions, which were implemented when migrating to the current accounting system.

The possibilities of a municipality to affect the accumulation of surplus or deficit depend on its decisions concerning its operational economy (i.e. revenues and expenditure) and on its accounting measures (such as depreciation, corporatisation or revaluation). The figure is also affected by any extraordinary items, derivatives arrangements, selected investment financing models (e.g. ownership, renting, leasing), and central government measures targeted at municipalities, such as adjustments to central government transfers.

Municipalities commonly underestimate their depreciations

Insufficient estimation of depreciations by municipalities, i.e. under-depreciation, has been a known issue for a long time, but it has been difficult to obtain specific data about the magnitude of the issue. According to information received in the audit, further inquiries in the matter have indicated systematic under-depreciation by municipalities, which is a significant finding in terms of the assessment of the budgetary balance of the entire local government sector.

Based on the audit, it is likely that a majority of municipalities make depreciations that are significantly smaller than recommended. Based on the results reported to the Municipal Guarantee Board (VTV, 2017)[25],

the issue of over- or under-depreciation may emerge when the expected income from or the productive capacity of fixed assets of municipalities or joint municipal authorities change considerably but the change is not entered as depreciations to the relevant balance-sheet items. For example, the productive capacity of fixed assets of a net migration municipality dilutes, if there are not enough residents to serve. In such case, the municipality should re-evaluate its ability to produce services and make the corresponding entries to the balance sheet. The issue may also originate in the baseline situation, if the depreciation criteria were purposefully set to provide the best possible outcome.

The level of depreciations falls behind the recommended level

The report commissioned by the Municipal Guarantee Board compared outturn data on depreciations and the lower limit for depreciations set in the general guidelines of the municipality subcommittee of the Finnish Accounting Board were compared against the assets eligible for depreciation. The investigation revealed that the level of actual depreciations has remained below the recommended imputable depreciations every year in the period under review (1997-2014). The investigation included a survey targeted to municipalities, and the results of that survey also indicate that the actual depreciations of assets eligible for depreciation have been too small considering the wear and tear of fixed assets.

Correction of the under-depreciated items would have led to dozens of municipalities meeting the criteria for the assessment procedure

A municipality-specific comparison revealed that under-depreciation is at the highest level in euro terms in municipalities with largest populations. Under-depreciation per capita vary in these municipalities between EUR 200-1,600. This also involves a theoretical deficit impact. If the under-depreciated items had been corrected at the municipality level, dozens of municipalities would have met the criteria for the assessment procedure according to the current interpretation rules. According to the investigation, the combined balance sheet values were, in total, two billion euros too high due to the under-depreciation.

Depreciations made by joint municipal authorities were also examined in an investigation commissioned by the Municipal Guarantee Board. This investigation covered the period 2009-2014. The average actual depreciation percentage of joint municipal authorities in the field of basic social security is significantly higher, compared to the similar depreciations made by municipalities on average. The imputed depreciation percentage of joint municipal authorities is only slightly higher than the actual percentage, which indicates that the related balance sheet values correspond relatively well with the fair values of the items, at least theoretically. The reform of the criteria for municipalities in severe financial difficulties mean that consequences from a deficit accumulated in the balance sheet now also apply to joint municipal authorities. This may provide joint municipal authorities with an incentive to also start making smaller depreciations than recommended.

The level of depreciations is determined municipal-specifically. The assessment of whether that level is correct is not straightforward. Despite this, there have been some isolated cases where the Supreme Administrative Court has repealed the approval of final accounts of the municipality specifically due to under-depreciation (Supreme Administrative Court, 2017)[26]. There have been attempts to clarify the guidelines concerning depreciations, and municipalities have increased their depreciations to some extent during the 2010s.

Depreciation means an decrease in the value of fixed capital goods

Potential under-depreciation can also be detected by comparing depreciations according to accounts with the value reflecting the consumption of fixed capital in the local government sector of National Accounts. Consumption of fixed capital reflects the consumption of capital in production use based on its technical and economic service life. It should be noted, that in such a comparison, the differences between the local government sector of National Accounts and municipal accounting should be taken into account. Development of consumption of fixed capital and depreciation according to plan is illustrated in Figure 8.

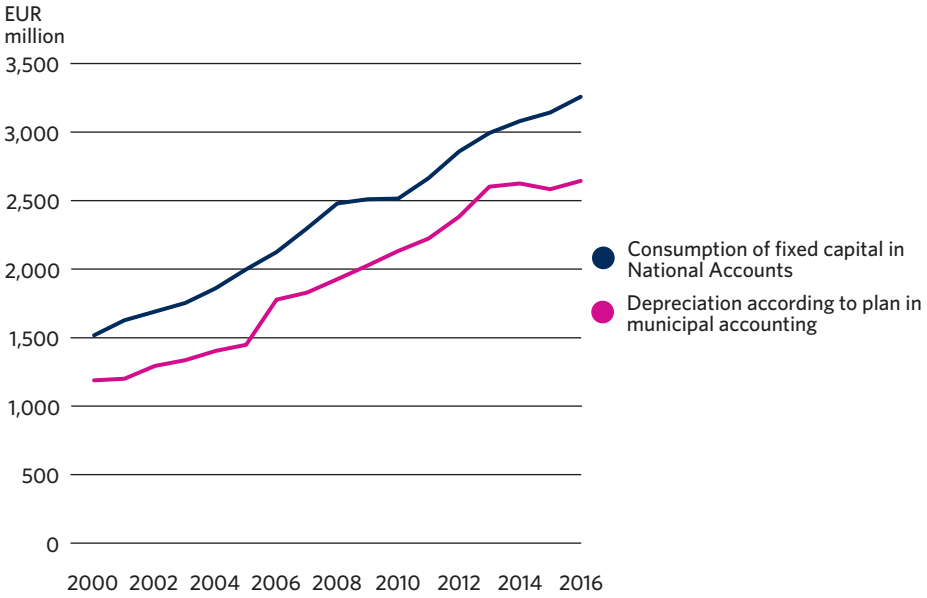

Figure 8: Development of depreciation according to plan in the accounts of municipalities and joint municipal authorities and consumption of fixed capital of the local government sector of National Accounts in 2000-2016 (Source: Statistics Finland)

Municipalities' fixed asset balance sheet values are not reliable

If the assets transferred to counties in connection to the health, social services and regional government reform are valued at their balance sheet value, it is likely that in the transfer it is more favourable to municipalities in declining areas than in growing areas. Based on the survey conducted in connection with the investigation commissioned by the Municipal Guarantee Board, it can be estimated that the under-depreciation of the health and social services buildings amounts to approximately EUR 670 million.

The balance-sheet value of the health and social services buildings is EUR 670 million overvalued

According to the investigation, the balance sheet values used by municipalities and the investment data used to determine those values do not meet the modern criteria for reliable data. Therefore, the balance sheet items of municipalities should be revalued and the level of depreciations should be revised. It should also be assessed if the current depreciation criteria are appropriate for their purpose. The situation varies greatly depending on whether the depreciation is based on an investment self-financing expenditure or the total investment. According to the investigation, asset values determined based on investment self-financing expenditure

would likely be more realistic exchange values than the current balance-sheet values. Any further examination of the issue is impeded by deficiencies in the data regarding the amount of repair backlog and how it is allocated to different items.

Based on the audit, the depreciation practices of municipalities should be further standardised by making the related recommendations more binding. If the varying depreciation practices converged with each other and with the provided recommendations, it would improve the effectiveness of the microeconomic steering tools currently in use. The determination of the fair value of municipalities' assets should also be considered in connection with the health, social services and regional government reform or thereafter.

Uniformity of the steering of local government finances should be enhanced

Deficit does not contain information about the indebtedness of municipalities

The link between the budgetary position target for the local government sector and the budgetary position of individual municipalities is weak. A macrolevel objective for the budgetary position of local government finances does not bind policy-making in individual municipalities. Financial management in municipalities is governed by the provisions of the Local Government Act and the Accounting Act. It is difficult to get municipal decision-makers to commit to financial management that could better guarantee the achievement of the budgetary position target, unless a corresponding balancing item can be indicated in the final accounts of the municipality. In terms of the achievement of the budgetary position target, it is important to investigate whether the microeconomic steering of municipalities can support the achievement of the budgetary position target for the entire local government sector.

The macroeconomic steering of local government finances and the microeconomic steering of individual municipalities should steer local government finances in a sufficiently uniform and consistent manner. Otherwise there is a risk that the macrolevel targets set for local government finances remain as recommendations and the budgetary position of the local government sector does not improve as intended.

Should the assessment procedure be used to support the targets of macroeconomic steering, the criteria for the procedure should also consider elements of national accounting, i.e. macroeconomic steering, which are currently missing from the microeconomic steering, which is based on municipal accounting. Deficit and surplus do not provide any information about the (net) indebtedness of municipalities, unlike net lending according the National Accounts, which is used as the basis for determining the budgetary position target for the macroeconomic steering.

Cash flow from operations and investments reflects the concept of net lending according to accounts better than deficit does

Of the concepts of municipal accounting, cash flow from operations and investments reflects the concept of net lending according to accounts better than deficit does. This indicator shows whether the income financing is sufficient to cover net investments. Negative cash flow from operations and investments provides information about the municipality's need for financing. Development of deficit, cash flow from operations and investments and net lending according to National Accounts is illustrated in Figure 9.

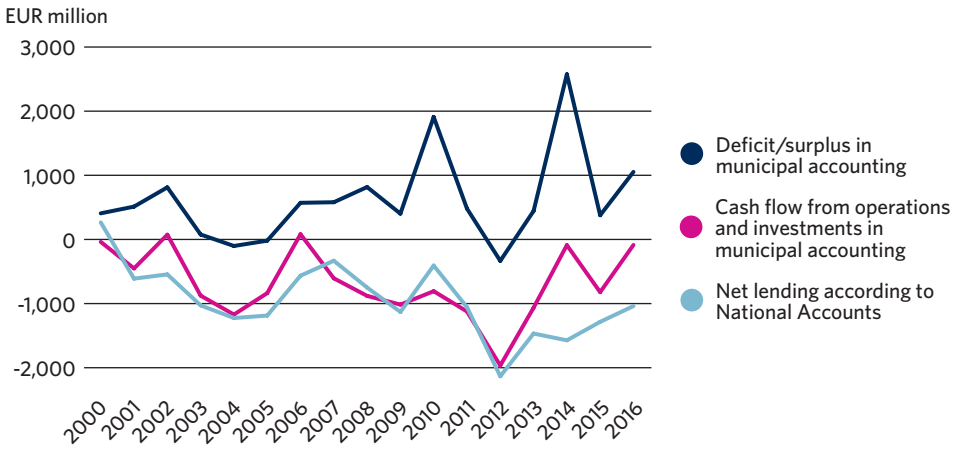

Figure 9: Development of deficit and cash flow from operations and investments of municipalities and joint municipal authorities and budgetary position of the local government sector of National Accounts in 2000-2016 (Source: Statistics Finland).

The role of the assessment procedure in supporting the achievement of the targets of the macroeconomic steering could be strengthened by replacing the existing indicator concerning deficit with the indicator reflecting cash flow from operations and investments, or by using the both in parallel. The limit value for cash flow from operations and investments should be selected so that it would support long-term economic sustainability. The limit value could be determined, for example, based on a rolling average over a period of four years, and it could be set at a level that would support the achievement of the budgetary position target set for the macroeconomic steering of local government finances. Furthermore, when specifying the limit value, it is also possible to take into account a targeted average rate of self-sufficiency for municipalities, which would set the limits for the acceptable rate of growth for indebtedness and would also take the assets accumulated in municipalities into account.

In 2016, the average cash flow from operations and investments in municipalities was EUR -22 per capita. The figure was lower than average in 45% of the total number of municipalities. If the limit value was EUR -1,000 per capita, only 2% of the total number of municipalities would fall below the limit. Of these, only two also have deficit accumulated in their balance sheets, which means that these indicators provide information about the budgetary position of municipalities from different perspectives. In 2016, a total of 21 of all municipalities had both deficit and negative cash flow from operations and investments, while the 15 other municipalities in deficit has positive cash flow from operations and investments.

When deciding on the measures of macroeconomic steering, it should be carefully analysed what kinds of incentive impacts do the measures involve for individual municipalities.

The targets of macroeconomic steering may be difficult to link to the assessment procedure without more municipalities falling within the scope of application of the assessment procedure than currently. Therefore, it might be possible to consider setting up a simplified procedure alongside the assessment procedure, particularly for the needs of macroeconomic steering. Another possibility is to improve the targeting of the steering so that it can better take account of the difference between municipal categories. For example, the criteria concerning indebtedness and investments could be assessed from a different viewpoint for gross and net migration municipalities.

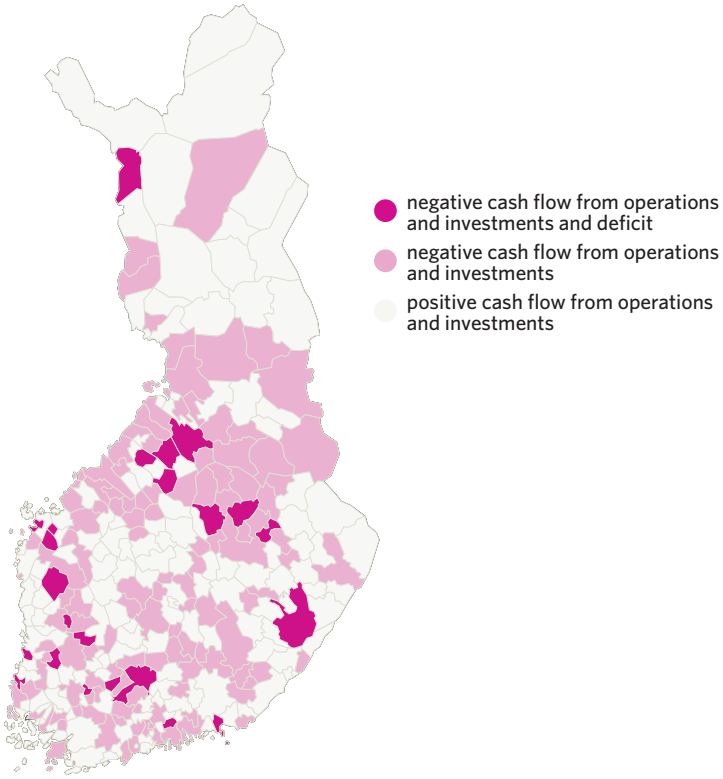

Figure 10: Municipalities with negative cash flow from operations and investments in 2016 (Source: Statistics Finland).

Compatibility of steering measures should be taken into account

When setting incentives, the effectiveness of the overall macroeconomic steering should be taken into consideration, i.e. how the normative steering, financial steering and information steering all function together. When drafting impact assessments of measures aiming at expenditure cuts, attention should be paid to limitations concerning, for example, the cutting of fixed costs, which arise from normative steering.

In general, municipalities already have incentives to secure their own financial sustainability, The savings measures implemented by municipalities independently also indicate that these incentives are effective. Overall, the policy applied in the steering of local government finances in recent years, which has aimed to cut down the tasks and obligations of municipalities while expanding the revenue base by relaxing the thresholds applied to payment and taxation criteria, has increased the possibilities of municipalities to balance their finances independently.

Appendix: Audit method

Appendix

This appendix describes how the findings presented in the audit were produced and what are the limitations concerning the findings.

Audit objective and use of the audit findings

The purpose of the audit was to verify whether the steering of local government finances, which is under the responsibility of the Ministry of Finance, meets the targets set for the steering and functions in an effective and efficient manner, considering the relevant limitations. If the steering meets the above criteria, it is possible to impact the development of local government finances in a proactive and timely manner, and thus also to ensure the achievement of the sustainability target of public finances. Another objective was to assess and promote the transparency of the steering of local government finances, as well as to evaluate the effectiveness of recent steering development measures and to promote further development of the steering. Furthermore, the aim was to assess the reliability of the information base used in the steering of local government finances.

The results can be utilised in the development of the steering of local and regional government finances. The key parties using the audit results are the Government, the Ministry of Finance and Parliament. In addition, the audit also contributes to the continuous fiscal policy evaluation performed by the National Audit Office.

Audited entity

The audit primarily targeted the Ministry of Finance, which is responsible for the overall steering of local government finances. In the Ministry of Finance, the Budget Department, the Economics Department, the Tax Department and the Department for Local Government and Regional Administration participate in the processes concerning the steering of local government finances. In addition, the Public Sector ICT Department is responsible for the coordination of the reform concerning the information base for the steering of local government finances.

Opinions on the draft audit report were requested from the Ministry of Finance, the Ministry of Education and Culture, the Ministry of Social Affairs and Health, Statistics Finland and the Association of Finnish Local and Regional Authorities, which all also provided their opinion. The feedback contained in the opinions was taken into account in the preparation of the final audit report. The opinions and the abstract based on them can be viewed on the website of the National Audit Office.

In addition to opinions, comments on the draft audit report were requested from the Municipal Guarantee Board, VATT Institute for Economic Research and the secretariat of the Finnish Council of Regulatory Impact Analysis.

Audit issues and sub-issues

1. Does the macroeconomic steering of local government finances support the achievement of the objectives set for the overall steering of general government finances?
- Does the macroeconomic steering of local government finances support decision-making in the area of public finances and the achievement of the medium-term objective set for the general government structural balance?
- Do the administrative processes of the Ministry of Finance support the steering of local government finances in an efficient manner?
- How is the implementation of the expenditure limit set by the state for municipalities monitored and is the monitoring carried out in an open and transparent manner?
- Do the calculations presented in the General Government Fiscal Plan that assess the impacts of central government measures on local government finances provide a true and fair view of the real situation?
- What incentives are included in the macroeconomic steering of local government finances?
- What kinds of opportunities will the new data materials generated as a result of the Local Government Data Programme provide for the macroeconomic steering of local government finances?
- What types of change needs does the health, social services and regional government reform cause in terms of the macroeconomic steering of the local government sector?

Audit criteria, material and methods

Criteria: Transparency of the macroeconomic steering of local government finances and the related information base and risks, efficient utilisation of available information, and timely access to data.

Material: Government Programme, General Government Fiscal Plan, Programme for Local Government Finances, documents concerning the Local Government Data Programme, interviews, and calculations utilised in the drafting of the General Government Fiscal Plan.

Analysis methods: Document analysis, analysis of interviews and analysis of calculations

2. Does the microeconomic steering of municipalities improve the sustainability of local government finance and achievement of the macroeconomic targets?
- What incentives are included in the microeconomic steering of local government finances?
- What types of change needs does the health, social services and regional government reform cause in terms of the microeconomic steering of the local government sector?
- What kinds of opportunities will the new data materials generated as a result of the Local Government Data Programme provide for the microeconomic steering of local government finances?
- Can the recommendations and provisions concerning the reporting of local government data ensure the generation of high-quality data for the use in the steering of local government finances?
- Are the macroeconomic and microeconomic steering of municipalities mutually compatible from the perspective of the budgetary position target for general government finances?

Criteria: Objectives of the provisions of the Local Government Act governing local government finances, objectives set for the system of central government transfers in terms of the steering of local government finances, optimum information base to facilitate the targets set for the steering of local government finances, compatibility of the incentive impacts of the microeconomic and macroeconomic steering.

Material: Local Government Act, Programme for Local Government Finances, final accounts and statistics reflecting the status of local government finances, documents concerning the Local Government Data Programme, interviews, guidelines concerning financial and operational reporting in the local government sector, and National Accounts.

Analysis methods: Document analysis, analysis of the final accounts, analysis of interviews and statistical analysis.

Audit process

The preliminary review for the audit was carried out between 2 March 2017 and 2 June 2017. At the preliminary review stage, comments on the audit design were requested and received from specialists of the Ministry of Finance. These comments were taken into account in the final audit design. They did not result in any significant changes to the audit design.

The audit was started on 5 June 2017 and it was completed on 16 March 2018. The interviews utilised in the audit were conducted during the preliminary review stage in March-April 2017 and during the audit in August-November 2017. The latest changes concerning the audited entity or audit material that were taken into account in the audit were made in January 2018.

Auditors

The audit was performed by Ville Haltia, Principal Fiscal Policy Auditor, and auditor Sini Salmi. Director for Fiscal Policy Audit Matti Okko supervised the audit.

Limitations and reservations concerning the audit findings

- This audit focused on the assessment of the new steering system for local government finances. In practice, this refers to the steering of local government finances that is based on the General Government Fiscal Plan published since 2014 and on the reformed Local Government Act (2015). The statistical materials include information about the development of local government finances from the year 2000 onwards. The audit did not include an assessment of the local government financing system implemented with the help of the Municipal Guarantee Centre and Kuntarahoitus Oy because it was not deemed to involve a steering function concerning local government finances within the scope of the present audit. Although, it should be stated that the financing scheme to be implemented will have impacts on the steering of local government finances because the scheme has weakened the market-based steering of the financial markets by guaranteeing low-cost financing to all municipalities.
- As the audit report reveals, the steering system for local government finances has been developed in recent year in many ways, and the development work still continues. Since only a short period of time has elapsed since the development measures, it is not possible to present a reliable conclusion of the effectiveness of the steering of local government finances based on statistical analysis. Such analysis can only provide indicative support for other, evidence-based conclusions.

- Due to the continuing development work, some of the observations made during the audit may also be partly obsolete by the time of the publication of the audit report.
- The interview materials used are based on interviews conducted during the preliminary review and later during the audit. A total of 12 interviews were conducted in the Ministry of Finance. In addition, we also interviewed specialists from Statistics Finland, Association of Finnish Local and Regional Authorities, Kuntarahoitus Oy, VATT, Prime Minister's Office, Ministry of Education and Culture and Ministry of Social Affairs and Health.
- The main body of materials used in the document analysis is composed of the General Government Fiscal Plans and Programmes for Local Government Finances for 2015-2017, the Local Government Act, as well as various reports from working groups established for the development of the steering system and research reports.
- The statistical analysis is based on the official statistics of Statistics Finland (e.g. annual national accounts, final accounts of municipalities, joint municipal authorities and local authority corporations, financial and operational statistics of municipalities and joint municipal authorities).
- The audit approach is primarily system-based. The audit emphasises the effectiveness and transparency of the steering of local government finances and the steering system in the performance of public administration tasks.

References

References

1 Government Decree on the General Government Fiscal Plan, 13 February 2014. 120/2014.

2 Government Decree on the amendment of the Government Decree on the General Government Fiscal Plan, 31 August 2017. 601/2017.

3 Local Government Act 410/2015.

4 Opinion of the Constitutional Law Committee 34/2013 vp. Government proposal to Parliament for the legislation concerning an amendment of the Act on central government transfers to local government for basic public services.

5 Aho, M. 2011. A Construct for Performance Management Maturity Assessment.

6 Ministry of Finance, 2015. VM/2103/02.02.00.00/2014. General Government Fiscal Plan, 2 April 2015.

7 Press release by the Association of Finnish Local and Regional Authorities, 21 June 2017. Kuntaliiton kysely kuntatalouden sopeuttamistoimien vaikutuksista: Hallitusohjelman sopeutustoimet jäämässä tavoitteista, kuntien omat toimet korjaavat tilannetta.

8 Johtopäätökset kuntien säästökyselystä. Ministry of Finance, 2017.

9 Kuntatalouden makro-ohjauksen kehittäminen. Taloudelliset ja talouspoliittiset katsaukset. Ministry of Finance publications 6/2014.

10 Government Programme of Prime Minister Juha Sipilä's Government, 29 May 2015. Government publications 10/2015.

11 Ministry of Finance, 2015. Taloudellisten vaikutusten arviointi kuntatalouden näkökulmasta. Kunnallistalouden ja -hallinnon neuvottelukunnan taloudellisten vaikutusten arviointijaosto. Ministry of Finance publications 9/2015.

12 Government Decree on the Council of Regulatory Impact Analysis. 1735/2015.

13 Draft assessment report. Subcommittee for the assessment of economic impacts of the Advisory Committee on Local Government Finances and Administration. 9 January 2018.

14 Finnish Council of Regulatory Impact Analysis. Annual Review 2016. Prime Minister's Office. 2017.

15 Kohti julkisen talouden kokonaisohjausta. Economic Surveys of the Ministry of Finance 2/2015. Ministry of Finance, 2015.

16 Sinervo, Lotta-Maria (2011): Kunnan talouden tasapaino monitulkintaisena ilmiönä. Academic dissertation. Tampereen Yliopistopaino Oy – Juvenes Print. 2011, pp. 235-236.

17 HE 53/2013. Government proposal to Parliament for legislation concerning amendment and temporary amendment of the Act on local authority boundaries and repealing certain provisions of the Act on local authority boundaries, as well as supplementing the Government Proposal on amendment of the Language Act (HE 31/2013 vp).

18 Supreme Administrative Court 2016: 187. Yearbook decision.

19 Political Representation and Effects of Municipal Mergers. VATT, 2017.

20 VATT, 2015. Hyvän valtionosuusjärjestelmän periaatteet. VATT analysis 70.

21 https://www.kuntaliitto.fi/sites/default/files/media/file/menot_ja_tulot_marraskuu2017.pdf.

22 HE 15/2017. Government proposal to Parliament for legislation concerning the establishment of counties and reform of health and social services and on making the notification referred to in Article 12 and 13 of the European Charter of Local Self-Government.

23 Eurostat, 2016. Manual on Government Deficit and Debt. Implementation of ESA 2010.

24 http://tilastokeskus.fi/meta/luokitukset/_linkki/soveltamisp.html.

25 NAOF, 2017. Audit memorandum on the report presented at the Municipal Guarantee Board on the topic of whether the level of depreciations is adequate.

26 Decision of the Administrative Court of Hämeenlinna, 13 October 2017. Decision No 17/0635/3.

National Audit Office of Finland
Porkkalankatu 1, PO Box 1119, FI-00101 Helsinki, Finland
tel. +358 9 4321, www.vtv.fi