



RiR 2018:8

The municipal financing principle

– is it appropriately applied?

Summary

Background and rationale

Given Sweden's far-reaching municipal autonomy, relations between central and local government need to be good. An important central government policy instrument for maintaining this relation is economic regulation, such as the municipal financing principle. The intention of these regulations is to clarify the distinction between central and local government responsibilities, and to create a level playing field for municipalities.

The municipal financing principle has been applied since 1993 and means that the central government may not impose new responsibilities on municipalities and county councils without providing them with adequate funding. That is to say, reforms determined by the central government shall be neither underfunded nor overfunded. The principle is applied by means of allocating the reform's estimated cost or saving to the municipalities and county councils, respectively, on the basis of population size.

The Ministry of Finance has the main responsibility for implementation, whereas the sectoral ministries are responsible for drawing up data for decision-making and for

negotiations with the Swedish Association of Local Authorities and Regions (SALAR). On average about four new reforms are regulated annually, and since the regulation of each individual reform remains over time, these are cumulatively significant amounts. Consequently, the principle is fundamental for implementing reforms determined by the central government in the municipalities without impairing the financial relationship between the central and local governments. In addition, compliance with the principle is important for the legitimacy of central government reforms and to ensure that the underlying information for decision-making data is accurate.

Purpose

The Swedish NAO has audited the application of the municipal financing principle for the purpose of assessing whether the Governments' preparation and reporting process has been sufficient to result in adequate economic regulation. By adequate regulation is meant that the purpose of the financing principle is met, i.e. that municipalities are neither undercompensated nor overcompensated for reforms determined at the central government level. The assessment of what constitutes a sufficient preparation and reporting process has been made on the basis of the intention of economic regulation for municipalities, as well as the Riksdag's statements on how reforms regulated according to the the financing principle should be reported.

Three reforms in the areas of education and childcare were selected for audit:

- Higher standards and quality in the new upper secondary school (government bill 2008/09:199), also called the 2011 upper secondary school reform
- Childcare vouchers and universal preschool for three-year-olds (government bill 2008/09:115)
- Additional teaching hours in mathematics in compulsory school (government bill 2012/13:64)

Conclusions

The Swedish NAO's overall conclusion is that the financing principle has not been applied as intended in several aspects of the three reforms audited. In central parts of the preparatory process the Government Offices did not follow its own guidelines. In combination, the deficiencies in the preparatory process and reporting mean that, in the reforms audited, the Riksdag made decisions on economic regulation on the basis of information that is unclear and inadequate in several aspects.

The reforms' preparatory process is unclear and deficient in several aspects

The audit shows that the preparation of the reforms was not sufficient in that the Government, to varying degrees, did not clearly and openly report the assumptions and calculations on which the economic regulation of the reforms was based. For example, the assumptions are poorly argued, and there is no information on the specific data and statistical sources used. In the same way, no analysis has been made of how the calculations are affected by alternative assumptions. The lack of supporting documentation has made it more difficult for the municipalities to gain an insight into the reforms' calculations and to provide relevant comments.

Lack of negotiation and tight deadlines

The Government Offices did not hold negotiations with SALAR on any of the three reforms audited. Negotiations are a central part of the application of the financing principle and should take place in good time on the basis of well-founded preparatory documentation. In addition, the final stage of the preparatory process was characterised by tight deadlines for two of the audited reforms, which is in contravention of the Government Offices' own guidelines for the preparatory process. A lack of negotiation and tight deadlines in the preparatory process further complicates the ability of the central government to create legitimacy for the reforms to be implemented in the municipalities.

No analysis is made of how reforms impact individual municipalities

The Government Offices' own internal guidelines prescribe that an assessment must be made of whether an economic regulation entails important differences for individual municipalities. The Swedish NAO's audit shows that no such assessment was made either in the three reform cases, or generally for other reforms regulated according to the financing principle.

The Swedish NAO's own calculations show that structural differences (for example different target group sizes) mean that the costs of the audited reforms vary considerably between municipalities. It is true that the cost equalisation system in many cases corrects for this, but not always. In some cases, a deviation from the financing principle's main rule, to distribute the adjustment amount on the basis of population size, may therefore be needed. To assess such needs, it is essential to analyse municipality-specific circumstances. It is not possible to make such an analysis solely on the basis of data on

unit costs and volumes at national level, which the calculations underlying the Government's decision-making are based on. However, the Swedish NAO notes that corresponding data at municipal level is readily available from agencies that produce statistics.

Reform costs are rarely constant over time and are not monitored

The Government does not monitor the economic outcome of reforms regulated according to the financing principle. The main stated reason is that the application of the principle does not require monitoring, but also that monitoring of the economic outcome of reforms is associated with methodological difficulties.

The lack of monitoring of reforms' economic outcomes means that there is no knowledge of whether the purpose of the financing principle is maintained over time. As the financing principle is formulated, regulation must be made based on the price and volume levels applicable when the respective reform is implemented, which means that the regulation is undermined as the levels change. Normally, however, no analysis is included of the development of the unit costs and volumes concerned in the preparatory documentation. In the reforms audited, the underlying trend is only mentioned in one case, upon which the cost calculation is made on the assumption of a reversing trend. That is an assumption that the Swedish NAO does not consider well-founded. Overall, the Swedish NAO's analysis shows that there is a risk that the constant regulation applied is inaccurate.

Limited support for economic impact assessments for municipalities

The audit shows that the support to central government inquiries is limited, as it does not include the guidelines applicable to continued preparation of the financing principle in the Government Offices. At the same time, the internal guidelines emphasise the importance of analysing how reforms should be financed and the municipal economic consequences early in the preparatory process, for example in an inquiry report.

Recommendations

On the basis of the audit findings and conclusions, the Swedish National Audit Office makes the following recommendations to the Government:

- *Municipal economic reforms should be prepared in a transparent and informed manner.* This includes clearly and openly reporting the statistical sources used in the preparatory documentation and the assumptions and assessments made in the calculations concerning municipal economy. An analysis of how the estimated costs are impacted by alternative assumptions should also be made and reported for the reforms characterised by major uncertainties.
- *Representatives of municipalities and county councils should be invited in good time to participate in the preparatory work for municipal economic reforms.* Negotiations between the Government Offices and SÁLAR constitute a central part of the application of the financing principle. In accordance with the intention of the principle, representatives of municipalities and county councils should be given the opportunity to assess the economic impacts on municipalities of proposals on which the Riksdag will later decide. According to the Swedish NAO, this should be done in good time.
- *Preparation of the economic implications of reforms on municipalities should include an analysis of how the impact differs between municipalities.* The audit shows that a municipality-specific analysis is essential for assessing whether the allocation of the adjustment amount should be based on anything other than population size, or if changes in other systems, primarily the cost equalisation, are necessary. To enable such an analysis, the cost estimates need to be based on municipality-specific data rather than national averages.
- *Cost monitoring should be carried out.* In order to identify any incorrect adjustments, costs must be monitored. This is particularly important for reforms involving large amounts. This monitoring should be clearly and transparently reported. Where there are clear trends, it should also be possible to adapt the adjustment amount, so as to avoid incorrect adjustments over time.

The Swedish NAO makes the following recommendation to the Government Offices:

- *Committees should be given sufficient support to be able to make cost estimates in accordance with the guidelines.* The intention of a government inquiry is to provide well-founded preparatory documentation. To ensure that the assessments of the municipal economic consequences made in government inquiries can be used in the continued preparatory process in the Government Offices, the responsible sectoral ministry must ensure that the committees have access to the guidelines that apply to the financing principle.