Translation of a letter

From: The Association of Finnish Local and Regional Authorities

Letter dated: 5 January 2012

To: European Commission

Subject: Reply of the Association of Finnish Local and Regional Authorities to the Commission's Green Paper on stability bonds

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The Association of Finnish Local and Regional Authorities consists of the municipalities of Finland. The Association's goal is to improve the operating conditions of local authorities by looking after their interests and providing development and other services. All of Finland's municipalities and cities are members of the Association. The Association employs about 300 persons, mainly in expert duties. The Association's office in Brussels serves as its lobbying centre for EU affairs.

The Association of Finnish Local and Regional Authorities is registered in the EU's Transparency Register (ID 10235216783-84).

Municipality Finance Plc, owned by the municipal sector and the State of Finland, plays an important role in financing the operations of Finland's municipalities. The fund-raising organised by Municipality Finance Plc is secured by the Municipal Guarantee Board, which has institutional responsibility under public law.

In Finland's experience, joint financing arrangements are successful when:

1. The level of indebtedness is low; in Finland the local government debt to GDP ratio is about 7%.

2. As regards municipalities in financial straits, there are sufficient intervention mechanisms based on the law that function well and are used whenever the necessary conditions are met.

3. The economic development of municipalities is monitored based on a joint accounting system and a uniform operating culture.

In its reply, the Association of Finnish Local and Regional Authorities states that the partly similar system proposed for the EU should enable the same kind of control and supervision as the one used in Finnish local government.

In our view, creating such a system at European level is extremely challenging and also very unlikely, considering the Member States' different economies and operating cultures.

Therefore the Association of Finnish Local and Regional Authorities cannot support a system where the credit rating of Finland's municipal sector would depend on the credit rating of the entire euro area, no matter how well Finnish local government handled its own affairs and obligations.

1. Local government and local finances in Finland

Finland is divided regionally into municipalities, where the autonomy of inhabitants is safeguarded in the Constitution of Finland. At present there are 336 municipalities in Finland. Decision-making power in a municipality rests with the municipal council, elected by the inhabitants. Municipalities aim to promote the well-being of their inhabitants and sustainable development in their area. By virtue of their autonomy, they carry out the duties they have assumed themselves and those prescribed by law.

In Finland, the responsibility of municipalities and their collective associations - the most important ones financially being the federations of municipalities - for social services, healthcare, educational and cultural services, public infrastructure as well as the organisation of other welfare services is extremely significant by international and also European standards. Local government accounts for two-thirds of public consumption in Finland. The ratio of the total expenditure of local government to GDP has been about 20% in recent years. Local government employs about one fifth of the total Finnish labour force.

The financing of municipal services is part of the financing system of the public economy. It is characterised by municipalities' right of taxation based on their autonomy and by the financing principle. Municipalities have the right to tax the earned income of their inhabitants (*municipal income taxation*) and municipalities are paid tax on the basis of the value of real property (*tax on real property*). Municipalities are also entitled to a share of corporate income tax. According to the financing principle, the State must contribute sufficiently to the financing of the duties it has laid down so that municipalities have the financial capacity to perform them. The objective of the State subsidy system is to guarantee equal opportunities for organising basic services throughout the country while at the same time keeping taxation at a reasonable level.

2. Cooperation between the State and municipalities

The participation of Finnish municipalities at the highest level of the State's decision-making process implemented by the Finnish Parliament is divided into two parts: the Association of Finnish Local and Regional Authorities' activities and the parliamentary activities of decision-makers involved in municipal decision-making. In parliamentary committees, the municipal sector is usually represented by the Association of Finnish Local and Regional Authorities. In consultations with experts, individual municipalities and, for example, federations of municipalities may request to be represented in matters pertaining to their own sector.

Supreme legislative power in Finland is wielded by Parliament, which is elected every four years. Parliament has 200 members. Electoral districts in Finland are based on region and population size. The votes of electoral districts are divided between the parties according to proportionality. Parliament enacts laws usually on the basis of government proposals, which are prepared in the relevant Ministries. As a rule, the Association of Finnish Local and Regional Authorities is involved in these preparations when the legislative reform being discussed affects the operations and finances of municipalities. In 2009 the Association was represented in 102 ministerial working groups.

The cooperation between the State and municipalities is based on the Local Government Act, which states that legislation affecting municipalities and the coordination of municipal finances and administration and of State finances and municipal finances is

discussed in negotiations between these parties. The negotiation procedure covers a multiannual basic services programme and basic services budget, both drawn up annually.

3. Basic services procedure

A ministerial group composed of members of the Council of State directs the basic services procedure. The ministerial group is chaired by the Minister of Finance. The other members are the ministers of the other administrative sectors and their principal assistants. In the ministerial group discussing the basic services programme, Finnish municipalities are represented by two permanent members, the Chairman of the Association of Finnish Local and Regional Authorities' board and the Association's Managing Director.

The goal of the basic services programme is to examine changes in municipalities' duties, the development of municipal finances in the context of the public economy and the financing needs of municipalities. The programme then proposes measures aiming at balancing income and expenditure. In principle this procedure should secure balanced finances for all Finnish municipalities. However, individual municipalities may encounter particular financial difficulties, and therefore the basic services procedure has been supplemented by a mechanism specially designed to take into account municipalities in a particularly difficult situation.

In principle, the basic services procedure should secure balanced finances for each Finnish municipality. However, as it is possible that individual municipalities may encounter particular financial difficulties not identified in the basic services procedure, a mechanism has been devised to help such municipalities.

4. The State's role in financing the operations of municipalities

The basic services procedure described above and the related State aid to municipalities cover on average 19% of the financing required by Finnish municipalities (figures for 2011). The remaining funding, about 81%, consisting above all of income from taxes and fees, is based on local conditions, which are not always taken into account by the procedures explained above.

In Finnish municipal finances, the State supports local government directly through a general, cost-balancing scheme based on calculated variables and also through a mutual municipal compensation arrangement for state contributions based on municipal tax income. The purpose of the compensation arrangement is to enable municipalities to provide similar basic services to all their inhabitants, regardless of the municipality's financial situation.

5. Balanced municipal finances and the indebtedness of municipalities

A municipality's finances are based on the budget adopted by the municipal council. When adopting the budget, the municipal council also decides on a financing plan for the municipality covering the budget year and at least the two following calendar years. While the budget does not require a municipality to balance its income and expenditure for the budget year, municipalities must achieve a balance during the period covered by the financing plan. If the budget shows that expenditure exceeds income (a budget deficit), the municipal council, which is in charge of financial management, must prepare a proposal for balancing the budget.

Finnish municipalities, independently of central government (the State), have the right to fund their operations with debt financing. In addition to the loan amount, the municipality can freely choose the debt instruments and loan provider. In practice, municipalities and federations of municipalities have taken out loans mainly to finance their investments. Rarely have they financed their operating costs by contracting a debt. The amount of outstanding debt of Finnish municipalities and federations of municipalities was EUR 11.7 billion at year-end 2010, i.e. 6.5% of GDP. This relative indebtedness was close to the 1971-2010 average.

Finnish municipalities' right to decide on their own loan-taking has efficiently prevented moral hazard, which would have been a real risk if the level of indebtedness had been regulated by central government or the State. If the matter was the State's or central government's responsibility, this would be an implicit promise that the State or central government would be liable for municipalities' debts as long as they were within the limits set. Moral hazard would follow in a situation where the levels set by central government would in effect become the minimum level of indebtedness. Such a scenario has been prevented in Finland by granting municipalities autonomy in matters of debt.

6. Municipal fund-raising – Municipality Finance Plc and the Municipal Guarantee Board

The main role in the financing of the Finnish municipal sector is played by Municipality Finance Plc, owned by the municipal sector and the Finnish State. Municipality Finance is a public limited company that is authorised to operate as a credit institution and is supervised by the Financial Supervisory Authority. The activities of Municipality Finance are closed linked to those of the Municipal Guarantee Board, a corporation established by law (its members are the municipalities) that guarantees all the fund-raising of Municipality Finance Plc.

In connection with its debt programmes, Municipality Finance issues bonds on international and domestic capital markets and uses the proceeds to grant loans to Finnish municipalities, federations of municipalities, corporations controlled by municipalities and specially appointed public utility institutions responsible for social housing supported by the State. Loans are granted on the basis of competitive tendering, in other words customers from the municipal sector send invitations to tender to several operators (including commercial banks) and then decide on whether to accept a loan.

In recent years (since the financial crisis), Municipality Finance's market share of the municipal sector's new loans has been about 80%, because the financial crisis seriously weakened the competitive position of commercial banks. Municipality Finance's AAA credit rating has guaranteed the availability of sufficiently long-term financing at competitive prices. The funding of the Finnish municipal sector by Municipality Finance has proved its usefulness in a time of crisis. Municipality Finance has never in its entire history suffered losses from the loans granted to its customers.

7. The Association of Finnish Local and Regional Authorities' opinion of the Commission's proposals

The Commission's proposals in the Green Paper are made from a debtor's perspective, and the investor perspective is missing altogether. The proposals include a number of objectives, but there is very little about the methods necessary to meet them. More attention should be paid to the needs, behaviour and operating conditions of other institutions on the financing market, because the debt contracting practices of States affect many parties directly or indirectly.

The Association of Finnish Local and Regional Authorities notes that the Green Paper makes no mention of the position of major public operators at a level lower than central government, which is rather unusual.

The proposed system makes it difficult for investors to distinguish between the credit risk of individual operators closely linked to States and the credit risk of the euro area, and this may substantially hamper these operators' fund-raising on capital markets. The Association therefore considers that nearly all the alternatives presented worsen the position of Municipality Finance, the main provider of financing for the Finnish municipal sector, on the fund-raising market.

In Finland, the municipalities' strong autonomy, which is part of the Nordic model of local government, has guaranteed Municipality Finance's independent position on the fund-raising market. In many other European countries local government is organised in a very different manner and does not enjoy the same kind of autonomy (such as full right of taxation) enabling it to operate independently on the capital markets.

The stability bond system proposed by the Commission would make it difficult to preserve specific local features in the future, and this would affect the operations of issuing institutions relying on such local features on the capital markets.

Under the new system, Municipality Finance would depart from the Nordic model and would, in investors' minds, become more closely identified with European local government, which would raise the company's credit risk in investors' eyes and consequently the price of fund-raising. In this way the proposed arrangements would significantly increase the cost of financing for Finland's local government, although it has managed its finances well.

If stability bonds are introduced, nearly all euro area states will have to cut costs drastically, and this might have a negative effect on global economic growth. Besides, the objectives are contradictory: indebtedness should be reduced but at the same time there should be continued capacity to support problem states.

The proposal states that the mere possibility of using stability bonds could alleviate a state's debt crisis, as Member States paying high interest rates would benefit from the good credit standing of Member States paying low interest rates.

The basic idea of the European Monetary Union has always been that economically strong states are able to influence the budgetary and financing behaviour of euro area countries. This has not been the case, however. Instead, moral hazard has occurred and made investors suspicious of the entire system.

The ongoing discussion on the fate of triple A ratings is bound to affect the way issuing states and investors view stability bonds. Many institutional investors must decide on the structure of their debt investments. In particular in a situation where triple A ratings disappear, even for just a fixed period of time, it is necessary to find investments to replace them. Are "the relatively best investments" good enough for investors? Such a choice might eliminate investors who would no longer be interested in the loans of states with lower credit ratings, even in the form of stability bonds.

According to the proposal, stability bonds will reinforce the impact of the euro area's monetary policy (measures). If this refers to the traditional thinking that long-term interest rates reflect expectations of future short-term rates (= central bank decisions), it

should be pointed out that in recent years this link has weakened in all big bond markets (euro area, USA, Japan), as has the predictability of financial markets.

Budgetary discipline and reliance on the permanence of the present triple A ratings are the only means presented for guaranteeing a good credit rating for stability bonds. However, credit rating agencies are considering lowering the AAA ratings of certain countries. How is it then possible to ensure a good credit rating for stability bonds? In order for stability bonds to gain external and internal acceptance, they must first win the trust of the markets. Only then can these eurobonds – perhaps – be introduced.

The Association of Finnish Local and Regional Authorities has serious reservations and is very sceptical about the possibilities of the stability bond system stabilising the volatile financial markets.

Therefore it would be very risky for Finnish municipalities to participate in a financing system involving stability bonds, particularly if it meant that the municipal sector's credit rating depended in all circumstances on the euro area's credit rating, regardless of how well the sector had managed its affairs in investors' eyes.

ASSOCIATION OF FINNISH LOCAL AND REGIONAL AUTHORITIES

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