Spend and tax, and then tax and spend? Looking for a relationship between municipal service responsibilities and taxing powers in Finland

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1 Introduction

This paper provides a general description of the developments in the local tax structure and service responsibilities in Finland. It can be argued that the present framework dates back to the formation of independent State of Finland, and the people's desire to create a strong local self-government, built on local democracy and the right to levy taxes.

The later decisions to develop a "Nordic welfare state" in Finland by delegating the service provision to local government seem to have led to increasing role of local revenues and especially taxation. The Finnish municipalities, that form the single-tier local government, were given new tax bases and freedom to set tax rates, as the municipal obligations accumulated. The grants from central government played a significant role as well.

Once the welfare state reached a mature stage, the role of tax policy in the overall local public sector became more important. Therefore, one can argue that today the revenue base dominates the spending side. Nevertheless, even during the present time of economic crisis, it seems difficult to constrain the delegation of new tasks from the center to the local level.

2 A brief history of Finnish local government

The 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.

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 councils that were elected in general elections got the highest decision making power. Later, in 1932, provisions on inter-municipal co-operative organisations and joint municipal authorities were added to municipal legislation.

Since the end of the 1950's many new statutory obligations have been assigned to municipalities. The state owned general hospitals were transferred to local government ownership, and some private comprehensive and upper secondary schools became municipal schools. The enlargement of local government tasks was especially rapid in the 1970's and 1980's. In 1980's the uniform system of welfare services had spread all over the country, with massive central government steering.

The central government financed municipal expenditures with specific matching grant system. The matching grant rates varied depending on financial capacity of the municipality, and each task had a different matching rate scale. The so called "capacity classification" divided municipalities into 10 groups based on per capita tax base (50 % weight), financial condition of the municipality, population density and unemployment rate. The higher the municipality was ranked in the classification, the less state support (because of lower matching rate) it received. Evaluation of the classification was carried out annually.

In 1993, there was a major grant system reform from a pure matching grant system to a formula based block grants system and a revenue equalization system. The new Local Government Act in 1995 meant an end to the tight central government regulation.

In sum, as a result of the decentralization policy since the 1960s, all main social welfare, health care and education services are today performed by municipalities or by joint municipal authorities. Hence, the overall economic importance of the municipal sector became considerable. Municipality spending as share of GDP is now around 18 percent and municipalities employ roughly 20 percent of the total Finnish workforce.

3 Municipal finances

Municipal finances are presently based on own source revenues (tax revenue, user fees and sales revenue) and grants from the central government (Figure 1). This basic structure of revenues dates from the end of 19th century (Loikkanen and Nivalainen, 2011).

Tax revenues make up 46 per cent of all municipal revenues. The main tax revenue comes from income tax. The property tax and municipal share of corporate tax generates much less revenue to municipalities. 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. 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 1 Municipal sector revenue (left box) and tax revenue (right box) composition, 2011

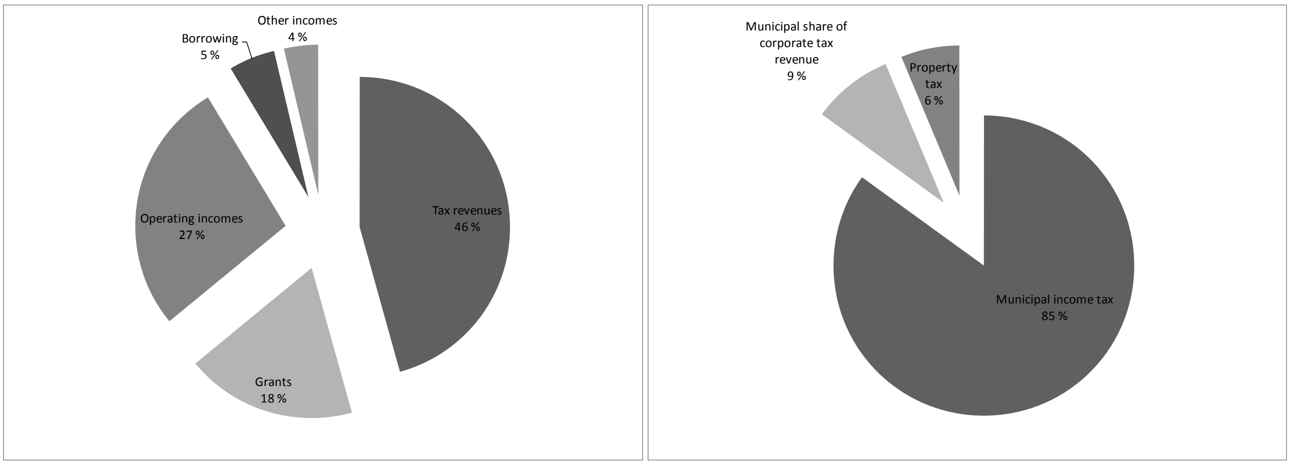
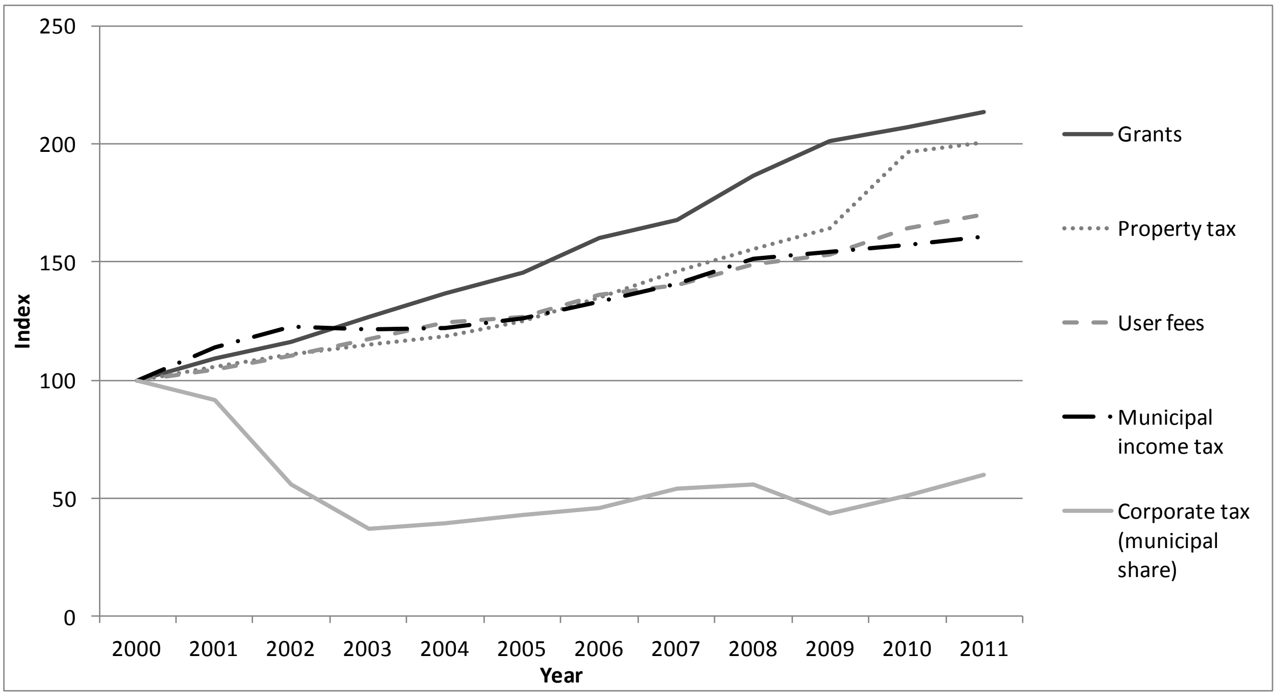


Figure 2 Municipal revenues during 2000-2011 (nominal prices, index 2000=100)



3.1 Tax revenues

Since 1920 the municipalities were allowed to tax local income, properties and local firms. At first, the local taxation used to be administered by municipal tax boards, but in 1960 the system was reformed so that all income taxation was administered by one tax authority. Tax collection was still operated by separate ministries until 1979, when all tax collection was concentrated to central tax authority. In 1989 the tax reform expanded both central and local income tax bases: altogether 16 different tax deductions were eliminated. During 1990-1992 some further tax changes were made that generally tightened taxation. These changes were done mainly to increase the tax revenues both in state and municipal taxation, because of the negative effect of major economic recession to tax revenues. In 1993 there was a major reform to separate the capital and labor income taxation. After the reform, the central government earned income tax was based on a progressive tax rates and capital gains began to be taxed at a flat rate. For the municipalities the reform meant that the local income tax was restricted to a tax on earned income and capital income was excluded. The reform was also important for the municipalities because it introduced the present form property tax and municipalities were given a share of corporate income tax revenues.

3.1.1 Income tax

Local income tax base is determined by the central government but municipalities have full control over the rate. Most municipal tax revenue is raised through the local tax on personal income.[1] 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. The revenue losses of these allowances are compensated to municipalities through the grant system, though.

Municipal income tax rate has been steadily rising (figure 3), reflecting the increasing municipal service responsibilities, hike in public sector wages and since 2009 the economic slump that has reduced the income tax base. The changes in taxable incomes (see figure 4) reflect the business cycles and the tax reforms that were described above.

[1] The 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.

Figure 3 Municipal income tax rate, 1970-2012

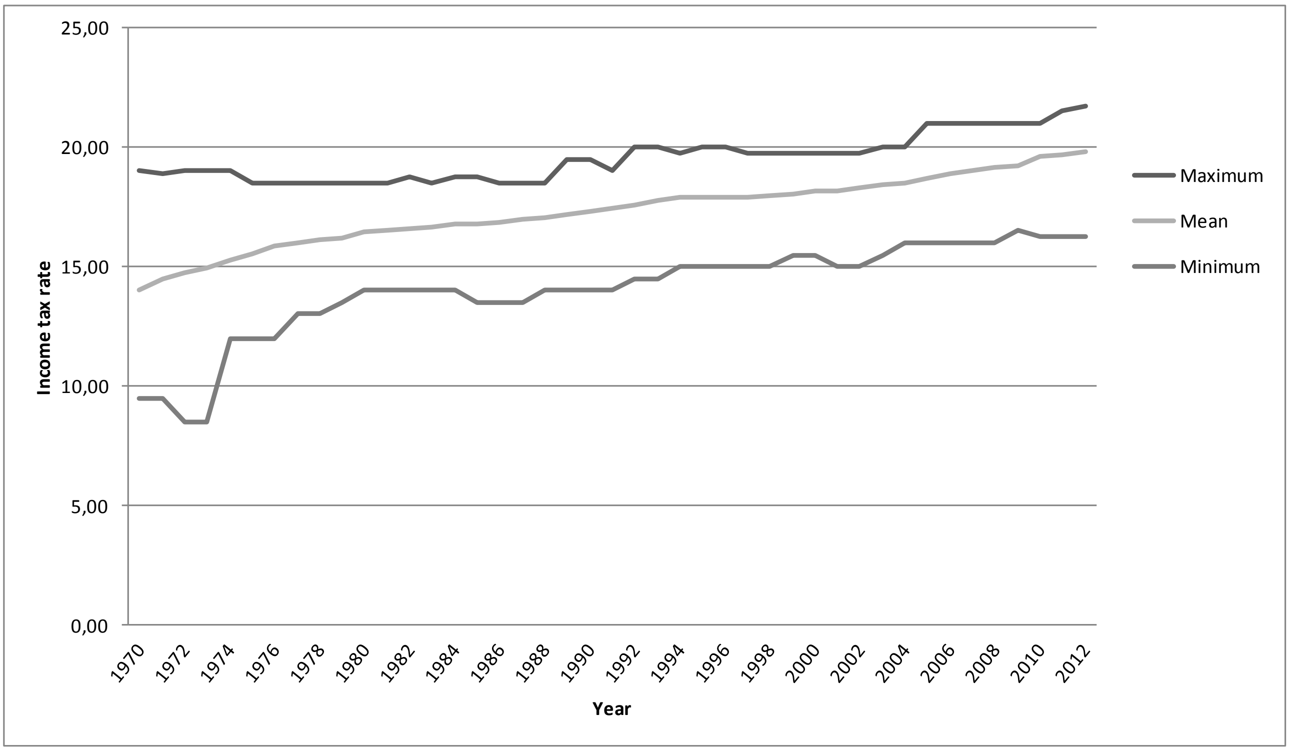


Figure 4 Taxable incomes in central government and municipal taxation, 1970-2011

3.1.2 Property tax

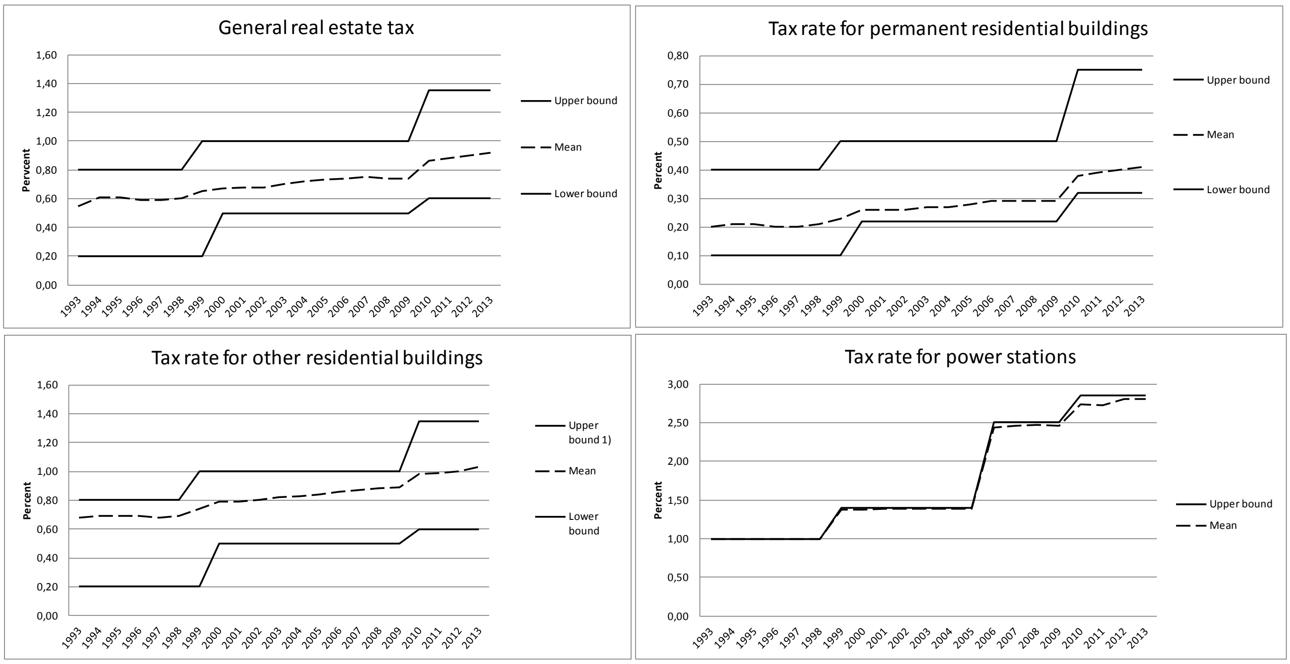
The property tax system in its present form was started in 1993. Before that, the property taxation comprised of complex system of fees and charges on real property such as discretionary property tax, the land tax, the street charge and the tax on income from housing.[2] At present, the property tax system consists of five taxes: the *general real estate tax,* the tax for *permanent residential buildings*, the tax for *other residential buildings*, the tax for *power stations* and tax for *nuclear power stations*. The owner of the real estate is subject to real estate tax. Property taxes are collected by central tax authority but each municipality decides their own property tax rates within upper and lower limits set by the central government. Municipalities are the sole receivers of property tax revenues. Figure 5 shows the development of the limits for each tax and the mean rates. For the main property tax bases, the *general real estate tax and* the tax for *permanent residential buildings,* the municipalities have been reluctant to use property taxation very actively. For example, no municipality uses the maximum rate, and for most property tax rates the mean rate is closer to minimum than maximum limit (except for the leisure homes and power stations). [3] The mean rates have been slightly rising though. The central government has changed the limits twice, in 1999 and 2010. As a result of the 1999 reform, about 49 % of the municipalities applied the new lower limit rate whereas before the reform only 5 percent applied the lowest allowed rate.[4]

[2] See Lyytikäinen 2009 and Lyytikäinen 2012 for a thorough description of the Finnish property tax system and its reforms.

[3] The real estate tax rate for vacant construction sites must be set between 1.00 % and 3.00 %. In certain municipalities in the metropolitan area, the real estate tax rate for vacant construction sites must be set at least 1.00 percentage point above the general real estate tax rate. Non-profit organizations may be exempt from property taxes. Municipalities are not liable to pay real estate tax on real estate located on municipal land.

[4] 35 % of the municipalities increased their rate from 1999 to 2000, and 15 % were already applying the new lowest allowed rate in 1999.

Figure 5 Property tax rates 1993-2013[5]



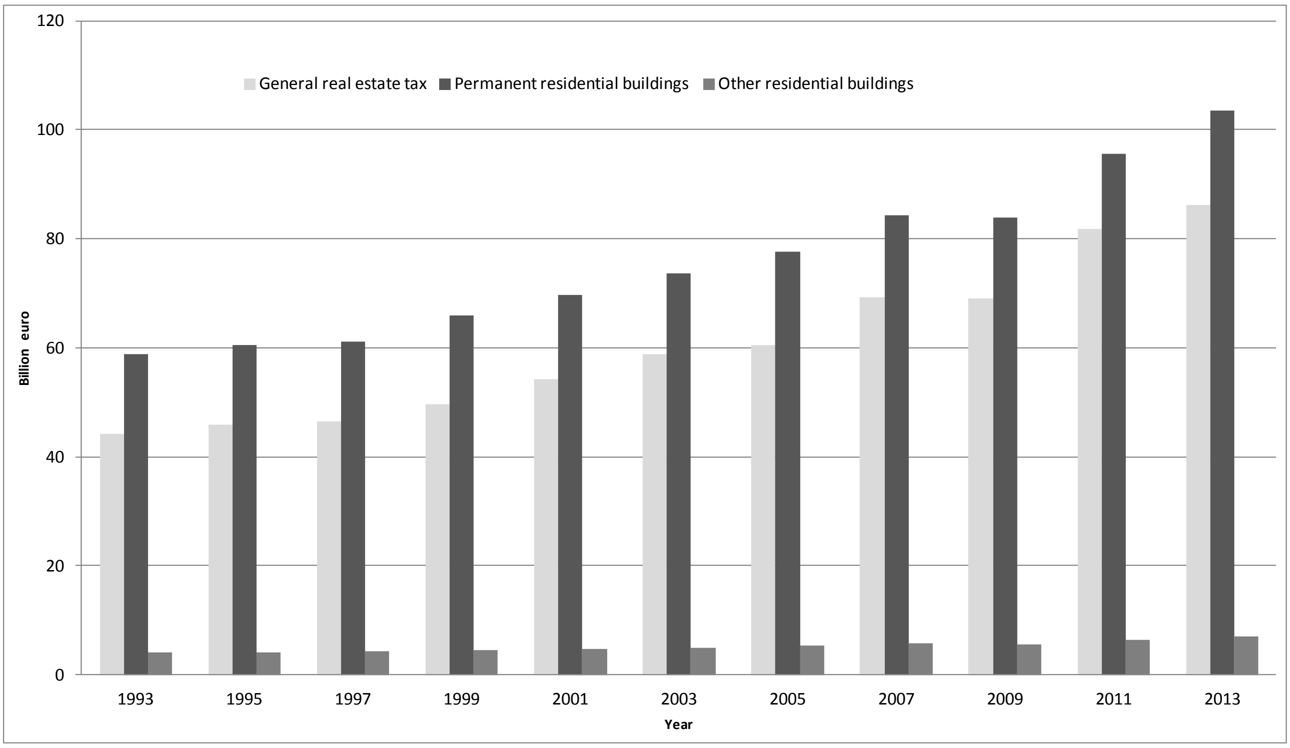
The general property tax is applied to both residential and commercial land and commercial buildings.[6] The taxable value of land is based on the estimated market value of the site for the previous year. The taxable value of buildings is based on estimated construction cost less depreciation. The general property tax on buildings and the residential property tax makes investment less profitable and therefore property taxation affects the location decisions of capital. It is then possible that municipalities use the property taxation as a means to attract business capital. Lyytikäinen (2012) uses the government decision in 1999 to increase the lower limits of property tax rates as source of exogenous variation to study the property tax competition between municipalities, finding no evidence of spatial interaction in property tax rates.

Property taxes account only for 3 percent of total municipal revenues. The long term political objective has been to increase the importance of property taxation in municipal finances and thus reduce the pressure to increase local income tax rates. The upper and lower limits of property taxation have been increased in 1999 and 2010, which forced some municipalities to increase their rates. Since 2012, the government also decided to remove the property taxation from the tax base equalisation. One of the benefits from this change is that the municipalities can now keep the increased property tax revenue that result in increased property or land prices. Municipalities may, for example, improve the quality and efficiency of the local public services, or use zoning to increase the value of land and properties. At the moment, the government is preparing a reform to improve the real estate and land valuation. It is noteworthy (see figure 6) that the property tax base has been increasing steadily and has been less affected by the economic crisis since 2009.

[5] The mean rate is the tax base weighted average of tax rates.
[6] The land used for agriculture or forestry is exempt from general property tax.

Despite the measures taken to increase the importance of property taxation, and the planned further measures, it is however unlikely that property taxes will become a significantly more important source of local revenue in Finland.

Figure 6 Property tax bases 1993-2013

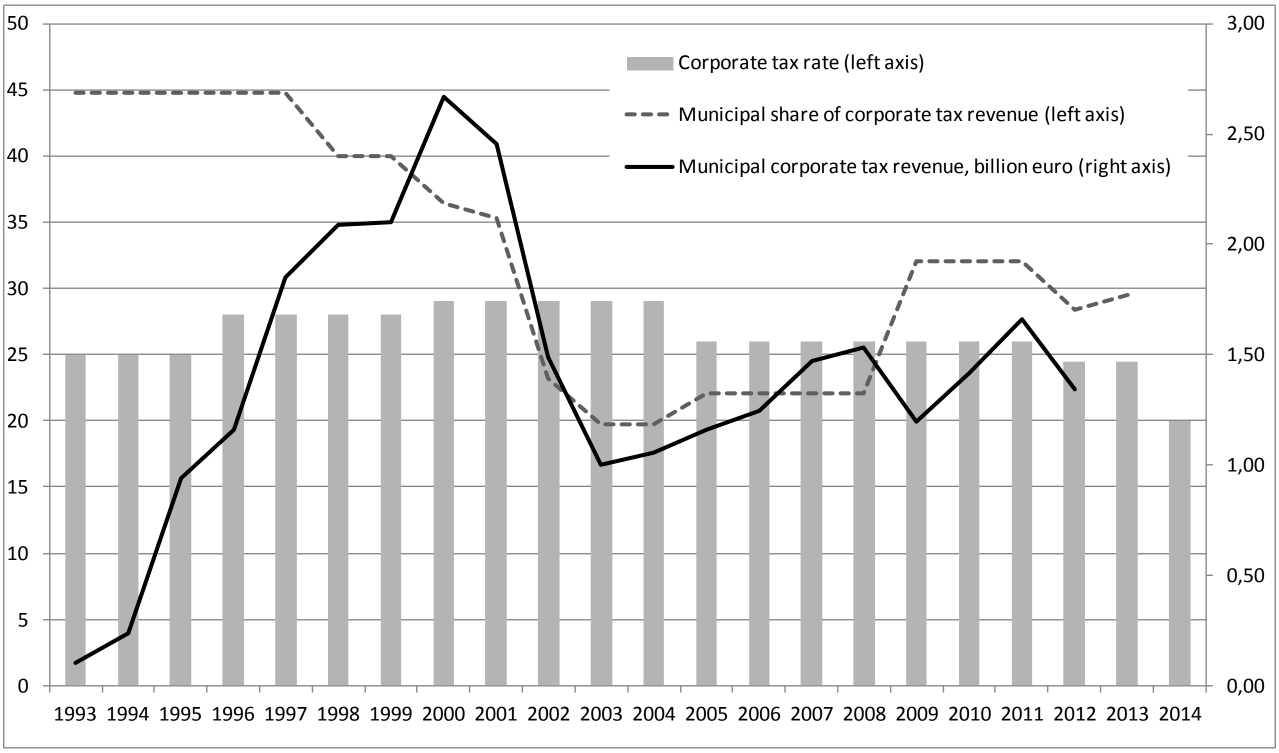


3.1.3 Municipal share of corporate tax revenues

Since 1993 the municipalities have received a share of the corporate tax revenue. The central government has changed the municipal share, sometimes yearly, to adjust the municipal sector economy (figure 7). The share of corporate tax revenue channelled to the municipalities was reduced from about 45 percent in 1997 to 20 percent in 2003. In 2005 the share was increased again to 22 percent to smooth municipal revenues 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.

There has been discussion to replace the corporate tax revenue from the municipal revenues menu with increased grants. Municipalities have strongly opposed all these proposals. Opposition is particularly strong in areas such as Helsinki (the capital) where corporate income tax has been 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 both in general and in individual municipalities. The high volatility is claimed to cause problems because it makes revenues unpredictable and also makes it less likely that revenues can be used to reduce the personal income tax rate. In addition, the windfall gains from corporate tax revenues may lead to higher expenditure that is difficult to reverse. However, it must also be noted that central government has been quite active in adjusting the municipal share.

Figure 7 Municipal share of corporate tax revenue 1993-2012



4 Municipal tasks and regulation

According to the recent study by Ministry of Finance, there are presently 535 statutory municipal tasks and 974 norms that regulate these tasks. The number of statutory tasks started to grow quickly since 1970s (figure 8). In the 1970s the decisions to delegate the education, health care and social welfare services were made. Since then the tasks (and norms) have grown about 50 percent every decade.

While there are still new proposals (and laws being prepared) to increase the municipal task burden, the present government has recently decided to cut the municipal tasks and regulations so that in 2017 the municipal spending will be reduced by EUR 1 billion. The list of tasks to cut will be prepared by a Ministry of Finance working group by the end of November 2013.

In addition to the changes in municipal tasks, also the grants will be cut. The decisions of grant cuts were already done in March 2013 and the cuts will be in effect since 2014.

The government will also increase the fiscal control of municipalities. How this will be done in practice - and which fiscal rules will be used to accomplish this - is still unknown. However, the idea seems to be to strengthen the powers of the so-called Basic Public Services Programme and the Basic Public Services budget[7]. These procedures are already in place for the negotiating procedure between central and local government. Also, the Basic Public Services budget is used when preparing the government budget. The main aims of the Basic Public Services Programme are:

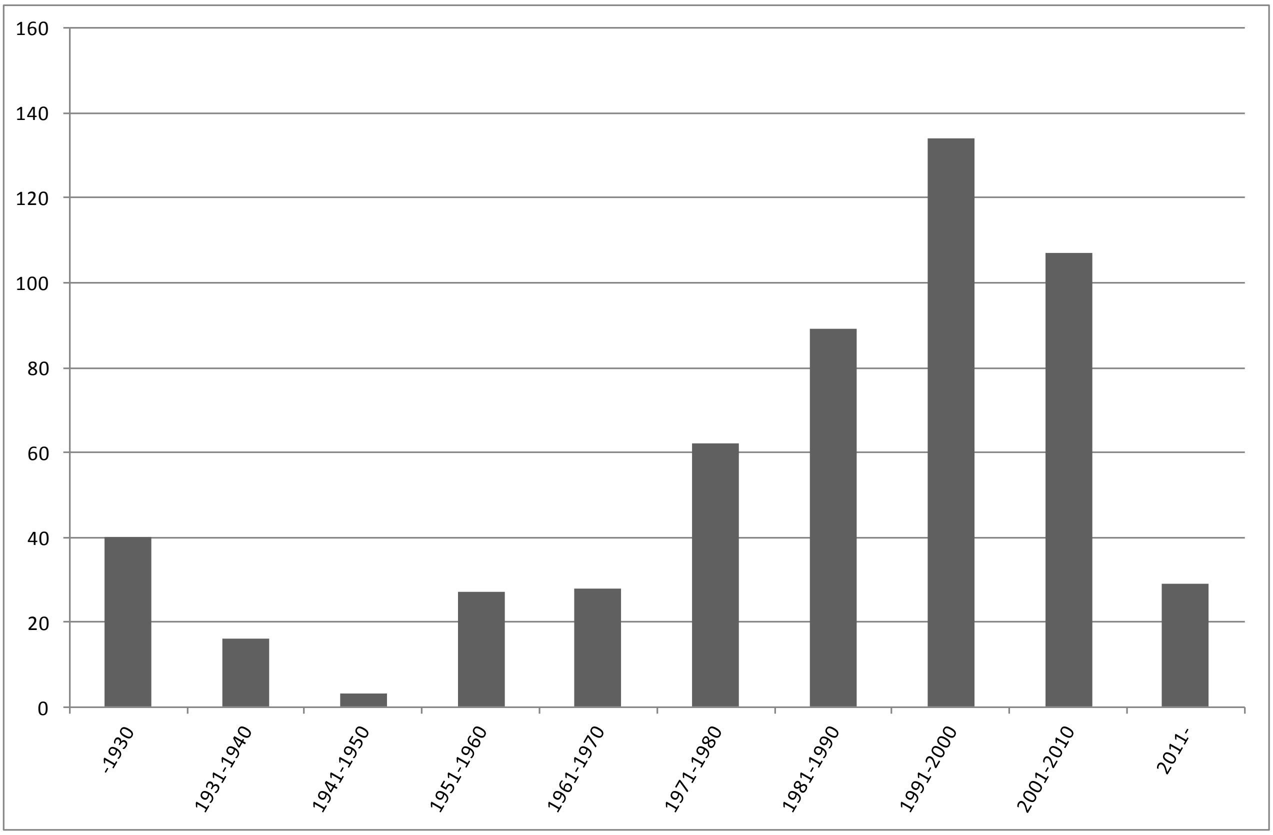
- to evaluate changes in the local government operating environment and the demand for services;
- to monitor the trend in local government finances and changes in local government functions;
- to draw up a plan of the measures required for balancing municipal revenue and expenditure;
- to make a proposition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

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

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

[7] The Basic Public Services Programme has run since 2005 as part of the negotiation between municipalities (represented by the Association of Finnish Local and Regional Authorities) and central government (several ministries were involved). Since the outset, the process was used as part of the planning process for the central government budget. Despite this, the Basic Public Services Programme and Basic Public Services budget were not given a permanent role and legal status until 2008.

Figure 8 Number of present municipal tasks by decade of delegation



5 Summary and conclusion

Finnish economy faces presently three main challenges: the economic downturn, the ongoing structural change in the Finnish export industry and the sustainability gap of public finances due to ageing population.

The government has recently decided on a structural reform programme to tackle the problems. Due to the importance of local government sector in Finnish public finances, the structural reform package includes a number of measures that will affect the local government. These measures include the municipal merger reform, the service structure reform in social and health care and cutting down the number of municipal tasks and regulation. It seems that the long-term policy to accumulate the municipal sector burden by increasing tasks and regulation is about to end.

During the past decades, the tax policy and the policy to build the Nordic welfare state seem to have proceeded largely independently of one another. In the municipal sector, the policy was concentrating to the welfare state. At the same time, the municipalities were given enough own revenue bases so that on average the municipal sector was able to fund the bulk of the expenditures by itself. The grant system took care of those municipalities that could not raise enough own funds.

The present policy aims to create stronger municipalities and to reduce central government regulation. The grant system reform will support this development, because the plan is to make it slightly less equalising. An important plan is also to increase the macroeconomic control of the municipal finances. It then seems that the traditional normative regulation will be replaced by (not so traditional by Finnish standards) tighter fiscal regulation.

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