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# Policy Reports 2

Public services at the local level –  
The Finnish way

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*Heikki A. Loikkanen*

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# VATT POLICY REPORTS

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# Public services at the local level – The Finnish way

Government Institute for Economic Research

VATT Policy Reports 2/2010

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## Abstract

This paper describes the organisation, tasks and financing of the Finnish local government. The description concentrates on social service, health and education tasks and their financing. The other municipal tasks are mentioned only briefly. Using the latest research and evaluation results, the past and ongoing reforms concerning the Finnish local government are discussed.

Key words: municipal finance, public services, municipal size

JEL classification numbers: H7

## Tiivistelmä

Tämä raportti sisältää englanninkielisen kuvauksen Suomen kuntajärjestelmästä, sen tehtävistä, rahoituksesta ja uudistushankkeista. Raportti pyrkii antamaan kattavan kuvan kuntien ja kuntayhtymien toiminnasta ja tehtävistä, mutta pääpaino on kuntasektorin keskeisissä palvelutehtävissä. Raportissa tehdään myös yhteenvetoa viimeaikaista kuntapalveluja, rahoitusta ja kuntarakenteen uudistusta koskevista uudistushankkeista ja niitä koskevista tutkimustuloksista.

Asiasanat: kuntatalous, peruspalvelut, kuntarakenne

JEL-luokittelu: H7



# Contents

<b>1. Introduction</b>	<b>1</b>
<b>2. Finnish public administration in brief</b>	<b>3</b>
<b>3. Finnish local government</b>	<b>5</b>
3.1 A short history of Finnish local government	5
3.2 The present organisation of Finnish local government	7
3.2.1 Overview	7
3.2.2 Budgetary decision-making in the municipalities	9
3.2.3 Municipal cooperation	10
3.2.4 Public utilities and companies	12
3.2.5 Ongoing or planned reforms concerning municipal organisation	12
3.3 Tasks of local authorities	16
3.3.1 Overview	16
3.3.2 Health services	20
3.3.3 Social and welfare services	23
3.3.4 Educational services	24
3.3.5 Other municipal services	26
3.4 Municipal finance	28
3.4.1 Overview	28
3.4.2 Tax revenues	29
3.4.3 Grants	33
3.4.4 Other revenues	37
<b>4. Finnish local government compared internationally</b>	<b>38</b>
<b>5. Discussion</b>	<b>46</b>





# 1. Introduction

Finland is by population a small Nordic country with a challenging environment for arranging local public services and fiscal equalisation. The country is large in area and therefore mostly sparsely populated. Despite the rapid urbanisation in recent decades, around one third of the 5.3 million inhabitants still live in rural areas. Also the age structure of the population varies considerably between municipalities. As a result, the service needs and the operating environment as well as the ability to raise own source revenues differs much between areas in Finland. Despite these obstacles, Finland has been able to build an extensive public service system so that the country is considered to be a “Nordic welfare state”.

Although Finland clearly belongs to the Nordic countries’ group with regards to its high degree of decentralisation, the Finnish case differs from the other Nordics in many ways. The most obvious difference is that in Finland public administration is organised by only two tiers of government, the central government and the municipalities, whereas in Sweden, Norway and Denmark the local government consist of municipalities and intermediate government level.

Due to the intense decentralisation and a single tier of local government, the Finnish municipalities bear a heavy burden of tasks. Municipalities are responsible for providing social welfare and health care services as well as most education and culture services. In addition, municipalities provide the basic environment and technical infrastructure services. The fact that nearly half of the Finnish municipalities have populations of less than 5000 inhabitants means that many municipalities are too small to organise all these services alone. As an answer to the economies of scale problem, the Finnish solution has been to organise the most demanding tasks through cooperative arrangements. At the beginning of 2010, there were 342 municipalities and 226 joint authorities.

Finnish municipalities are self-governing entities by constitution. But despite their self-governing status, the provision of many public services has been delegated from central government to the municipal sector in Finland. And because a number of municipal tasks are regulated in detail by central government legislation, the municipalities may have little or no room to manoeuvre independently. In practice, it is often only the wealthiest municipalities that can afford to provide services above the set standards.

Due to the many tasks assigned to municipalities, the overall economic importance of the municipal sector is considerable. Municipality spending as share of GDP is around 18% and municipalities employ roughly 20% of the total Finnish workforce.

Municipal finances are based on own source revenues and grants from central government. On average, grants cover some 20 per cent of the total municipal revenues. The main source of revenue is the municipal income tax that makes up 41 percent of all revenues. Municipalities are the sole receivers of property taxes but the share of property taxes is only 2.5 per cent of revenues. Municipalities also receive a share of corporate tax revenues. The rest of the municipal revenues consist of user fees and sales incomes. Due to big differences in size between municipalities, the small rural municipalities rely on the grant system and equalisation. In 2009, grants covered more than 50 percent of all revenues in every fourth municipality.

The rapidly aging population and domestic migration is threatening to erode the tax bases and increase the service needs in Finnish municipalities. To rescue the local service system, the central government has launched various new policy programmes. These include municipal mergers, enhanced cooperation and productivity programmes. The political discussion about further measures has started and the new government will have to make decisions on these after the parliamentary elections in 2011.

The main purpose of this paper is to describe the organisation, tasks and financing of the Finnish local government. The description concentrates on welfare, health and education tasks and their financing. The other municipal tasks are mentioned only briefly. When possible, we refer to the latest available research results. Although the most important aim is to give the reader a general picture of Finnish local government, some assessment of the present system is also provided.

This paper is organised as follows. Section two describes briefly the Finnish public administration. Section three describes the local government organisation, tasks and finance. Section four compares Finnish local government to other Nordic countries and some OECD countries. Section 5 concludes the paper with discussion on the present stage and future prospects of Finnish local public sector.

## **2. Finnish public administration in brief**

Finland is a unitary state where the highest organs of government consist of the Parliament, the President of the Republic and the Government. Public administration is organised with two tiers of government: the State administration and the self-governing municipalities.

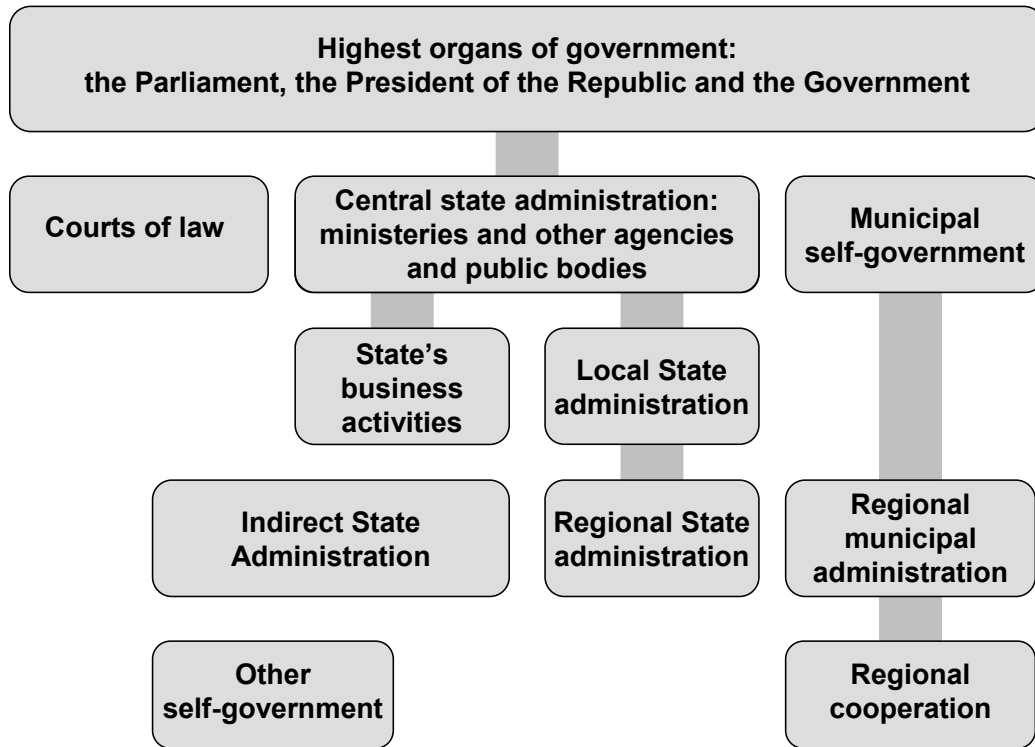
The State administration consists of central, regional and local State administration. At the central level, State administration includes twelve ministries, the State's bureaux and agencies and the State's business activities. The regional State administration was recently reformed and the new organisation has been functioning since the beginning of 2010. There are six Regional State Administrative Agencies (AVI) that legislate, steer and supervise functions in the regions. The agencies follow the local situations on basic rights and legal protection, access to basic public services, environmental protection, environmental sustainability, public safety and working environment in the regions.

In addition to the AVI's, the State regional administration includes fifteen Centres for Economic Development, Transport and the Environment (ELY). These units promote entrepreneurship, labour market functioning, competence and cultural activities, ensure safe and smooth transport operations, a healthy environment and sustainable use of natural resources in the regions. They are also in charge of functions relating to labour force immigration. The local State administration consists of police and prosecuting authorities, registry offices and tax offices. The State administration has on average a total of 122,000 employees, 5,000 of whom are employed in ministries, 24,000 in other central government agencies and public bodies, and 54,000 in the State's regional and local administration. Universities and polytechnics have approximately 31,000 employees.

Finnish local government consists of municipalities and joint authorities of municipalities. At the beginning of year 2010, there were 342 municipalities and 226 joint authorities. Municipalities may set up a joint authority for any service they desire, but membership of a joint authority is compulsory for specialised health care (hospitals) and regional councils. The joint authorities usually organise basic health care because a number of small municipalities are too weak to arrange health care alone. Joint municipal authorities are also common in education. The 19 regional councils are responsible for regional development and supervision of the interests of regional players. The Kainuu Regional Council is an exception as, since 2005, it has been responsible for most of the services in the region, including those that used to come under the regional State administration. Kainuu (together with Åland) is the only region in Finland that has a directly elected regional assembly, and the lessons learned from the Kainuu region

experiment will be considered when developing regional municipal administration elsewhere in Finland. The total number of municipal employees is 437,000.

*Figure 1. Public Sector in Finland – the main institutions*



Source: State Treasury

## **3. Finnish local government**

### **3.1 A short history of Finnish local government**

The legislative basis for the present system of local government in Finland was laid down between 1865 and 1873, when laws on rural municipalities and towns were enacted. Local authorities gained the right to levy taxes and they were given responsibilities regarding, for example, the poor relief and basic education of citizens.

After Finland gained its independence in 1917, a provision on local self-government was added to the first Finnish Constitution in 1919 and universal and equal voting rights were introduced for municipal elections. The municipal assemblies of rural municipalities were replaced by councils. In towns, the councils that were elected in general elections got the highest decision making power displacing the old bodies of magistrates and aldermen. (Heuru 2003).

In 1932 provisions on inter-municipal co-operative organisations and joint municipal authorities were added to municipal legislation. This was a significant decision because since then Finland has kept the model of a single tier local government system.

The municipal legislation was updated in 1949 when towns and rural municipalities were brought together under one Local Government Act. At that time the system of municipal managers were adopted by all municipalities.

Since the end of the 1950's many new statutory obligations have been assigned to municipalities. At the same time central government devolved some state tasks to municipalities. Also, some tasks that were previously run by private foundations and associations were transferred to municipalities. For instance, state owned general hospitals were transferred to local government ownership, and some private comprehensive and upper secondary schools became municipal schools. This development meant that municipalities became essential implementing bodies in Finland. As a result of this process, nearly all basic social, health care and education services are now performed by municipalities or by joint municipal authorities. The enlargement of local government tasks was especially rapid in the 1970's and 1980's. As a result, the number of local government personnel increased rapidly. In 1970 a special organisation of local authority employers was established and labour market negotiations were centralised. Central government financed part of the municipal expenditures via a specific matching grant system.

In 1976 a new Local Government Act was enacted. The distinction between rural municipalities and other local authorities was abandoned in the law. Also, the position of elected council members was enhanced and their working conditions

improved. Besides annual budgeting, that had been obligatory from the start, long term comprehensive planning also became obligatory. Each municipality was required to have a paid municipal manager, but managers were no longer allowed to chair the municipal board as before.

As a response to criticism against public sector inefficiency and bureaucracy, the traditional administrative-legalistic way of running local government slowly gave way to a New Public Management in Finland. By the 1980's the uniform system of welfare services had spread all over the country. It had then become debatable whether massive central government steering was still necessary. This discussion together with the change in political climate paved the way to later grant reforms and deregulation of the municipalities.

But it was the deep economic recession in the beginning of the 1990s that eventually forced the decision-makers to the reforming path. Between 1990 and 1994 Finland faced a severe economic slump during which GDP fell cumulatively by more than 10 per cent. The recession drove the public sector into serious deficit. From 1990 until the mid-1990s the public debt, which consisted mainly of central government debt, increased from about 15 percent to 60 percent of GDP.

The recession caused difficulties in municipalities. As the unemployment rate rose from 4 per cent at the end of the 1980s to over 16 per cent in 1994, the tax revenues of municipalities decreased sharply. Municipalities reacted to the decreasing income tax base by raising tax rates, increasing fees for health care and social welfare services, borrowing, by holding back investments and restraining the health care and social welfare expenditures. Municipal salary expenditures were reduced by discharging part-time labour and also by laying off full-time employees.

In 1993, there was a major grant system reform that meant a change from a pure matching grant system to a formula based block grants system. In addition, the new Local Government Act was enacted in 1995. These reforms gave municipalities much more independence to decide their own matters. The economic situation started to improve from 1994, but the municipal finances were still tight for many years partly due to grant reductions during the years 1993-1998.

As a result of the crisis and the reforms that followed, modernisation and implementation of new market-oriented mechanisms took place in the municipalities. The market-orientation was brought into practice by outsourcing, service-provider splitting, incorporating public utilities, competitive tendering in procurements, Public-Private Partnership models and privatisation (Niemi-Iilahti 1995, 272–275).

When Finland became a full member of the EU in 1995 municipalities had to change certain practices. Due to membership, Finnish legislation was harmonised with EU legislation and directives. For the municipal sector this meant that some monopolies operating as producers of local government services had to be opened to competition, and that public procurements had to be subjected to competitive tendering rules.

## **3.2 The present organisation of Finnish local government**

### **3.2.1 Overview**

At the beginning of 2010 there were 342 municipalities. In 1945 there were 558 municipalities and 460 in 1990. The reduction in the number of municipalities was based on voluntary mergers. Since the 1990's the central government has tried to step up the voluntary merger process with supplementary merger grants and lately by setting minimum population bases for some services.

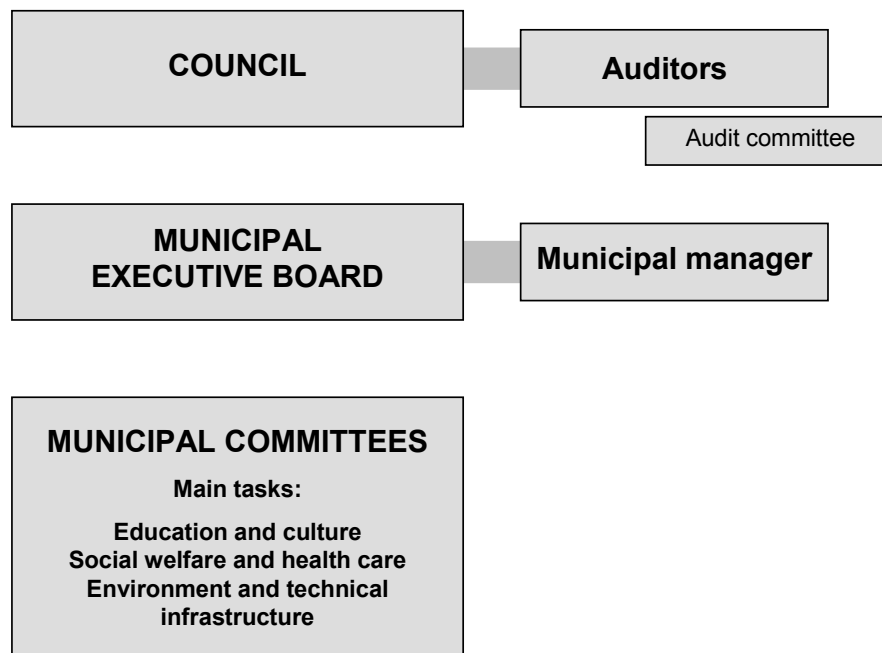
Although municipalities can organise their administration relatively freely, the Local Government Act stipulates that each municipality must have a municipal council, a municipal board, an auditing committee, and a committee for organising elections. A municipality must also have a municipal manager, a civil servant, elected by the municipal council. The municipal manager is not a member of the council.

A municipal council is elected by the residents in a secret ballot for four year terms. The number of councillors is proportional to the population of the municipality and may vary from 17 to 85. As in all Finnish elections, votes are given to individuals rather than party lists. The municipal council must decide upon strategic and financial outlines and on the main objectives for different municipal activities. Councils can set up committees that handle functions of a permanent character, for example, social and health care services, education, urban planning and environment and cultural and leisure services. The committee members are usually local politicians but not necessary members of the council.

The members of the municipal board are chosen by the municipal council. The composition of the municipal board is based on the political makeup of the council: the parties represented in the council get seats in the municipal board according to their share of council seats. Thus, there is no real opposition in local politics and municipal elections do not typically cause major changes in local politics. The municipal board is responsible for municipal administration and financial management. It prepares matters to be decided by the council, executes the decisions and ensures their legality. Municipal boards hold a strong administrative position, because the most important matters prepared for the council are politically agreed in advance in the board.

The municipal manager is a civil servant who works under the municipal board as the head of municipal administration, financial management and other functions. This arrangement differs from most other European countries, where municipality managers are (directly or by councils) elected mayors, who are also chairs of local councils or boards or both.<sup>1</sup> In Finland, the municipality managers hold their position either for a fixed term or the positions are permanent. The choices of city managers do not necessarily take place close to local elections. The situation is however slightly different for the biggest cities. City managers (called mayors and deputy mayors) in the biggest cities are often de facto politicians, who have risen up from city councils or national politics to this position elected by local councils. A recent study by Loikkanen, Susiluoto and Funk (2008) indicates that Finnish municipal managers are in a strong position as civil servants. In a sense they face challenges partly similar to CEOs of multi-product companies. The study shows that the characteristics of municipal managers and their work environment affect the efficiency of service provision at local level.

*Figure 2. Main bodies of Finnish municipal organisation*



Source: Association of Finnish Local and Regional Authorities (modified)

<sup>1</sup> According to the Local Government Act, it is also possible to establish an elected mayor post in Finland but this possibility has been used so far only by couple of municipalities.



### 3.2.2 Budgetary decision-making in the municipalities

Municipal councils approve the annual budget. In addition, the councils approve the financial plan for at least the next three years. The emphasis of the budget is on performance budgeting, i.e. the council sets operational goals that the committees and agencies must realise with the budget money allowed by the council.<sup>2</sup> This procedure, together with performance auditing and reporting to the council, gives the council the power to assure that the decided output goals will be implemented.

Some of the budgetary power can be delegated to lower level committees in the municipality. The committees that work under the council are responsible for municipal service departments (such as health and welfare, education etc...). The decentralised power within the municipal organisation is mainly based on net budgeting and frame budgeting principles (Kallio et al. 2005). In this case, the council allocates a net budget, calculated as gross expenditure less revenue that the budget unit collects. If the budget unit agency earns more revenues than expected (for example because of better than anticipated fee incomes), it can decide to increase expenditure provided that it keeps within the net limit. Naturally, especially in tight economic times, the situation may work in reverse.

The municipal board prepares the proposals for the council and executes the decisions of the council. It is often the case that the municipal board together with the leading civil servants have the real budget power, although the council has the ultimate formal power (Kallio et al. 2005).

The budgetary power of the municipalities is somewhat limited by the Municipal Act. By law, the municipalities are obliged to draw up a plan for covering accumulated deficits<sup>3</sup>. The aim of this rule is to prevent the accumulation of deficits on municipal balance sheets and to avoid economic imbalance in municipalities. However, there are no sanctions for not following the plan.

The municipal auditing consists of two elements: a professional external auditing and performance auditing. The external auditors concentrate on the municipal financial statements and annual reports. The external auditors are certified public

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<sup>2</sup> According to the Local Government Act the budget must include performance objectives and appropriations needed to fulfil these performance objectives.

<sup>3</sup> The deficit concept defined in the Local Government Act has been criticised for not giving an accurate picture of the real balance of municipal economy. According to this critic, the mere profit and loss statement may give too narrow view of the municipality's real economic balance. When considering economic balance, one should also take into consideration that municipalities with growing populations need surplus in order to finance investments, whereas in a shrinking municipality with minor investment needs, a deficit is not necessarily a sign of economic imbalance. In addition, the imbalance of the local government sector may be a signal that central government policy towards municipalities is out of balance and that obligatory municipal tasks stipulated by legislation are not in concord with municipalities' own income sources and State grants (Kärki et al. 2006).

sector auditors and each municipality selects the auditing company through a public tendering process.<sup>4</sup> The performance auditing is executed by special auditing committee and its role is mainly in “value for money auditing”. The obligatory auditing committee is appointed by the council for the duration of its term of office. The focus of the performance auditing is on the goals and objectives decided by the council in the budget. Using the performance audits and the reports from external auditors, the council assesses whether the operational and financial goals set by the council have been attained. The auditing committee's role can be seen as a verifier of the municipal board's annual report – the auditing committee's evaluation report gives an independent opinion to the council about whether the objectives of the council have been achieved or not.<sup>5</sup>

In addition to the performance auditing accomplished by the obligatory auditing committee, some of the bigger cities have established internal auditing (internal audit units, usually with 1–5 internal auditors) serving the top management.

### **3.2.3 Municipal cooperation**

#### **Joint authorities**

There are 226 joint authorities in Finland. Joint authorities are set up by two or more municipalities mainly for tasks that require a larger population base than the small municipalities can have alone. The most important joint authorities include hospital districts, basic health care (health centres), districts for care of the disabled, vocational education and regional councils. Joint authority is the traditional form of municipal cooperation in Finland. Membership in a joint authority is voluntary with few exceptions, the most important example being hospital services, where each municipality is obliged by law to belong in a hospital district.

Joint authorities are independent legal public entities governed by municipal legislation. They have no taxation rights and their decision makers are chosen by the member municipalities. Joint authorities for social and health care (hospital districts, districts for care of the disabled) are not recipients of State grants. Instead, they are financed by selling their services to municipalities. Joint authorities running hospitals are therefore fully dependent on municipalities

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<sup>4</sup> The external auditing process was established in connection with the 1993 grant reform. The external auditors replaced the central government monitoring that was necessary during the matching grants system.

<sup>5</sup> According to recent research, the experience from the municipalities from the first four years showed that in many municipalities the budget plans did not contain clear measurable goals and objectives. This lack of measurable objectives severely hinders the evaluation work of audit committees, as well as the fact that committees in small municipalities often have quite modest resources for performance auditing. The situation has somewhat improved during the later years, however (Kallio et al. 2000; Kallio et al. 2005).

buying their services while municipalities pay hospitals according to actual usage at full cost pricing.<sup>6</sup>

### **Kainuu-region**

An experiment that created a regional level authority for cooperation and decision making was launched in the Kainuu region in 2005. The experiment will last until 2012. Kainuu region is located in remote Eastern Finland and comprises 9 municipalities. The aim of the experiment is to strengthen the municipal economic base by operating on a larger scale and to enable equality of access to services throughout the region. The Kainuu region experiment is based on regional self government and not on the traditional municipal cooperation via their joint authorities. The regional council is elected every fourth year by people entitled to vote in the region (Act 9.5.2003/343). As the experiment is still ongoing, the final results of the experiment are still to be seen. However, according to a recent follow-up report, the experiment has been able to cut the costs of service provision (Jäntti et al. 2010). In addition, according to the study, municipal decision-making has been eased because of the experiment.

### **Other forms of cooperation**

Small municipalities in particular have set up municipal offices shared jointly by more than one local authority. In this case, the cooperation is organised as a client-producer model, in which one municipality manages some tasks on behalf of the other municipalities. This is called a "host municipality model". The clients are municipal governments and the producers are the host municipalities. By organising the services in this way, the goal is to obtain a decentralised, network-based operations model. These arrangements are less bureaucratic than the joint authorities.

Contractual co-operation is common in the areas of waste management, water supply, rescue services, building inspection, consumer and debt counselling, and education. Some contracts are statutory, such as co-operation agreements on rescue services, and contracts for building and maintaining regional emergency dispatch centres.

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<sup>6</sup> The 1993 grant reform had a profound impact on risk sharing of costs in the health care sector. Before the 1993 grant reform, joint authorities first subtracted the grant revenue from the costs and billed municipalities only the average net cost. With matching grants, this actually meant a kind of a risk sharing arrangement in health financing. Today, the municipalities pay the full cost less the non-matching grants that are not influenced by real costs of the municipality.

### **3.2.4 Public utilities and companies**

There are about 150 municipally owned public utilities and 1300 public limited companies whose main owner is a municipality. Limited companies, co-operative societies and foundations offer a possibility to combine public and private capital to implement suitable projects and service systems. For instance, local authorities have established joint waste management companies and urban development and enterprise service companies as well as health care companies.

If a local authority is a major shareholder in a company, or exercises dominant influence in an association or a foundation, they make up together a consolidated corporation. The regulations on municipal corporations determine the policies of the participating companies and communities and their obligation is to report to the local authority. Corporate thinking and steering is more embedded in big urban local governments (Kallio et al. 2005).

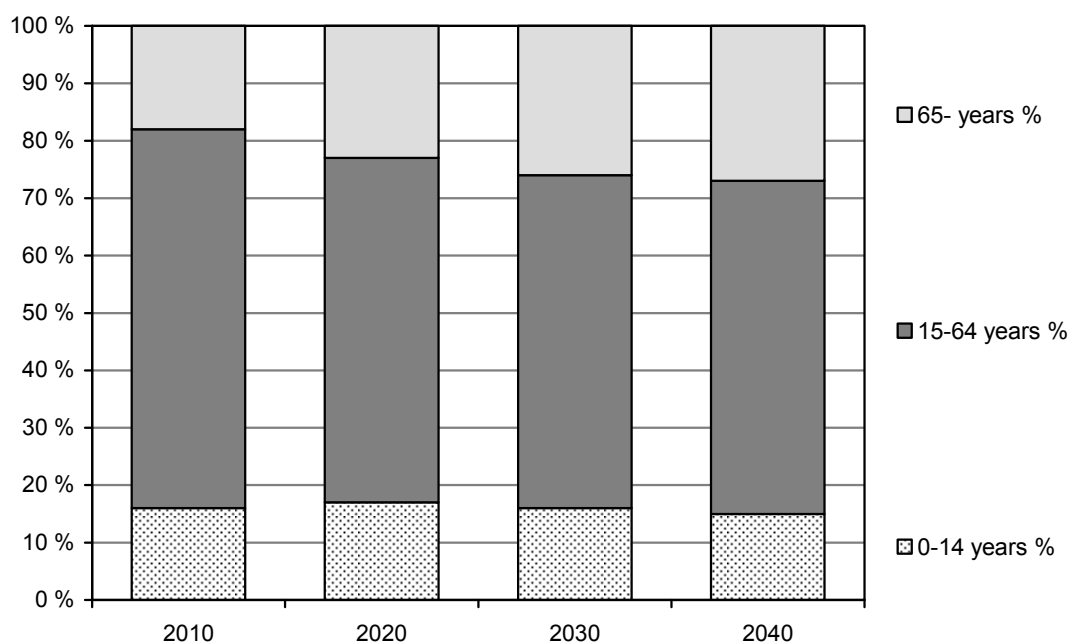
A local authority is also allowed to purchase services from another local authority or the private sector. Competitive tendering for externally purchased services is obligatory according to the Public Procurement Act. According to recent statistics, during 2008 municipalities and joint authorities paid a total amount of 10.8 billion € for outside services, materials and rents, which was 32 per cent of total current expenditure.

### **3.2.5 Ongoing or planned reforms concerning municipal organisation**

#### **The structural reform project (PARAS)**

A local government restructuring project was launched in 2005 by central government. The main goal of the project was to create bigger municipalities or enhanced cooperation of municipalities. The project aims to achieve economies of scale and sound capacity in the municipalities to provide services. Bigger municipalities and intensified municipal cooperation are expected to help the municipalities to cope with growing demand for the municipal services due to the aging population (see Figure 3 below), that is expected to rapidly increase, especially the demand for health care and elderly care services.

Figure 3. *Age structure of Finnish population according to population forecast*



Source: Statistics Finland

As a follow-up to the restructuring project, the Structural Reform Act was enacted in 2006. According to this Act, municipalities are obliged to prepare plans to reach the predetermined minimum population bases for different activities defined in the Act. In primary health care and associated social services, municipalities should reach a population base of at least 20,000, and in vocational basic education a population base of 50,000. In 2010, only a quarter of health centres had a population base of more than 20,000. Some flexibility is allowed based on archipelago environments, long distances and language and cultural rights. Municipalities have been free to decide whether they reach the minimum population bases with mergers or with enhanced cooperation. In cases where a partnership area is formed, a new joint municipal body must be established for the management of the relevant tasks.

In addition, the biggest urban regions – i.e. the four local authorities in the Helsinki Metropolitan Area as well as 16 other cities in the other parts of Finland with their neighbouring municipalities (altogether 102 municipalities) – had to draw up cooperation plans by 31 August 2007. These plans have to deal with land use, housing and transportation, and use of services across municipal boundaries.

As for municipal mergers, the central government goal was to promote mergers by grants for the mergers during 2008–2013. The grant was 1.8-fold if the merger become effective on January 1<sup>st</sup> either in 2008 or 2009 and 1.4-fold if the merger is carried out at the start of 2010 or 2011. In connection with the reform, a minor amendment to the basic state grant system was also made in 2009.

So far, the Structural Reform Act has led to mergers reducing the number of municipalities to 326 (as of January 1st 2010) (see Table 1 below). For the rest of the municipalities, new service provision models based on inter-municipal cooperation have been presented. In health care and welfare services, there will be some 65 cooperative areas by the end of year 2013.

The Ministry of Social Affairs and Health has criticised the implementation of cooperation in health care and social and welfare services based on equity concerns and possible problems in coordination of health and welfare structures. According to the Ministry, the cooperative areas in primary health care do not always match the hospital district areas which could cause problems in operating the services. Also, some of the municipalities plan to produce part of the social and welfare services themselves and part through the cooperation which may result in complicated service structures. According to some experts, the cooperation arrangements and gained efficiency in service provision have so far been insufficient, especially regarding the municipal cooperation in the capital region (Stenvall et al., 2009).<sup>7</sup>

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<sup>7</sup> In addition to the cooperation among the hospital districts of the capital region municipalities, the present capital region cooperative bodies have mainly focused on the Helsinki region's international competitiveness. Regional cooperation focuses particularly on land use, housing and transport issues as well as regional services. Decisions on the details of the cooperation are made under an annual action plan. At present, there are two main bodies of capital city area cooperation. First, the Helsinki Metropolitan Area Advisory Board consists of leading elected officials in the cities of Helsinki, Vantaa, Espoo and Kauniainen. The activities of the Advisory Board are based on decisions made by the city councils of the cities involved. Items on the agenda are prepared at mayors' meetings, and a joint work plan is adopted every year. Another cooperative body for the whole Helsinki region is the Helsinki Region Cooperation Assembly that came into force on 1 October 2005. The Assembly consists of the leading elected officials of the fourteen municipalities in the Helsinki region.

*Table 1. Mergers as outcomes of the PARAS-project*

Year	Number of mergers	Total number of municipalities (excluding the 16 municipalities of the autonomous Åland islands)
2005	10	416
2006	1	415
2007	14	400
2008	1	399
2009	33	332
2010	4	326

As for the effects of municipal mergers, the research evidence seems to be mixed. For example, Moisio and Uusitalo (2003) were unable to find clear evidence of reductions in total per capita expenditure in those Finnish municipalities that had already merged. In addition, Loikkanen and Susiluoto (2005) studied municipalities (with populations above 2,000) as multiple service providers and found that the most cost efficient municipalities were relatively small. When population was included in regression models explaining cost efficiency, it got a negative sign. Alternative models indicated that municipalities with a population below 10,000 seemed to be less efficient than those in the range from 10,000 to about 40,000 inhabitants. In this range population did not explain efficiency differences practically at all. Finally, the biggest cities had relatively low cost efficiency in the provision of basic welfare services. On the other hand some other studies that have concentrated on specific municipal services suggest that the optimal size of the municipality for that service is somewhere between 20,000 and 40,000. Hence, if such services are chosen to determine municipality size there seem to be grounds for increasing the average size of the municipalities from the present 15,000 (Aaltonen et al 2006, Aaltonen et al 2009). However, the fact that the government policy is based on voluntary mergers with an obligatory 5 year period of transition may make it difficult to reach productivity improvements with municipal mergers. This is because during the transition period, no structural changes can be made without consensus agreements. It also seems that the municipalities who decide to merge are those who have had a history of joint cooperation (Saarimaa and Tukiainen, 2010). Hence, it is possible that the economies of scale have been utilised already prior to the merger. Furthermore, it is not clear that the municipalities that end up merging, would necessarily be the best combinations to achieve cost savings.

## **Proposals to reform the health care**

The Ministry of Health and Welfare is at the moment preparing proposals to renew the system of public health care services so that the patients would have more rights to choose service producers across municipal borders. The aim is that local governments should establish functionally larger health care districts that take care of both special and primary health care services. At the moment it is unclear whether these plans will result in actual reforms.

## **Plans to reform the metropolitan area administration in the capital city area**

The City of Helsinki, the capital city of Finland, and its neighbouring municipality, the City of Vantaa, are investigating jointly the viability of a municipal merger. In addition, the feasibility of a new intermediate level of government in the Helsinki region is under study. These studies will outline the pros and cons of the proposed merger and the intermediate government level in the capital city area. The study's final report will aim to help the council members of the two cities to decide whether the formation of one large city would bring more benefits than drawbacks. The merger could be a reality by 2011 if council members agree to pursue the merger. The third big city in the area, City of Espoo, has not agreed to take part in these investigations. The merger of Helsinki and Vantaa would bring the capital's population to over three quarters of a million.

## **3.3 Tasks of local authorities**

### **3.3.1 Overview**

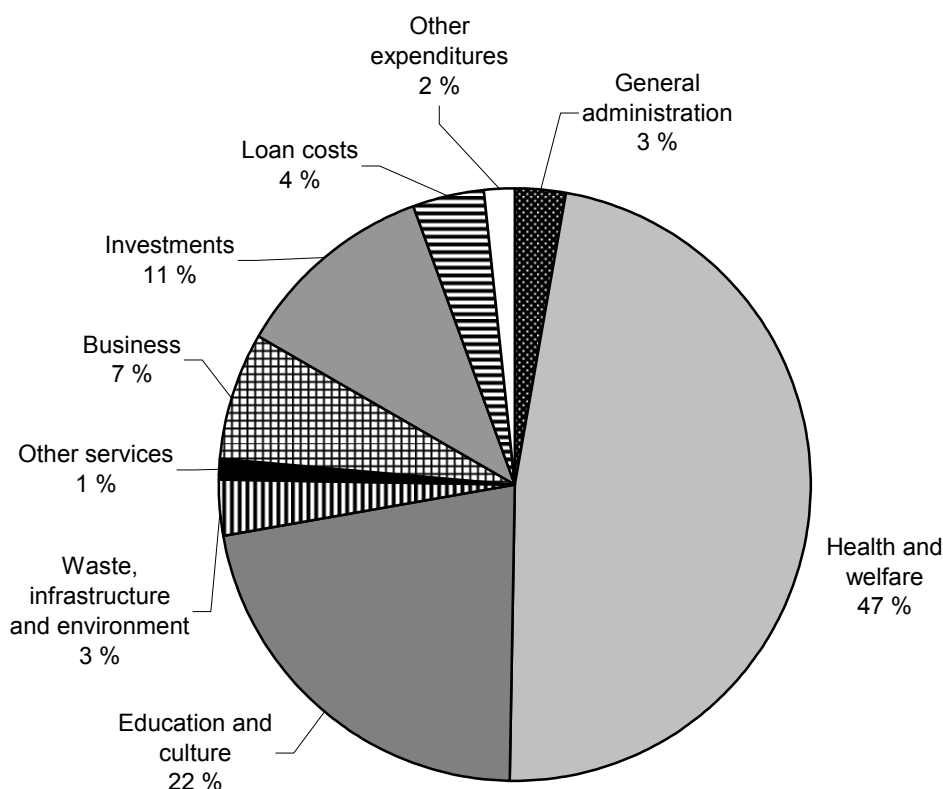
Finnish municipalities are self-governing entities by constitution. This means that central government cannot assign new responsibilities to municipalities without first passing legislation to this effect. Despite this, the decentralisation of public services to local level has been very extensive. Municipalities are responsible for supplying all health and welfare services and all education services except for university education. These services comprise about 70 per cent of the municipal sector expenditures. In addition to these main services, municipalities and joint authorities run or organise a wide variety of other tasks such as cultural, environmental, leisure and planning services (see Table 2 for a list of the most important service categories).

Municipal tasks grew rapidly especially in 1970s mainly because of political agreement to build the "Nordic Welfare State" in Finland. This development meant not just reorganising the services but also considerable improvements and enlargements of the service tasks. The fundamental reforms that were carried out in schooling and health services resulted in a rapid increase in the number of municipal employees especially in the 1970s. In addition, in the 1980s the



matching grant system and favourable economic situation jointly boosted growth in municipal services. There also seems to be the political economy side of this development. According to recent research evidence, the growth in the number of municipal employees can at least partly be explained by local politics and bureaucracy. Dahlberg and Mörk (2008) show that local elections, that are held every four years, have had a positive effect on the number of local employees in Finnish municipalities.<sup>8</sup>

*Figure 4. Expenditures in municipalities and joint municipal authorities in 2008*



Source: Association of Finnish Local and Regional Authorities

<sup>8</sup> For the past decade or so, it has become more difficult to relate the level of municipal tasks to the number of employees because nowadays municipalities often buy the services from a private producer or set up their own public utilities or limited companies. Hence, although it seems that the growth in the number of municipal employees has ceased, this may be partly explained by outsourcing.

Table 2. *Services that are organised by municipalities*

<b>Education</b>
Comprehensive and upper secondary schools
Vocational institutes
Polytechnics
Adult education
Basic music and art education
<b>Culture</b>
Libraries
Other culture services (theatres, museums, orchestras...)
<b>Health care</b>
Primary care
Specialist care
Dental care
Environmental health care (health protection)
<b>Welfare</b>
Child day-care
Elderly care
Care for disabled and the mentally handicapped
Child protection and welfare
Income support
Welfare for intoxicant / drug abusers
<b>Public utilities</b>
Water and energy supply
Waste management
Street and road maintenance
Environmental protection
Public transport
<b>Sports and leisure</b>
Parks and outdoor areas
Sports facilities
<b>Other</b>
Land use planning and building supervision
Promoting commerce and employment
Municipal housing, public building

Figure 5. *Municipal employees 1970- 2008*

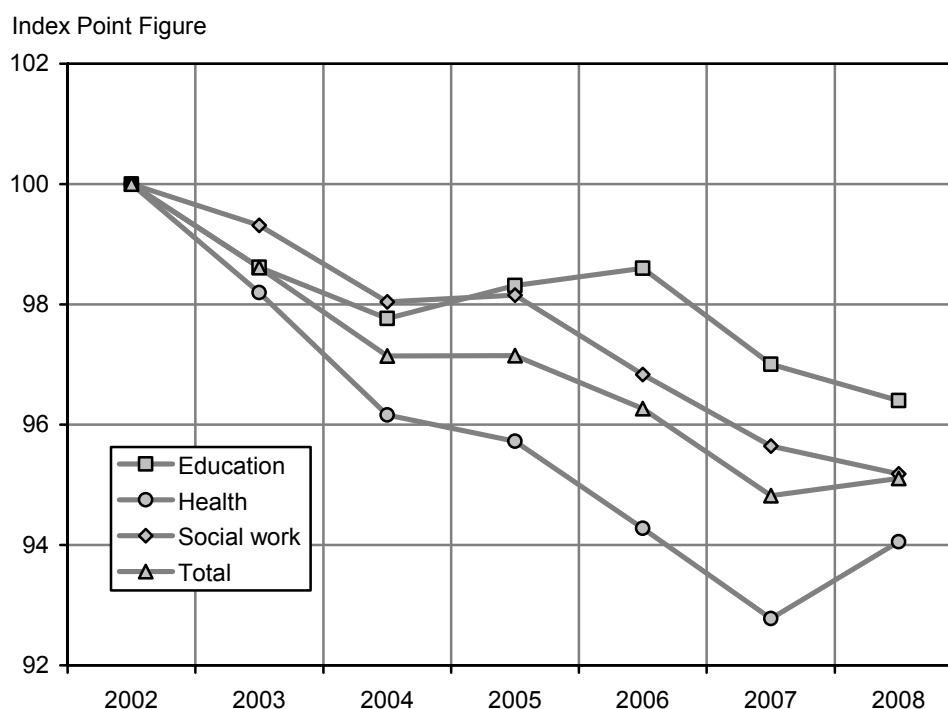


Source: Commission for Local Authority Employers

One should also note that Finland is a bilingual country. Local authorities are obliged to provide the services in both Finnish and Swedish in municipalities where both languages are spoken. In the very north of Finland, the Sami language is supported by special arrangements, for example by teaching in the Sami language.

According to recent productivity reports by Statistics Finland, productivity development of local public services has shown a decreasing trend during the last six years (Figure 6). There are numerous possible reasons for this observation. Firstly, the favourable development of municipal own source revenues during the past decade, and secondly the central government policy to increase the grants to municipalities. Yet another explanation has been that the municipal services have simply recovered from the harsh cuts made into municipal services during the 1990s. In any case, the number of municipal employees has grown steadily during the last ten years or so. Also municipal wages have increased somewhat faster than before.

Figure 6. *Development in the total productivity of education, health and social services of local government in 2002–2008 (2002=100)*



Source: Statistics Finland

### 3.3.2 Health services

#### Primary health care

The primary health care services are provided by health centres, which are operated either by single municipalities or by joint municipal authorities. At the moment there are 194 health centres<sup>9</sup>: 130 of these are operated by single municipalities, 38 are run by joint municipal authorities and 26 by “host municipal” arrangement. The joint authorities have their own administration and council which consists of municipal representatives. Each member municipality pays for their agreed share of the costs.<sup>10</sup> In the host municipality situation, one municipality arranges health care for two or more municipalities.

Compared to primary health care arrangements in most other countries, the Finnish health centres provide a large variety of services. In addition to basic

<sup>9</sup> A health centre may have one or more health care stations. Typically in rural municipalities the health services have been concentrated in one health station but in big cities there are number of health stations and other health care facilities.

<sup>10</sup> The Kainuu region is experimenting on providing health care services on regional basis.

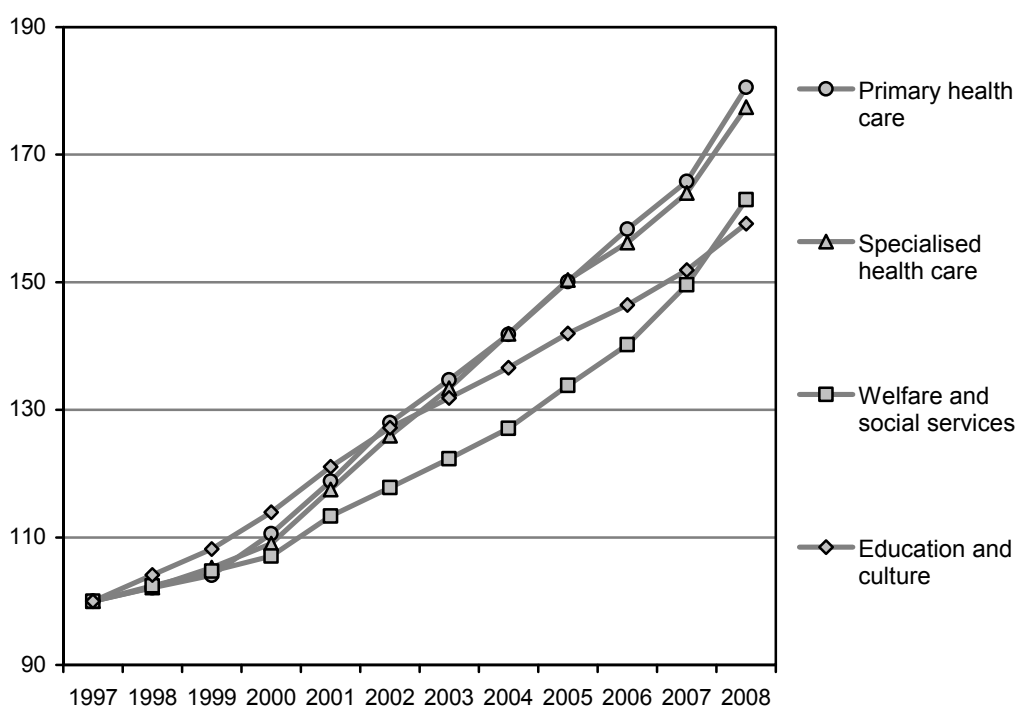
primary care, the health centres offer also maternal and child health care, cancer screening services, community nursing, school health care, dental care, physiotherapy and occupational health care. They also usually have inpatient departments, with typically 30-60 beds, which are occupied mainly by elderly and chronically ill patients.

In addition to municipal health care, there is an occupational health service system, financed by employers and the State, which is responsible for much of the health care for the workforce. The OECD has criticised Finnish health care system for inequitable access to general practitioners. The problem is due to the fact that the employed population can access the free occupational health care whereas the non-employed population must rely on services provided by public health centres and the private sector services that are often subject to a fee.

Contracting out in primary health care to private health care companies has happened to a minor but growing extent. Interestingly enough, the findings from a recent study suggest that outsourcing in primary care has resulted in higher costs compared to own provision (Mikkola, 2009). According to that study, the competitive tendering was not a remedy to cost problems especially in small municipalities with weak negotiating power and underdeveloped markets. In big cities contracting out seem to have worked better. However, in some small municipalities there is no alternative to contracting out in health care because of difficulties in attracting doctors to permanent positions in municipal health centers.

The productivity indicators suggest that there has been a decreasing productivity trend in primary health care during recent years (Räty et al., 2005; Aaltonen et al., 2009). The lack of high quality data on inputs and outputs in primary health care has however raised the question about the validity of these results. Although the primary health care expenditures have grown faster than the other municipal expenditures (see Figure 7 below) or the measurable health care output indicators, this development may well be explained by improved quality and/or more demanding care.

Figure 7. *Municipal per capita expenditures 1997-2008 (nominal price index 1997=100)*



## Hospitals

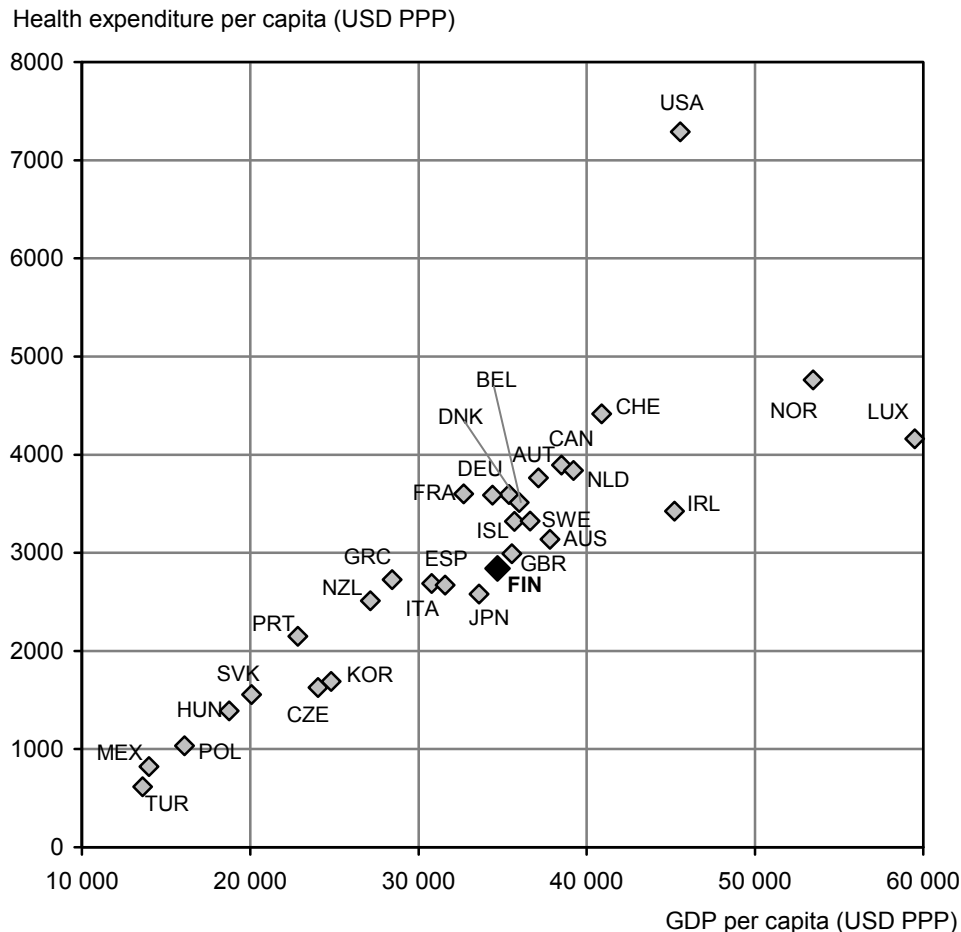
Finland is divided into 20 hospital districts that run the hospitals in their area. Every municipality is required by law to be a member of a joint municipal authority administering a hospital district. These public hospitals run by joint municipal authorities provide 95 per cent of all specialist medical care. The rest is provided by the private sector and this is mostly concentrated in the biggest cities.

During the economic recession in 1991–1994, the costs of somatic inpatient care decreased in real terms by seven per cent. Since then, the figures have been steadily rising: in 2003, the real value of resources was 23 per cent higher than in 1991. In 2003 the number of person-years worked by doctors in specialist medical care was 31 per cent higher than in 1991.

Productivity in specialist medical care increased significantly in the early 1990s: at the same time as the resources decreased, output remained at more or less the same level or even increased somewhat. Since then the resources available have increased, but there has been no further increase in productivity measures. Nevertheless, according to research results on hospital productivity in Nordic countries, Finnish hospitals perform well (Häkkinen et al, 2008; Linna et al, 2006). Also, a recent OECD comparison shows that the Finnish health care

system uses moderate amount of inputs (Figure 8) with better than average results (OECD 2009).

Figure 8. Total health expenditure per capita and GDP per capita 2007



Source: OECD Health at a Glance (2009)

### 3.3.3 Social and welfare services

Social and welfare services are mainly provided by local authorities. These services include care for the elderly, child day-care, care for the disabled, child protection and income support for the poor.

The care for the elderly is a combination of home-help services, various support services, informal care allowance, housing services and institutional care. Client fees cover one tenth of the cost of services. One of the aims of the central government has been to cut down the institutional care. In municipalities, the incentives to follow this policy ought to be strong because institutional care is very expensive despite the fact that the user fee for the long term institutional care is 85 per cent of the clients' incomes.

Institutional care for the mentally handicapped was cut back in the 1990s with the aim of providing care in smaller residential service units and gaining cost savings. However, it seems that the reforms in this field have not been so successful. According to the OECD “Health At a Glance report” (OECD 2009), the mental care services seem to lag behind those of other OECD countries.

Municipalities also provide child care services. Finland was one of the first Nordic countries to introduce public child care provisions (the Act on Child Day Care 1973). By law, all children under school age are entitled to municipal day care, when maternity leave ends. As an alternative, local authorities can pay a home-care allowance to the families with children under three years who are looked after at home or private care allowance for children under school age who are looked after at private day care centres. Two-thirds of day-care places are at day-care centres. Children’s day care is subject to a fee. The fee charged is determined by the family’s income. Income from such fees covers approximately 15 per cent of the overall cost of services. Before starting school, six-year-olds can attend pre-school in day-care centres or at comprehensive schools.

Municipalities are responsible for their residents’ subsistence. Municipalities provide income support for persons who cannot earn a reasonable living. The income support is based on case evaluation by municipal authorities. Half of the municipal income support expenditures are financed by central government with specific grant.

Many local governments use contracting out and competitive tendering in some social and welfare services. Recent research into competitive tendering in sheltered housing and supporting services for old people suggests that municipalities have been able to cut costs with these policies (Kähkönen and Volk, 2008).

### **3.3.4 Educational services**

#### **Basic education**

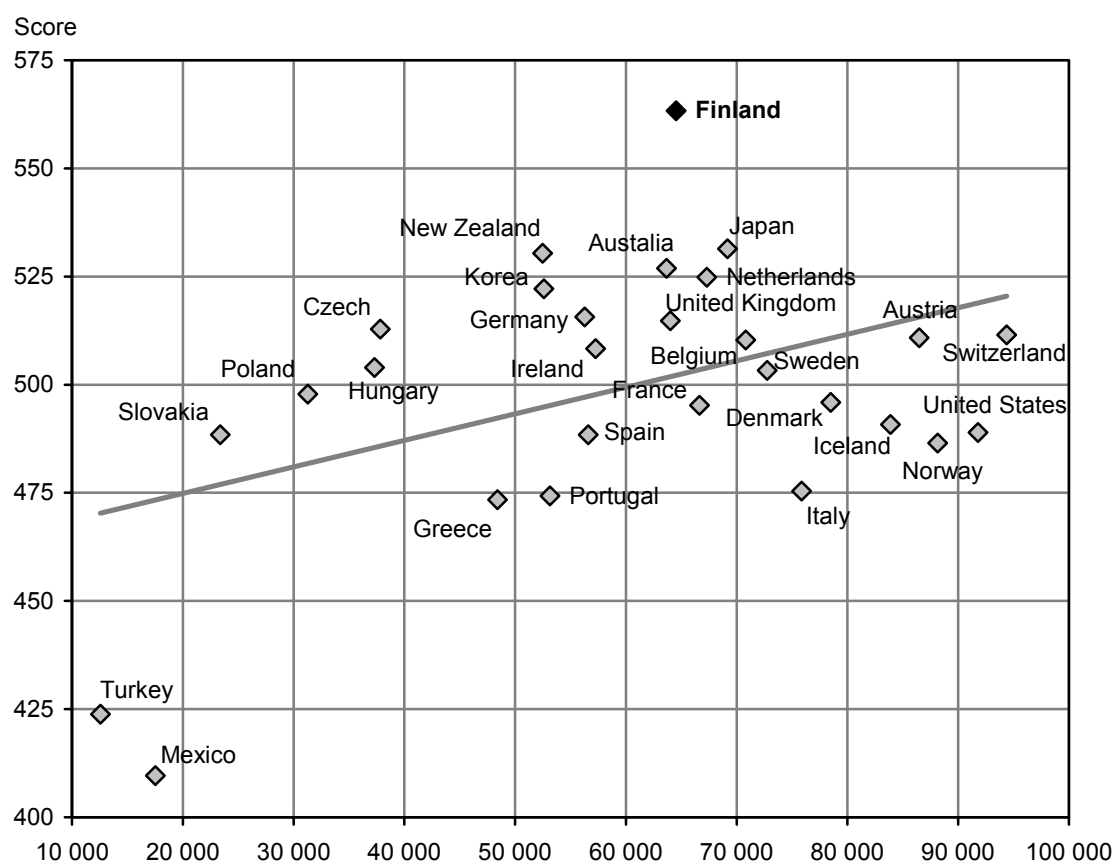
The Finnish school system is based on universal and uniform 9-year compulsory basic education provided by comprehensive schools. Most comprehensive schools are municipal institutions but there are also privately run comprehensive schools. Municipal schools are financed by municipalities and part of the cost is funded by education block grant. Private schools get their funding directly from central government. All education is free for students in Finland.

Finnish basic education ranks at the top in international comparisons of learning performance (OECD 2007). One reason behind these results may be local self-government, which has made it possible to organise basic education so that the needs of pupils in all age groups are met. Also, the high-level pedagogic



standards for teachers and the relatively uniform quality of schools regardless of location may explain the good performance. Teachers with permanent position are municipal civil servants who must have a Masters level academic degree. Teachers must also pass practical training in the field before obtaining the qualification. International comparisons have shown that the costs of education per pupil are quite reasonable in Finland (Figure 9).

Figure 9. Student (OECD PISA) performance in science and spending per student\*



Source: OECD 2007

\* Relationship between performance in science and cumulative expenditure on educational institutions per student between the ages of 6 and 15 years, in USD, converted using purchasing power parities (PPPs)

### Upper secondary education

After completing the basic education, students can apply for upper secondary education through a joint application system independent of where they live. The upper secondary education is divided into general upper secondary education and

work-oriented vocational upper secondary education (the so called dual model of upper secondary schooling). Both routes of education provide eligibility for higher education such as polytechnic and university studies.

The majority of upper secondary and vocational education is provided by municipalities or joint municipal authorities. Vocational education, especially, is often provided by joint municipal authorities. The responsibility for financing is shared by central and local governments.

### **Higher education**

Like upper secondary education, Finnish higher education is also based on a dual model. Higher education is provided at:

- 28 polytechnics. Polytechnics provide professionally oriented higher education that prepares students for professional expert work and research. Polytechnics are involved in research and development based on regional development needs. Most polytechnics are municipal institutions or owned by joint municipal authorities.
- 18 universities. University education is mainly financed by the central government, and the universities are autonomous.

### **Adult education**

Adult education services include, for example, open higher education, language proficiency certificates, personnel training, vocational continuation education, training for immigrants and general upper secondary education. Adult education is provided by adult education centres, located in nearly all municipalities, and by summer universities. Adult education centres are mainly run by municipalities or joint municipal authorities.

## **3.3.5 Other municipal services**

### **Libraries and cultural services**

Library services are available in every municipality and they are free of charge to users. About 80 per cent of residents use the library services. Local authorities also run art institutions and museums, provide art education, support art and cultural heritage and provide opportunities for cultural and artistic activities. There are also municipally run theatres and symphony orchestras.

### **Sports, leisure and youth policy**

There are around 30,000 different sports facilities in Finland, the majority of which are owned and maintained by municipalities. Non profit sports clubs often operate the sports activities and the services are usually subject to a fee.

Municipal youth work and policy are conducted in collaboration between different professionals. Youth facilities, camps and other leisure activities, workshops for those requiring special support, and various groups and channels for influence and participation are available for the young.

### **Land planning, infrastructure and housing**

In the Finnish context, those tasks related to providing (mostly also producing) merit goods like health, social and education services are the most important economic activities carried out by municipalities. In providing these services, municipalities act as the agents of central government (=principal) whereas the national parliament makes key decisions on these services. The most important locally controlled task performed by local governments is the provision of local public goods in their area. A key function in this respect is that municipalities are responsible for land use planning in their area. Local policies in land use affect settlement structures, location of businesses, residential areas and transportation. These choices affect productivity in the private sector (World Bank 2009) and the efficiency of public service provision because merit goods (health units, schools etc) and other services need spatial networks of units. Land use decisions (zoning) affect the nature of these networks and costs of provision.

Municipalities are also responsible for building supervision; they grant environmental permits, monitor the state of the environment and control functions affecting the state of the environment.

Municipalities are also responsible for street maintenance and the maintenance of parks and outdoor areas. They also organise public transport in their own area. Municipalities are responsible for municipal waste management in their areas. Real estate properties are required to join the municipal waste transport system.

Municipal utilities owned by the municipalities and, more rarely, private corporations are responsible for the water supply and sewage systems. Almost 90 per cent of the population has access to municipal water supply. The residents pay water and sewage charges which cover the costs. In many areas, municipalities are responsible for the distribution of electricity and district heating. The biggest cities may have their own energy production companies.

Municipal housing policy has the objective to promote the development of good living environments and the housing of all population groups. Municipalities

take care of public building and construction to ensure adequate facilities for their service provision.

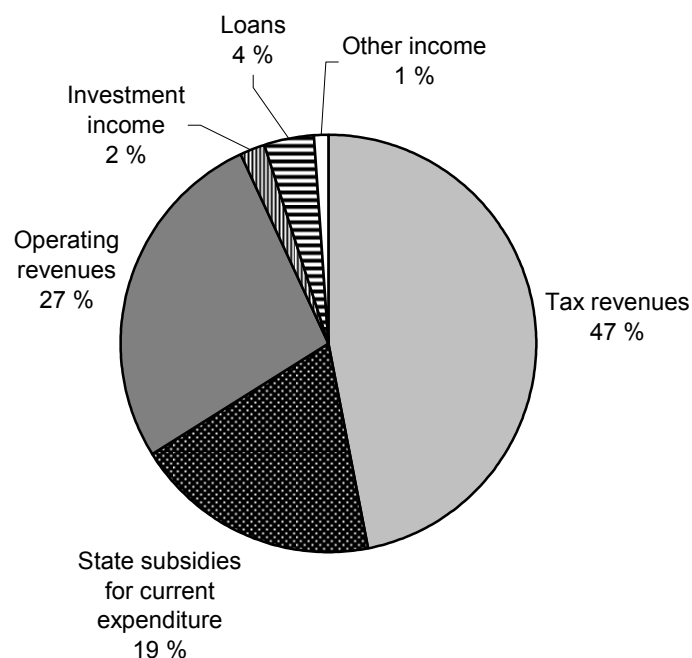
### 3.4 Municipal finance

#### 3.4.1 Overview

Municipal finances are based on own source revenues and grants from the central government. The main source of revenue is the municipal income tax revenue that makes up 47 per cent of all revenues. Municipalities also receive a share of corporate tax revenues. The rest of the municipal own source revenues consist of user fees and sales incomes.

On average, grants from the central government cover some 20 per cent of the total municipal sector revenues (municipalities and joint authorities). Still, due to big differences between municipalities both in service cost factors and revenue bases, the importance of fiscal equalisation systems is significant for many municipalities. In 2009 for every fourth municipality, the share of grants is more than 50 per cent of all revenues. This is especially the case for the rural municipalities. In contrast, the wealthiest municipalities, such as the cities in the capital city area, receive only modest amounts of grants.

Figure 10. Total municipal sector income (2009 estimate)



Source: Association of Finnish Local and Regional Authorities

### 3.4.2 Tax revenues

Most municipal tax revenue is raised through the local tax on personal income.<sup>11</sup> Municipal income tax is a flat rate tax, although central government policy for tax allowances for persons with low incomes has made the local tax more like a progressive tax. Hence, the local income tax base is determined by the central government but municipalities have full control over the rate. For 2010, roughly one in three municipalities raised income tax rates, partly as a response to decreasing tax bases and partly because of the hike in public sector wages during the past couple of years. Municipal income tax rate has been steadily rising (Figure 11).

Municipalities are the sole receivers of the property taxes but the share of property taxes of total municipal revenues is only 2.5 per cent. Compared to income taxation, municipalities have little discretion over property tax rates as maximum and minimum rates are legislated by the central government. Over the years, the central government has increased property tax rates by raising the lower and upper bounds of the tax. One problem with the property tax is that the assessment value of property is based on the re-purchase value set annually by the Ministry of Finance, and this has not fully kept pace with house price inflation.<sup>12</sup> The modest role of property taxes in financing the Finnish municipalities has been repeatedly criticised by OECD. It has been argued that from a global perspective, the present situation is sub-optimal, since higher spending obligations associated with rising health care costs can force municipalities to raise taxes on income, whereas property taxes would be less of a disincentive to work (OECD 2008).

The third tax revenue of the municipalities is corporate income tax. No local taxes are levied on corporate profit but the municipalities receive a share of the state tax revenue. The share of corporate tax revenue channelled to the municipalities was reduced from about 45 percent in 1997 to 20 percent in 2003. However, the share was increased again to 22 percent in 2005 to keep municipal revenues from this source unchanged when the overall corporate tax rate was reduced from 29 percent to 26 percent. As part of the central government fiscal stimulus package, the municipal share was temporarily increased to 32 percent from 2009 to 2011. Municipalities have strongly opposed all proposals to drop the corporate tax revenue from the municipalities' revenues menu, because of concerns that municipalities would not be fully compensated by higher state

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<sup>11</sup> In Finland the dual income tax (DIT) system is applied (adopted in 1993), which divides personal income into two components: **capital income** (which includes dividend income, interest receipts, realised capital gains and rental income) is taxed at a flat rate of 28%; and **earned income** (which includes wages, salaries, pensions and social security benefits) is subject to central government income tax at progressive rates and to municipal and church taxes at proportional rates. In addition, there are social security contributions.

<sup>12</sup> The properties are valued as 73.5 percent of the repurchase value.

grants. Opposition is particularly strong in areas such as Helsinki (the capital) where corporate income tax is an important revenue source. Nevertheless, corporate tax revenue has been criticised as a source of municipal financing, due to the volatility of the tax base (Table 3). The high volatility is claimed to cause problems because windfall gains may lead to higher expenditure that is difficult to reverse. Second, volatility makes revenues unpredictable and also makes it less likely that revenues can be used to reduce the personal income tax rate. (OECD, 2008).

The revenue from the tax on capital goes completely to central government. The Association of Finnish Local and Regional Authorities, that represents the municipalities in state-local negotiations, has criticised this and urged that a part of the tax revenue should belong to municipalities. It has been said that high income professionals can effectively transform their incomes to capital incomes and so avoid the municipal income tax even if they use municipal services.

Between 2004 and 2009 the municipal nominal tax revenues grew on average about 4.7 per cent a year (see Figure 12) but at the same time the average growth of municipal expenditures has been over 6 per cent a year. As the tax revenues are estimated to diminish in 2010 and the growth in the following years is expected to be modest, the municipalities will find it difficult to adjust the expenditures accordingly. This is so despite the central government support package to municipalities (see Box 1 below).<sup>13</sup>

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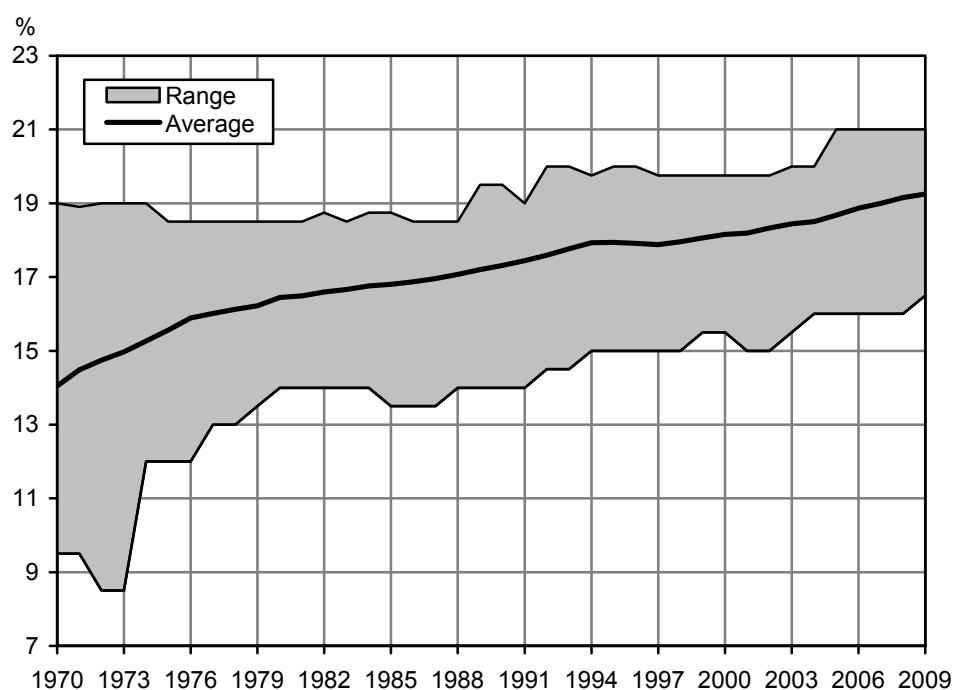
<sup>13</sup> According to the Association of Finnish Local and Regional Authorities, the central government should add grants-in-aid to municipalities and/or transfer some state taxes partly, like capital income tax, or completely, like waste tax, to municipalities and so widen their tax base.

Table 3. *Volatility of tax revenues*

	1980	1990	1995	2000	2006	Volatility 1980–2006 <sup>1</sup>
	Tax revenue as a share of GDP (%)					
Total tax revenue	35.7	43.5	45.7	47.2	43.5	0.03
Personal income tax	12.8	15.1	14.2	14.5	13.2	0.06
Corporate income tax	1.2	2.0	2.3	5.9	3.4	0.48
Social security contributions	8.4	11.2	14.1	11.9	12.1	0.08
Property taxes	0.7	1.1	1.0	1.2	1.1	0.06
Taxes on goods and services	12.6	14.2	13.8	13.7	13.6	0.02
<i>Memorandum:</i>						
Municipal personal income tax	7.2	8.5	8.7	7.6	7.9	0.06
Municipal corporate income tax	0.6	0.8	1.0	2.2	0.8	0.54

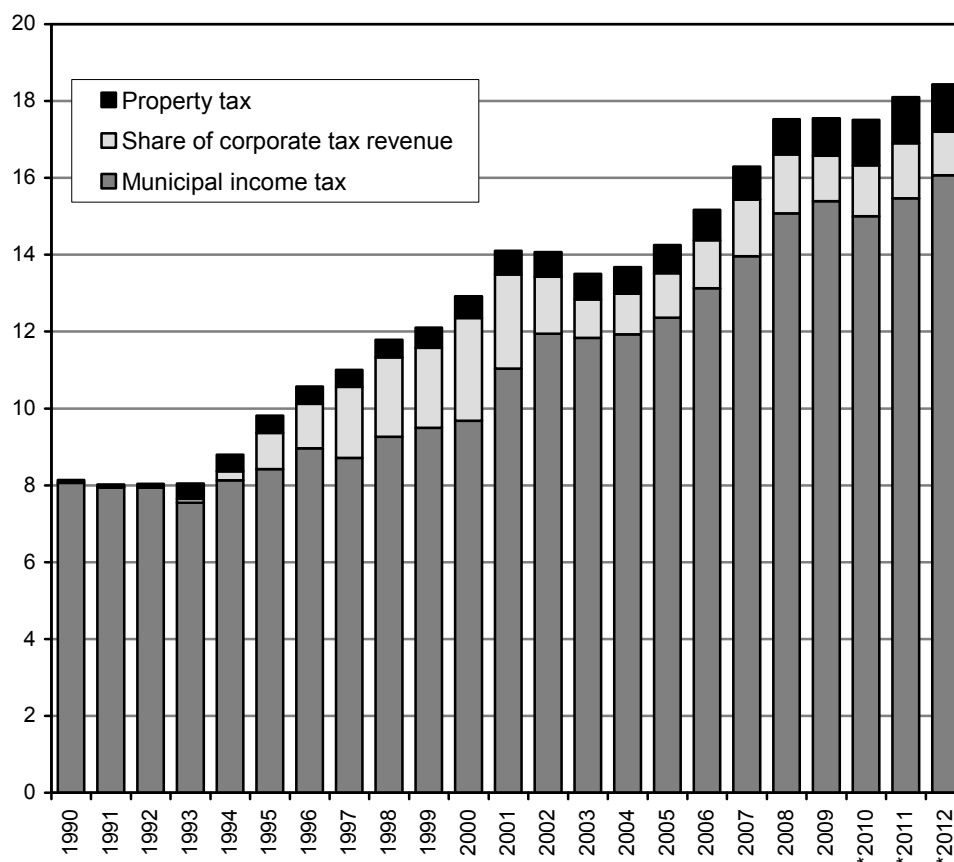
1. Volatility measured by the coefficient of variation for the tax revenue to GDP ratio.

Source: OECD (2008)

Figure 11. *Municipal income tax rate 1970–2009*

Source : Statistics Finland and VATT Structural Indicators

Figure 12. *Municipal tax revenues 1990-2012\**



Note: Figures for years 2010–2012 are estimates.

Source: Statistics Finland, Association of Finnish Local and Regional Authorities, Ministry of Finance

*Box 1. Central government stimulus measures to municipalities (2009 situation)*

The range of property taxes is raised from the current 0.5–1.0 per cent to 0.6–1.35 per cent. The range for permanent residential buildings is re-adjusted from the current 0.22–0.5 per cent to 0.32 – 0.75 per cent. This will raise the property tax rates for those municipalities that have been at the lowest level. At the minimum, the estimated effect of this is 46 million €.

Municipalities' share of the corporate tax revenue is temporarily increased (from 22.02 per cent to 33.02 per cent). The estimated increase in municipal revenue will be 1,125 billion € for three year period (2009-2011).

In addition, the national pension contribution paid by employer is lowered by 0.8 percentage points as of 1 April 2009 and to abolish entirely as of 1 January 2010. This will reduce labour costs of municipalities by € 78 million in 2009 and € 248 million from 2010 onwards. The total effect of this measure is estimated to be 326 million €.

Source: Ministry of Finance, 2010



### 3.4.3 Grants

#### Overview

The fiscal equalisation consists of two parts: the block grants system that aims to offset disparities in public service costs and the revenue equalisation that aims to equalise tax bases. Until the end of 2009, three ministries were involved in the operation of the fiscal equalisation: the Ministry of Finance, the Ministry of Education and the Ministry of Social Affairs and Health. The basic framework of the system is shown by Figure 13. The block grants are defined using formulae. The revenue equalisation is organised separately, but block grants and revenue equalisation are united in the payments phase. The fiscal equalisation is quite extensive, as can be seen from Figure 14. After tax base equalisation and block grants, the tax and grant resources per capita are similar in municipalities of different population sizes. One must remember of course that cost equalisation takes special account of the differences in need and operational environment, and that these are often highest in sparsely populated small municipalities.<sup>14</sup>

In 2009, the total amount of grants paid to municipalities and joint authorities of municipalities was 9.4 billion €, of which 5.5 billion € was provided by the Ministry of Social Affairs and Health, 3.7 billion € provided by the Ministry of Education and the rest around 200 million € was the general grant operated by the Ministry of Finance. The funds in the revenue equalisation system were around 800 million €.

The block grant system was first introduced in 1993 when the matching grant system was abolished. The block grant system is based on so called “calculatory costs” that are defined using various formulae depending on the service. The block grant system constitutes the cost equalisation of the State grants system and is totally financed from the central government budget. The revenue equalisation is operated solely between municipalities and no central government funding is involved. Nevertheless, the system works so that revenue equalisation is used to alter the block grants so that if the municipality has to pay in to the “revenue equalisation fund”, the block grants of that municipality are reduced by that amount. Similarly, in case where the municipality is a receiver of revenue equalisation, the block grants are increased accordingly. The cost equalisation forms about 90 per cent of the total fiscal municipal equalisation in Finland.

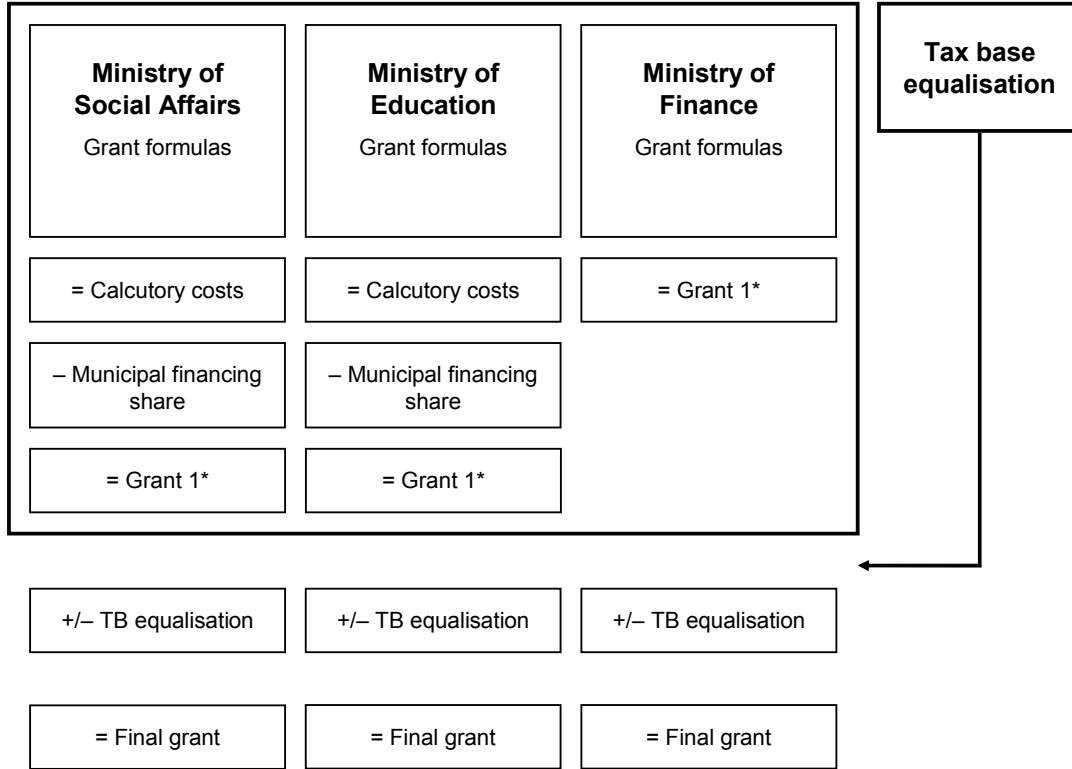
The grant system was altered at the beginning of 2010 so that the administration of the grant system was concentrated in the Ministry of Finance. Although the original purpose of the central government was to reform the grant system in a

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<sup>14</sup> The fact that costs are also often high in the big cities due to urban cost factors like the share of immigrant based pupils or higher need for social assistance, is not adequately taken into account in the present grant models. This is one observation of a recent study on the present grant system (Lehtonen et al, 2008).

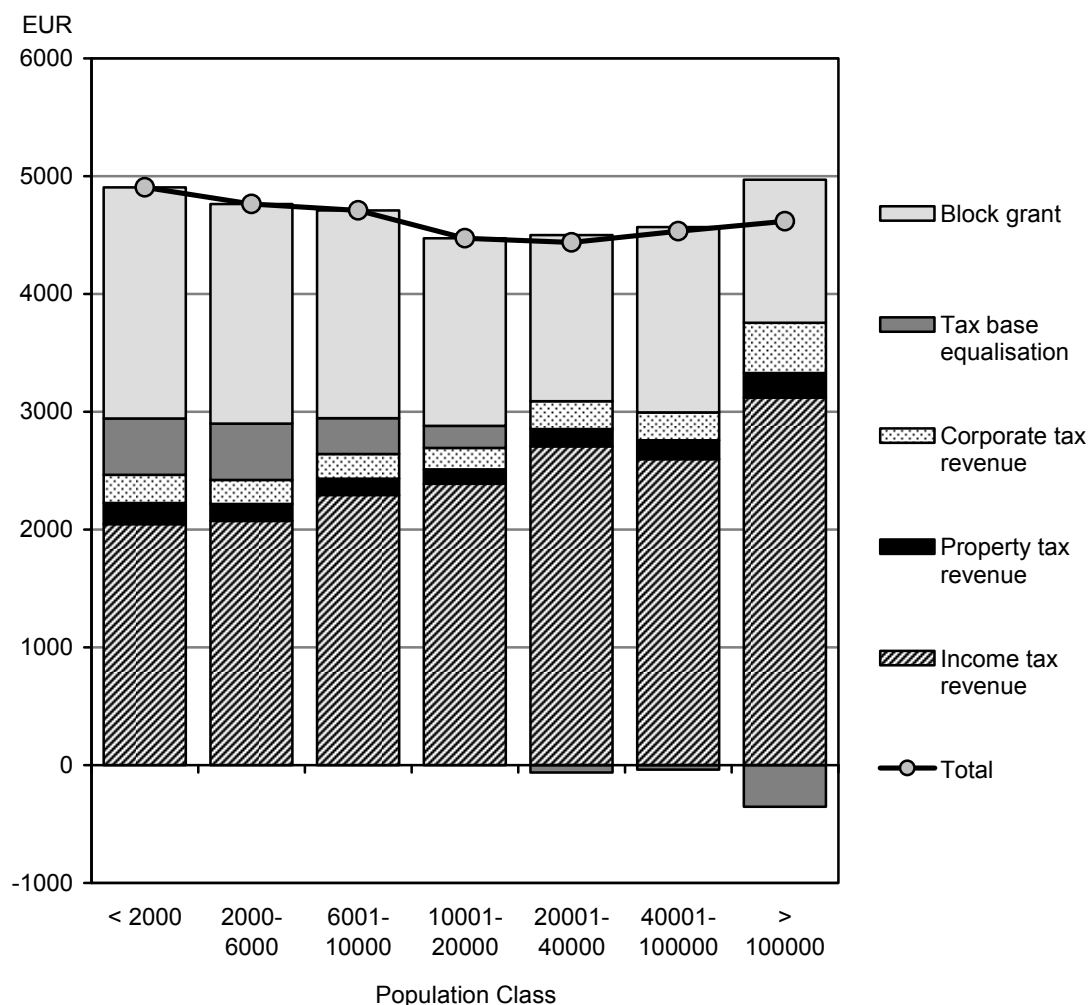
more comprehensive way, no changes to the grant formulae were made at this point. The reason announced for this was the economic problems of the municipalities resulting from the present economic recession.

Figure 13. The organisation of the Finnish grant system until 2009



\* Grant before the tax base equalisation.

Figure 14. *Municipal revenue sources by municipality size in 2007*



Source: Statistics Finland and VATT Structural Indicators

### Cost equalisation

The grant system for health and welfare services is based on formulae. The formula for *health care grant* uses measures for population age structure, sickness and remoteness of the municipality (long distances and low density population). In the *social and welfare services*, the formula uses measures such as the population shares of child and elderly people, unemployment and remoteness. In addition, the social and welfare services formula uses need indicators for child day-care, child welfare and aid for the handicapped.

The formulae are used to calculate the estimated costs for health and welfare services for each municipality. A threshold of 65 per cent of the country average per capita cost is then set based on municipality specific calculations. The grant

for the municipality is the amount of calculatory per capita cost that exceeds the limit of 65 per cent of the country average.

In the *education* services, such as comprehensive and secondary schooling, the formulae are based on the number of pupils. Also several additional cost indicators such as the share of pupils at the upper level of comprehensive schools, handicapped pupils, pupils in remedial instruction, pupils from foreign origin and Swedish speaking pupils are taken into account. In addition, indicators like population density, school size, bilingual status of the municipality and archipelago location are used. Just as in the health and welfare services formula, the calculatory costs of education and cultural services are used to define the grant for each municipality. The grant for the municipality is the amount of calculatory per capita cost that exceeds the limit of 58 per cent of the country average<sup>15</sup>.

The third element of the grant system, the general grant, is defined using several indicators that try to take both the rural and urban cost factors into account. The importance of this grant is small though, only 2 per cent of all grants.

The grant formulae and the coefficients used in the formulae are defined by two sector ministries, the Ministry for Education and the Ministry for Welfare and Health, so that the grant system matches the policy they wish to advance in the municipalities.

### **Revenue equalisation**

Revenue equalisation is based on a municipality-specific calculation of the tax revenues that the municipalities could raise, if they used the country average tax rates. The calculatory tax revenues are then based on actual taxable incomes and property tax bases together with the country average tax rates.<sup>16</sup> The revenue equalisation system is to guarantee all municipalities 91.86 per cent of the average per capita calculatory tax revenues. The municipalities whose calculatory tax revenue is below this threshold receive the difference as a supplement to their block grants. The municipalities whose calculatory tax revenue is above the threshold, must pay 37 percent of the exceeding amount to the funding of the equalisation. In practice, the tax base equalisation is operated within the block grant system so that these sums reduce or increase the block grants. Although revenue equalisation is operated by the Ministry of Finance, the system is totally “financed” by the municipalities.

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<sup>15</sup> Population weighted average.

<sup>16</sup> The actual revenue from corporate tax is taken into account in the calculation.

### **The 2010 grant reform and pressures for further reform**

At the same time as the grant system was altered at the beginning of 2010, concentrating its administration in the Ministry of Finance, some minor changes were made to the grant formulae. However, all municipalities were guaranteed to receive the same amount of grants than previously. In other words, the full reform of the municipal grant system was postponed.

The present grant system has been repeatedly criticised for being complex and opaque. It has also been claimed that the system does not include enough incentives for productivity improvements in the municipalities. The fact that the grant system is mostly based on cost equalisation (with 90 percent weight), is said to expose the system to manipulation. In Sweden, for example, the grant system is almost totally based on revenue equalisation and cost equalisation is of minor importance. A grant system that is based on revenue equalisation has been claimed to be easier to administer (Ministry of Finance, 2010).

The more detailed criticism concerning the technical side of the grant formulae is based on recent research that has analysed the validity of the present grants formulae (Lehtonen et al, 2008). According to these results, the main problem of the present grant formulae is not the complexity but the poor quality of the indicators used in the formulae. For example, the presently used indicator for sickness in the health care grant formula seems to be imprecise and therefore a poor measure for health care needs (Lehtonen et al., 2008; Häkkinen et al. 2009). Similarly, for the education services grant, the formulae used seem to partially over-compensate or under-compensate the costs, depending on the criteria. This is the case for example for the cost effects of foreign origin pupils, Swedish speaking pupils, or the share of pupils in pre-schooling (Lehtonen et al., 2008).

#### **3.4.4 Other revenues**

Municipally collected fees and charges account for about a quarter of municipal revenues. Most of the customer charges are collected for services such as water supply, waste disposal, power supply and public transport. Just under one tenth of social welfare and health expenditure is covered through customer and patient charges. Basic education is free.

## 4. Finnish local government compared internationally

The purpose of this section is to perform a selective international comparison of structures of local government, their tasks (outlay structures) and main sources of revenue. Here, after describing government structures, we mainly confine ourselves to unitary countries within the group of EU15. This makes it possible to present the case of Finland relative to other rather similar countries.

The information in this section is based on IMF Government finance statistics (outlays and revenues). Description of government structures is based on CEMR (Council of European Municipalities and Regions) information. A fundamental difficulty is that most of it concerns all sub-national tiers of government, not only municipalities and even in most unitary countries (except Finland), there is more than one tier below central government.

The structure of government differs across countries in many respects. First, some countries are federations and have states or the like as the next tier under central government. Federal countries tend to be big in population, but in Europe they also include Austria and also since 1993, Belgium. Then there are unitary countries, which have either only one or several lower tiers of government. By tier, we mean here levels with their own democratic decision making units, tasks and with taxing powers. Table 4 summarizes the tiers of sub-national government in a number of European countries in 2005, and separately for unitary and federal countries. The number of government units at each tier is also given.

The number of municipalities varies dramatically from one country to another. Of the big unitary countries, France, Italy and Spain have a lot of them whereas the UK has very few. Among the included Nordic countries Finland was in 2005 the only one with a two tier system where only the municipalities represent sub-national government. Here, Finnish municipal joint authorities are not counted as a separate level. Also, nineteen regions (*maakunta*) are not listed as an intermediate tier. Their tasks include regional land use planning, which in principle is of great importance for the settlement structures and indirectly also for public service networks. In practice, the regional councils have had little power relative to municipalities, which have according to law land use (zoning) monopoly in their area. They also represent regions under the direction of central government and deal with EU projects. Thus, regional councils represent in practice just a form of municipal cooperation (joint municipal authority). The regional council members are not directly elected citizens, but are nominated by the member municipalities. In addition to limited tasks, the critical reason for not regarding regions and their councils as a tier of government is that they lack own revenue sources. Finnish regional governments have no powers of taxation. Unlike the Finnish case, Sweden and Norway have intermediate tiers (counties) with elected councils with their own tasks and revenue sources. This situation

demonstrates that the degree of decentralisation to municipalities in Finland is extensive. They provide (and mostly produce) many health care, education and infrastructure services which are tasks of intermediate or even higher levels of government in the other Nordic countries.

*Table 4. Sub-national government structure in some European countries in 2005*

Country	Regional or state governments	Intermediate regional government	Local government
<b>Unitary countries</b>			
Denmark		5 counties	98 kommuner
Finland			416 kuntaa
France	26 regions	100 departements	36.683 communes
Ireland		29 counties	85 municipalities
Italy	20 regions	103 provinces	8.102 comuni
Greece		50 prefectures	1.034 municipalities
Luxemburg			116 communes
Netherlands		12 provinces	443 gemeenten
Norway		19 fylkeskommuner	430 kommuner
Portugal	2 auton.regions		308 municipalities
Spain	17 regions	50 provinces	8.111 municipalities
Sweden		20 counties	290 kommuner
UK	3 regions	35 counties	437 districts
<b>Federal countries</b>			
Austria	9 länder		2.357 gemeinde
Belgium	6 regions	10 provinces	589 communes
Germany	16 länder	323 kreise	12.312 gemeinde
Switzerland	26 cantons		2.740 municipalities

<sup>1</sup> The governments included should have both elected bodies and own revenue sources.

Main source: CEMR

The number of municipalities has diminished in quite a few countries over time. Table 5 indicates that this is the case in Nordic countries (excluding Iceland). In Denmark there was a big municipality reform in 2007, and in Finland there is an ongoing local government structural reform, which has recently reduced the number of municipalities.

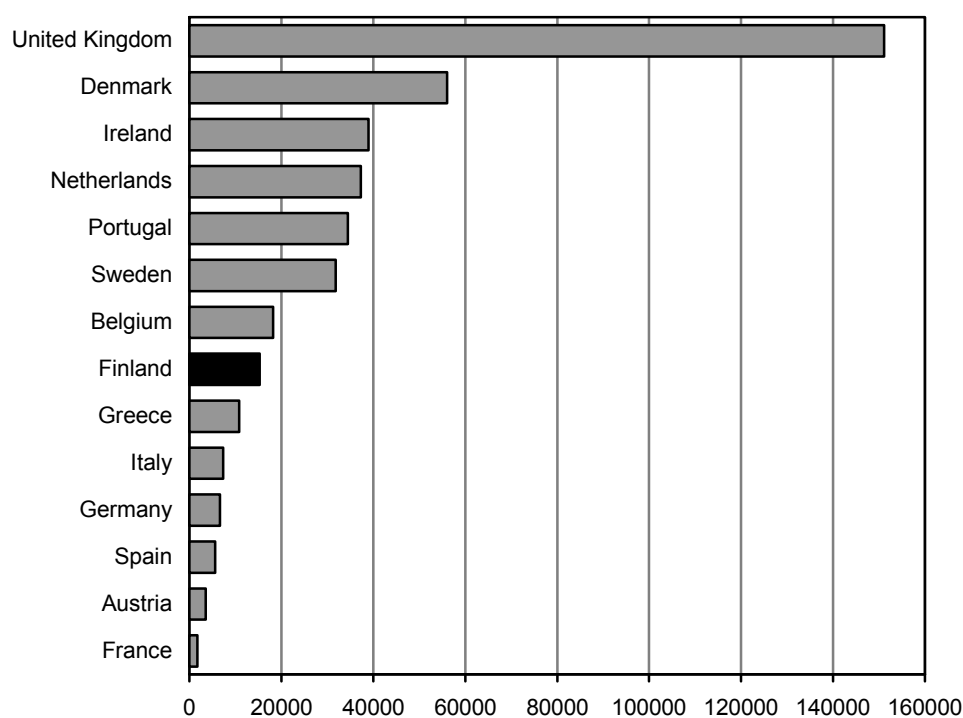
*Table 5. Change in the number of municipalities in Nordic\* countries 1950–2010*

Country	1950	1992	2005	2010
Finland	547	460	416	342
Sweden	2 281	286	290	290
Norway	744	439	430	430
Denmark	1 387	275	270	98

\* Iceland excluded

Not surprisingly, the average municipality size (Figure 15) is greatest in UK where the population is big and municipalities are few. France is an opposite case. Finland is a rather average case in 2005, but as a result of recent mergers of municipalities this average is now somewhat greater.

*Figure 15. Average municipality size in 2005*

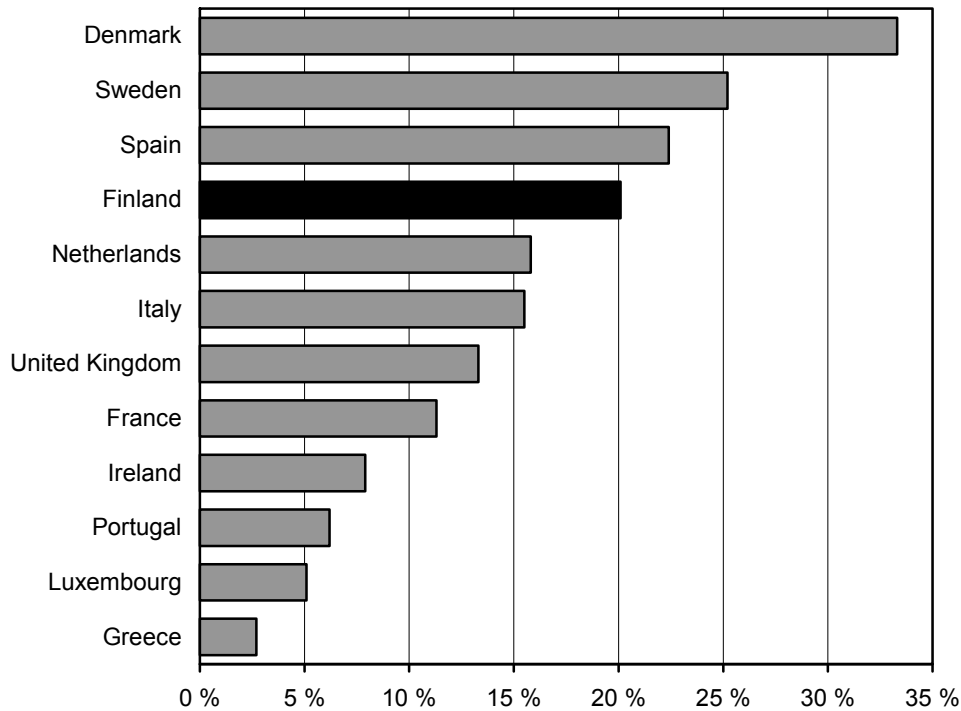


Source: Council of European Municipalities and Regions



The importance of local government in terms of its GDP revenue share is greatest among unitary countries in Denmark (Figure 16). Other Nordic countries are also high in this ranking. Note that here “sub-national” means not only municipalities but also other (intermediate) tiers below central government are included. In this comparison, Greece has the least decentralisation.

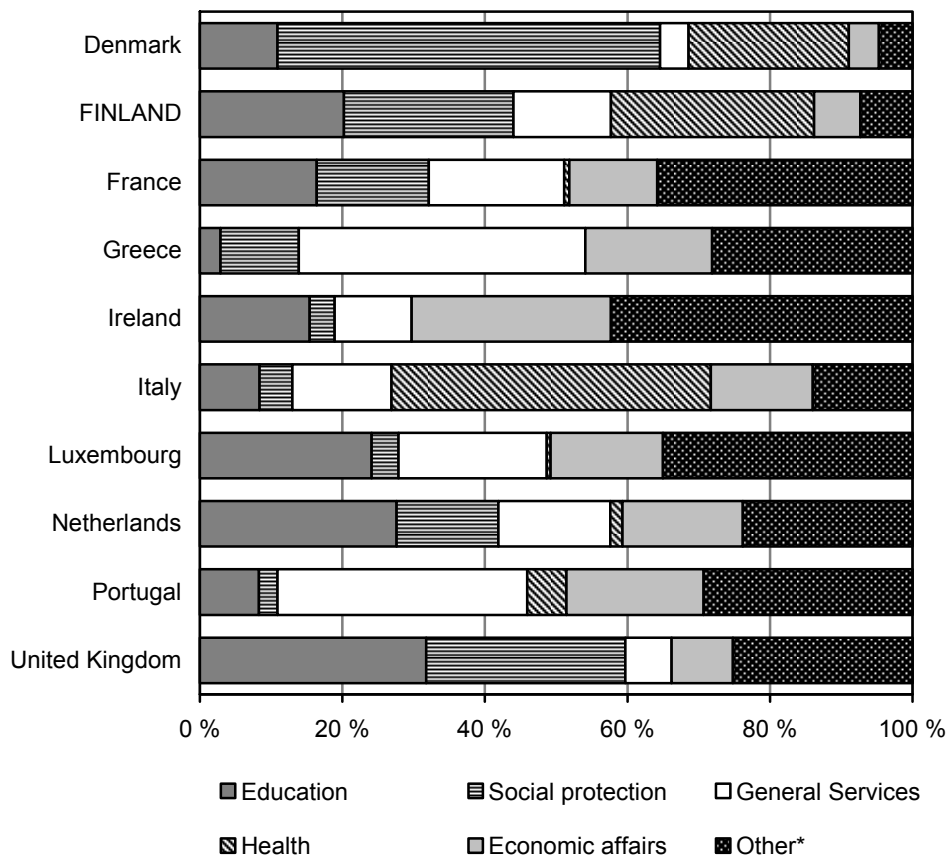
*Figure 16. The size of sub-national government in some unitary countries measured by total revenue as percent of GDP*



Source: Council of European Municipalities and Regions

The tasks and related expenditure structures of sub-national government (Figure 17) reveal some noteworthy differences among unitary countries. In the UK and Ireland, for instance health is not a task at sub-national level, and its role is small in France and the Netherlands also. In Finland and Denmark the opposite is true. In Denmark, unlike elsewhere, outlays at sub-national level include presumably items included in social protection (related to pensions) which are absent in other countries. This explains partly why the sub-national sector (Figure 16) is also big in Denmark.

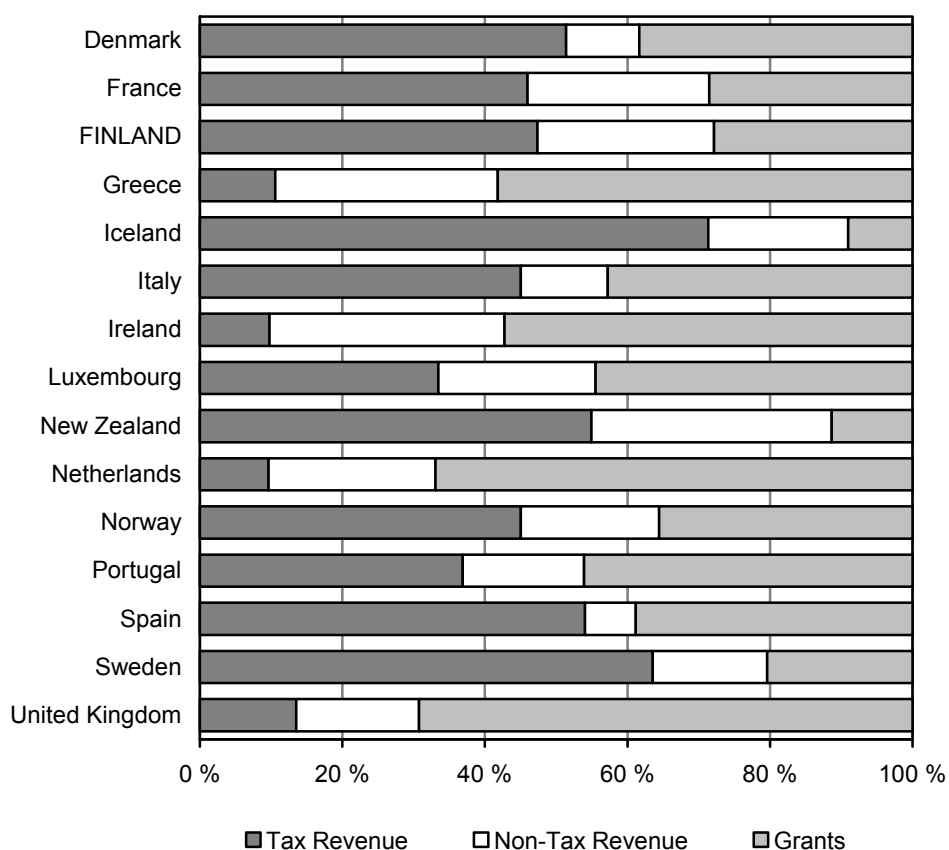
Figure 17. *Expenditure structure of sub-national government in some unitary countries, percent of outlays in 2005*



Source: Council of European Municipalities and Regions

To get an idea of the basic structure of local finance, the revenue side of local government is divided into tax revenue, non-tax revenue and grants (Figure 18). There is quite a lot of variability in the revenue structures. The share of taxes at local level range roughly from 10 to 70 per cent. The range for grants is from 10 to 70 per cent, and the typically smaller share on non-tax revenue ranges from less than 10 per cent to about 35 per cent.

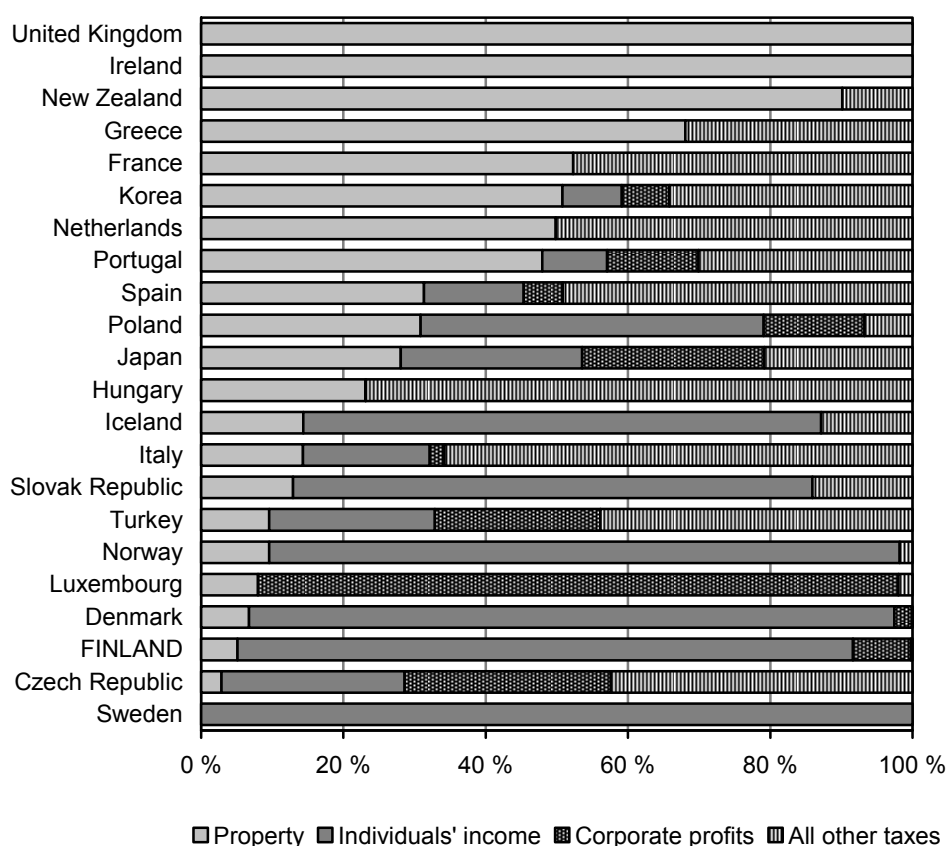
*Figure 18. Tax revenue, non-tax revenue and grants in some unitary countries, percent of total revenue in 2005*



Source: IMF Government Finance Statistics

As local taxes are an important source of local public finance, it is interesting to take a closer look at tax forms applied in different countries (Figure 19). The countries are placed in order by the share of property tax. UK and Ireland rely solely on this form of tax, and it is also important in Greece, the Netherlands and France. In Nordic countries local income tax is the most important form of tax, and in Finland municipalities also get a share of corporate profit tax revenue. Note that since the 1993 tax reform in Finland, capital income has not been taxed at local level, and the base for local income tax is therefore individuals' earned income.

*Figure 19. Tax revenues from main local taxes in 2005 in some unitary countries, percent of total tax revenues of local governments,*



Source: IMF Government Finance Statistics

The above international comparison indicates that Finland is an exceptionally decentralised country. Several tasks, which are handled elsewhere at higher levels of government (or tiers) than municipalities, are taken care of by the local governments and their joint organisations. Besides local infrastructure and local public goods, the merit goods of education, health and social services, are also provided by Finnish municipalities. The latter tasks have been devolved to

municipality level by decisions of the National Parliament, but their finance is shared. In addition to block grants, municipalities levy income taxes on individuals' incomes and receive shares of corporate tax revenues. Property taxation, introduced in 1993 has had a minor role.

Many of the countries considered deviate from Musgrave's (1959) principles of fiscal federalism in some respects. Finland is a rather extreme case even among them in solving the assignment problem of tasks and revenue sources to the lowest tier (municipalities). As for tasks, local public goods have a minor role compared to merit goods which are redistributive. As a result of this, Finnish municipality reforms concentrate predominantly on solving problems of health care and desired municipality size, something that has no role or only a minor role elsewhere at local level. The revenue structure also deviates from Musgravian principles which for instance UN-Habitat (2009) advocates to be applied globally. The small role of property taxation in Finland is one example of this. Reliance on corporate income (profits) taxation is another example, which is counter to the principle of centralised stabilization. According to this principle, revenue sources at local level should be more stable than at central level. As for the important role of local income tax, this is necessary given the large amount of tasks and the principle that municipalities cover part of the related costs from their own revenue sources.

All this makes decision making in Finnish municipal councils and governments a challenging task.

## 5. Discussion

Finnish local public sector appears to be a unique case in the country comparisons. This is not just because of the country's large public sector or the high degree of decentralisation. The fact that in Finland there is a single tier of local government - the municipalities - is also only a part of the explanation.

The thing that especially characterises Finnish local government is the extensive and sometimes complicated structure of cooperation between the municipalities. In order to cope with scarce resources, wide responsibilities, small population size and challenging operating environment, cooperation between municipalities has been essential. As a result, the smallest municipalities have been involved in a number of separate voluntary and partly obligatory cooperative coalitions. Some small municipalities have even been described as being purchasing organisations rather than municipalities in a traditional sense. This is just a minor exaggeration.

In Finland, the joint municipal authorities and other inter-municipal cooperation have effectively replaced the "missing" government tier at the local level. As such they correspond to special purpose entities which are used for certain purposes (like schools, waste management etc) in many countries, but in Finland they do not have directly elected decision making bodies and an own finance system. In fact this solution, together with central government aid, has ensured that the smallest municipalities in Finland have been able to operate at all.

Judged by the country comparisons performed by OECD and others, it seems that Finnish local public sector is performing fairly well. This is the case at least when comparing the outcomes and per capita expenditures. With this information, one may ask: why should we be worried about the future of Finnish local government?

But the truly big question in Finland at the moment is: even if the system has worked in the past, will it work in the future, too? Indeed, the future for the Finnish local government does not look very bright. With a rapidly aging population, growing numbers of retiring municipal employees, and diminishing tax bases, it may be very difficult to carry on with the old ways.

Having anticipated this, the government has taken steps to tackle the situation. With increased financial incentives for voluntary municipal mergers, regulations to enhance cooperation, requirements for productivity programme regarding the 20 biggest municipalities and the initiatives to improve the cooperation of the main Metropolitan areas, the government hopes to be able to strengthen local government. But it will take years before the effects of these policy actions become evident.

In addition to the measures already decided, there have been proposals for further policy measures. These include transferring the health care provision from the municipal sector to “health care districts” or even centralising the health care provision to be administered using a single “health care fund”. These proposals however have not yet been very detailed in practice, i.e. how to organise the decision-making bodies in these institutions, and how to ensure that the local needs and circumstances will be taken into consideration. As for the policy concerning the municipal structure, some have argued for compulsory mergers to speed up the structural change.

Over the years, there has been some discussion about new intermediate levels of government with its own tax base and elected councils, but so far these proposals have not gained much political support. At the moment, the Kainuu region experiment is the only example of an intermediate level solution in Finland. The proponents of intermediate level government in Finland have argued that the regional level of government allows better coordination and helps to address the externalities associated, for example, with land use planning and transportation. These tasks are conventionally regarded as key ones for local and regional governments, since land use patterns (densities) affect the productivity of the private sector (World Bank 2009) and also the networks for public service provision. The nature of these networks consisting of several service units can have more impact on efficiency than the mere size of municipalities.

Currently, the control of land use, housing and transportation are not tasks performed by regional councils in Finland. Regional councils mainly make plans and cannot decide on important matters such as land use. Namely, municipalities have legal zoning monopoly in their area and do not need to accept plans proposed by regional councils. According to some experts, there is thus a genuine need to have a regional body with more power in these issues. They argue that one reason for the scattered population structure and low density and sprawled urban fabric in Finland is the lack of binding land use plans that cover the whole region and not just single municipalities. The present situation permits an owner of a property to build almost anywhere as municipalities with zoning monopoly, usually allow such developments to take place. A new intermediate level with its own tasks related to land use, transportation etc. and its own revenue sources is an alternative, but then regional councils in the current form are hardly needed. An intermediate level of government could also be a stronger player in negotiations with central government.

The critics of an intermediate government tier argue, instead, that introducing a new intermediate level of government could result in waste of resources and duplication in the provision of the services. In a situation where the public sector should improve productivity and reduce administrative expenditures, the intermediate level of government does not seem like a good idea if it leads to increased expenditures. It has also been argued that as Finnish municipalities are

already utilising the economies of scale with intensive cooperation, and as the grant system addresses much of the spillover effects, there do not seem to be many economic arguments left for the new intermediate levels of government. It has also been pointed out that the experiences of the intermediate levels of government from the other Nordic countries do not seem very promising from the efficiency side. Norway has recently transferred the hospitals from the intermediate level to central government and Denmark has reduced the number of intermediate governments and their tasks.

The present system of voluntary cooperation between municipalities is defended with the argument that it retains the local autonomy and accountability. A locally decided combination of own production, joint provision and contracting out may give the municipalities the possibility to address economies of scale or service spillovers on a service by service basis. This can help the municipalities to find the most flexible way to organise their services, which may be good for cost efficiency. According to this opinion, the present model needs only slight modification, for example by amalgamating some of the weakest municipalities to create stronger independent municipalities. With more equal partners for cooperation, the inter-municipal cooperation could concentrate on services that truly need larger scale of operation.

As single tier of local government seems to be strongly rooted in the Finnish thinking, no radical change on this seems likely. Hence, the present government policy which is based on gradual increase of average municipal size and enhanced cooperation is likely to continue. Having said this, it is still possible that in special cases such as the capital city area, new administrative models will be considered.

But even if no ground-breaking change would be seen in the municipal administration, a small revolution may lie ahead in the utilisation of market mechanisms. While the separation of provider and producer roles in the municipalities has been the traditional attempt to utilise market mechanisms, some municipalities have recently outsourced part or all of their health care to private health care companies. In addition, new proposals to increase the freedom of consumer choice have been advanced. A new law of vouchers was enacted in 2009 with the aim to enhance the use of vouchers in social and health care services. So far, vouchers have been used on a small scale in services like nurse visits to home or other home care help. But at the moment the applications of voucher systems are rapidly increasing in many municipalities. It seems that so far the experiences of vouchers have been positive. Also, recent research results show that optimally designed vouchers can generate savings in Finnish health care, although vouchers are not suitable for all services and all cases.

Finnish local government is in a stage of transition. At the moment it is not clear whether the already decided reforms on local government will be sufficient. It



seems that the question of balance between municipal tasks and financing is still unsolved. In order to be able to do this, the central government policy towards local government sector needs to be better coordinated. The burden of tasks of the municipalities should no longer be increased. During the past decades, the central government ministries have delegated various tasks to municipalities. Perhaps now the political discussion about which tasks should be provided locally and which tasks should be centralised or privatised, should really start.

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