

# Choosing between Regulation and Local Self-government: the Finnish case

by Antti Moisio, Government Institute for Economic Research, Finland

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## 1. Introduction

The so called Musgrave-Oates-Tiebout model of fiscal federalism is based on four basic assumptions: local public goods, benefit taxation, mobility and no spillovers. Rattso (2002) notes that all these four assumptions are false from the European (and especially Nordic) perspective. This is mainly because central governments have decentralised the redistributive spending, keeping the financing powers tightly in central control. The resulting administrative federalism that is practiced in European countries instead of "pure fiscal federalism", uses decentralization mainly to avoid administrative overburden. But at the same time decentralised merit good provision requires norms, regulations and fiscal controls to guarantee equity. The key question then is how to implement the regulation so that it works in accordance with the original objectives of decentralization. Regulation can just as well be harmful if it limits the local discretion "too much".

Against this background, the Finnish case seems just another application of administrative federalism. But there are also some specific features that can be worth describing and discussing. This kind of discussion is especially interesting now, as the new government in Finland (in power since June 2011) has recently announced that it is determined to push through a radical municipal boundary reform. The main aim of the reform is to create municipalities that will be strong enough to provide the services alone, without need for municipal cooperation and with less central government involvement.

This paper aims to describe and discuss the present decentralization in Finland with some short remarks on normative framework and financial regulation. The paper is organized as follows. Section two describes briefly the intergovernmental relations in Finland, the municipal tasks and funding, the normative framework and financial regulation. Section three discusses some recent reforms concerning the intergovernmental relations. Section four summarises and concludes the paper.

## 2. Intergovernmental fiscal relations in Finland

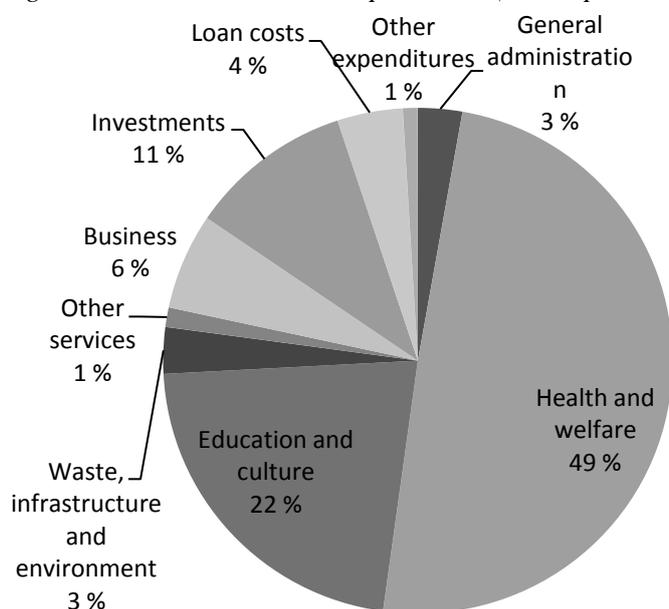
### 2.1. Municipal tasks and funding

Finnish municipalities have traditionally been responsible for many important tasks. For example, all health care, social welfare and most education services (except university education) belong to municipal obligations. These services comprise about 70 per cent of the municipal sector expenditures (Figure 1). Municipalities and joint authorities also run or organise cultural, environmental, leisure and planning services. As a result, municipal spending amounts to 65 percent of total public consumption expenditures and 18 percent of GDP.

At the beginning of 2011 there are 336 municipalities in Finland. In 1990 the number of municipalities was 460. The reduction in the number of municipalities was slow until 2005, when the central government started a project to reorganise local government. The municipal and service structure (PARAS) reform will be discussed in more detail below.

The fragmented municipal structure forms the major challenge to service delivery in Finland. To cope with the situation, the smallest municipalities are usually involved in inter-municipal cooperation and other partnership arrangements. Inter-municipal cooperation is practiced usually in health care, but also social welfare and education services.

Figure 1 Total municipal sector (municipalities and joint municipal authorities) expenditure, 2009



Source: Association of Finnish Local and Regional Authorities

Municipal finances are based on own source revenues and a single block grant from the central government. Municipalities are allowed to borrow for investment purposes and to finance running expenditures. The main own source revenue is the municipal income tax that makes up 40 per cent of all

revenues. Municipal income tax is a flat rate tax. The local income tax base is determined by the central government but municipalities have full control over the rate. During the past few years, central government has adjusted the tax deductions so that local tax has become a progressive tax.

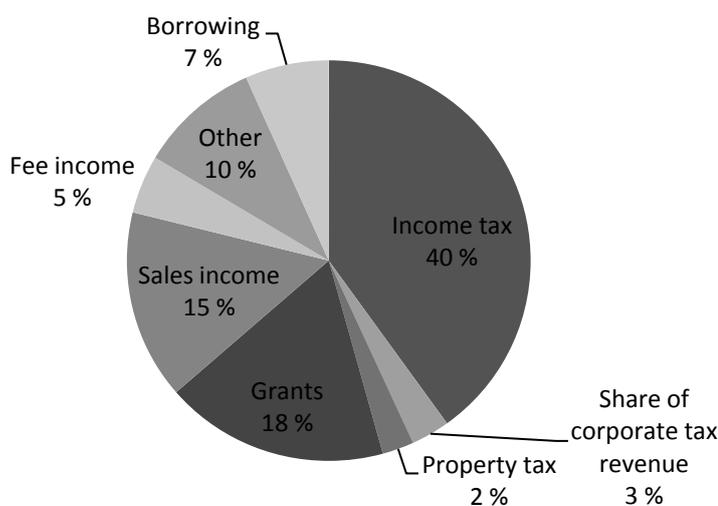
Another municipal tax is the property tax but the share of this tax revenue does not play an important role in the municipal finances. Compared to income taxation, municipalities have less discretion over tax rates, because maximum and minimum rates are set by the central government.

The third municipal tax revenue is the corporate tax revenue. This is a central government tax, but the municipalities receive a 32 percent share of the tax revenue collected in their area. The share will be dropped to 27 percent from the beginning of 2012 (the share was 22 percent before 2008, but as part of the central government fiscal stimulus package, the share was temporarily increased to 32 percent).

The block grant is an important source for funding for the poorest municipalities and those with relatively high service needs. The block grant is defined using formulae that measures the service need and cost differences in the municipalities (cost equalisation), and the differences in tax base (revenue equalisation). The revenue equalisation is built into the cost equalisation so that those municipalities whose per capita calculatory tax revenues (country average tax rate × own tax base) exceed the threshold of 91,8 percent of average per capita tax revenue, will receive less cost equalisation grants. Similarly, the municipalities whose per capita calculatory tax revenue is below the 91,8 percent threshold, will receive more cost equalisation grants. In other words, no municipal tax revenues are transferred from one municipality into another. The cost equalisation part dominates the system: the amount of cost equalisation is worth ten times the effect of tax base equalisation.

Public utilities have traditionally been an important source of funding for some municipalities. Most of the customer charges are collected for services such as water supply, waste disposal, power supply and public transport. At the moment there are about 150 municipally owned public utilities and 1300 public limited companies whose main owner is a municipality. Just under one tenth of social welfare and health expenditure is covered through customer and patient charges.

Figure 2 Total municipal sector (municipalities and joint municipal authorities) income, 2009



Source: Association of Finnish Local and Regional Authorities

## 2.2. Normative regulation

### *An overview*

The block grant reform (moving from matching grants to block grants) in the beginning of 1990s meant a sharp reduction of central government regulation and involvement in municipal affairs. Since then, the central government official policy has been to avoid very restrictive regulations and service standards at the local level. The basic idea after the reform of 1990s was that central government would steer the municipalities mainly by providing information about best practices and factors that affect service quality. For this purpose, the central government founded two expert/research institutions: the National Research and Development Centre for Welfare and Health (later called the National Institute for Health and Welfare) and the Finnish National Board of Education. These organisations are expected to provide up to date information and advice to municipalities, practitioners and the general public.

Recently, Ministry of Finance assigned a working group to evaluate the overall situation of norms and regulations targeted at municipal services. From the municipal side, the expectations on this working group were high because despite of the general policy of "no regulation", at the local level it is believed that the normative framework is the main obstacle in the way to improve the municipal efficiency. However, the working group ended up not proposing any reduction in the norms and other regulations. Instead, they suggested better planning and coordination of existing and future norms (Ministry of Finance, 2011). Whether the outcome by the working group means that there are no unnecessary norms in Finland, or something else, is somewhat unclear. In below, the Finnish framework is described shortly.

### *Legal framework*

The legal basis of the central-local relationship can be found in the Constitution, but the practical regulation of municipal services is executed through special legislation. In social services, for example, the Constitution determines the citizen's rights for services but there are dozens of special laws that regulate the municipal service delivery. Despite of this, the special legislation does not include any detailed regulation of the scope, content and ways of organizing the social services. Also, there is no legislation on sanctions for not following the norms, either.

A fairly recent trend has been to improve the services for special groups by establishing the so called "subjective rights". A good example of a subjective right is child daycare: each municipality is obliged to provide daycare (and preschooling) for every child of certain age in the municipality. There are also plans to introduce subjective rights in elderly care services. Although most of the subjective rights are defined in special laws, some of them are also determined in Constitution. An example of this kind of right is the right to free comprehensive school education.

Another quite recent political trend is to demand more detailed norms and standards. In health care, the so called "treatment guarantee" that sets the maximum waiting times of the patients for medical treatments (mostly surgery operations), is a good example.

In sum, despite of the original intention of reduced central government intervention and the aim of local self-governance, the importance of norms and regulations has clearly increased during the past ten or fifteen years.

### **Monitoring**

The monitoring of the municipalities is the responsibility of central government regional offices. These units follow the performance and quality of each municipal services in their area. They can also perform detailed inspection, for example by visiting schools and municipal health centres etc. These offices are not very well resourced, however, so the monitoring is not very intensive.

Much of the monitoring of municipal services is delegated to citizens themselves. In addition to local democratic processes, a person who is dissatisfied with the services or does not agree with the decisions made by the home municipality, has the right to appeal to Administrative Courts or the Supreme Administrative Court. This kind of appeal can be done on any municipal service or decision concerning the individual or group of individuals (for example, concerning the service availability or eligibility).

### **Planning**

The macro level central-local guidance and control is executed through the so called Basic Public Services Programme and the Basic Public Services budget (Ministry of Finance, 2008). These procedures form an integral part of the negotiating procedure between central and local government. Also, the Basic Public Services budget is used when preparing the government Budget. The main aims of the Basic Public Services Programme are:

- to evaluate changes in the local government operating environment and the demand for services
- to follow the trend in local government finances and changes in local government functions
- to draw up a plan of the measures required for balancing municipal revenue and expenditure
- to make a proposition for the financing needed for carrying out the statutory local government functions, for developing them and for increasing productivity

Based on the above, the Basic Public Services budget process evaluates the outlook in local government finances and the impact of the Government budget proposal on local government finances.

The Basic Public Services Programme and the Basic Public Services budget are prepared for four year periods (the latest is for 2009-2012). Ministry of Finance prepares the plans together with other ministries. The Association of Finnish Local and Regional Authorities participates in the procedure as a permanent expert.

## **2.3. Financial regulation**

### **Grant system**

So far, the above described developments in the normative area have not affected the grant system much. The grant system is still mostly based on non-earmarked grants. The single block grant (since 2010 there is only one block grant) is determined using variables that describe the service needs and cost factors so that municipalities themselves cannot directly affect the transfers they receive. Hence, the grant system is

mostly neutral from the normative point of view. In fact, the main problem with the present grant system is not lack of neutrality but poor quality of the indicators used in calculation. To be more specific, the indicators may over- or undercompensate the costs, depending on criteria (Lehtonen et al., 2008). In other words, some of the municipalities receive too much grants whereas others are underfunded. Naturally, this is a question of both equity and economy. But even as it is nowadays quite well known that the grant system could be improved with better indicators, lack of political agreement has so far prevented a comprehensive grant system reform. Instead, the system has been changed step by step, and this has made the system rather detailed and complicated to operate. Also, political demands for more earmarking have been on the rise, but so far Ministry of Finance has been able to reject most of these proposals.

Another problem of the grant system is the division of costs between central government and municipalities. Every four years, the actual unit costs (municipal spending per pupil, basic health spending per capita) are compared to the calculatory unit costs used in the block grant system. If the actual costs exceed those used in the grant system, then according to agreement with central government and municipalities, the difference from the past four years should be compensated to municipalities. How the compensation is done in practice, forms usually a major disagreement between Ministry of Finance and the Association of Finnish Local and Regional Authorities. Ministry of Finance has in some cases refused to pay the difference in full amount, or at least demanded that the payments should be spread over several years, to avoid positive shock in the municipal finances.

The reasons why grant funding and actual cost may differ are of course many, for example poor productivity development or unexpectedly high demand for the services. But in some cases the reasons is that the actual cost of recently mandated service has been higher than expected. This reason is important, because whenever central government assigns municipalities a new task, the total cost of the task is predicted in advance and this estimate is used to define the grants (since 2010, the central government has agreed to finance 50 percent of new mandated tasks). In practice, the cost estimates have often been inaccurate.

### **Fiscal rules**

It seems widely accepted that fiscal rules alone cannot guarantee fiscal discipline at the subnational level. This is especially the case if there is no political will at the local level and if there is no central government commitment to a credible no-bailout policy (Ter-Minassian, 2007). Nevertheless, fiscal rules are commonly used to restrict local government spending and revenue.

A comparison to OECD countries shows that in Finland the fiscal rules concerning the local government are less stringent than the OECD average (Sutherland et al., 2006). The Finnish situation concerning fiscal rules that restrict the municipal budgetary decision-making can be summarised as follows:

- **Borrowing:** no constraints on borrowing or debt brakes
- **Budget balancing:** municipalities are expected to balance their budgets over a four-year period, but there is no sanction for failing to fulfil this rule - failure to balance the budget within the four year period may lead into further inspection by central government in that municipality
- **Spending:** no caps or restrictions
- **Taxation:** no tax rate or tax revenue restrictions (except for property tax rates, that can vary only within a band set by the central government)

Despite of the lack of fiscal rules implemented at the local level, Finnish municipalities do not seem to be especially indebted or inefficient in international comparison (Sutherland et al., 2006). However, the recent statistics show that the municipal debt is on rise. A big problem in Finland concerning municipal revenues is the volatility of municipal tax base. This is mainly because of cyclical corporate tax revenue. The volatility of revenue may lead to a “ratchet effect”, where municipal expenditure rises in good times but is not cut in a downturn (Sutherland et al., 2006). As a result, tax rates may be raised to cover the loss. Or, in the absence of borrowing constraints, municipal borrowing is increased.

The new government programme pays attention to these issues and the government plan is to enhance the macro level agreement between local and central levels about tasks, expenditures and revenues. In minimum, this would mean a refinement of the present Basic Public Services Programme and the Basic Public Services budget processes.

### **3. Recent reforms affecting central-local relationship**

The most important past reforms concerning the Finnish central-local relationship and normative framework are the municipal restructuring project, service structure reforms and grant system reforms.

Aiming to reform the municipal size and improve the municipal cooperation, the government enacted the Structural Reform Act in 2006. The Act, and the following government led PARAS-project, required that in primary health care and associated social services, municipalities should reach a population base of at least 20 000. In comparison: in 2010, only a quarter of municipal health providers (single municipalities or joint municipal authorities) had a population base of more than 20,000. Some flexibility was allowed based on archipelago environments, long distances and language and cultural situation. In addition, municipalities were free to decide whether they reach the minimum population bases with municipal mergers or with enhanced cooperation. In cases where a new partnership area is formed, a new joint municipal body must also be established for the management of the relevant tasks. In health care and welfare services, some 67 new cooperative areas will start by the end of year 2013.

Simultaneously, the central government has continued to promote municipal mergers with a special merger grant policy and merger grants. The latest merger programme has been effective since the beginning of 2005 and the programme has been able to reduce the number of municipalities by 96 (by voluntary mergers). The merger programme as well as the structural reform Act will end in 2012.

The new coalition government (in power since June 2011) has announced that it will start a new reform programme that aims to create a totally new municipal structure to Finland. The details of the programme are still unknown, but the aim seems to be to reduce the number of municipalities from the present 336 to perhaps even to about 100 municipalities by 2015. The motivation for the restructuring is to create municipalities that would be strong enough to provide all or most services alone, without need for municipal cooperation (except for most advanced health care). The government also hopes that the new municipal structure would help to reach the government targets for public sector financial sustainability, prepare for population aging and improve the public sector efficiency and local democratic decision-making. With this reform, the government ends all previous speculations about new (regional) intermediate government levels and about centralising health care services in Finland.

## 4. Discussion

The small municipal size combined with demanding tasks has always been the main dilemma of the Finnish system. The inter-municipal cooperation has probably solved most of the scale and externality problems, but doubts about transparency and accountability of cooperative decision-making have remained.

The Finnish model of administrative federalism has given much responsibility to municipalities. Despite of the recent trend of “subjective rights”, the rules and regulations have been kept to the minimum to let the municipalities find the best way to organise the services. All this has worked reasonably well in the past. In fact it has worked so well, that it has become a practice of the central government to mandate new tasks to municipalities. This situation has been described by the OECD as follows: “the central government seems to first “push down” service delivery to the local level, and then evoke municipal autonomy to minimise its involvement and distance itself in the accountability chain” (OECD 2010).

The fact that Finnish population is aging has increased the pressures for reform. The small municipalities simply cannot bear their present tasks, not to mention the new tasks, even with cooperation. The main alternatives on the table have been either to centralise the health care, to perform a comprehensive reform of municipal structure or, to establish new government level (regional councils) that would take the responsibility of health and social welfare services. The new government has decided to rely on the so called “strong municipality model”. This will mean a radical boundary reform and it will also make most of the present municipal cooperation unnecessary. With this decision, the government shows that it wants to continue and to strengthen the policy of minimising central government involvement.

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