

Different financial health measurement systems in different governance settings. A matter of contingency?

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Abstract

Governments are being pressured by citizens and other stakeholders to improve their efficiency and effectiveness while, at the same time, they are seeing reductions in available resources. This is the result of several waves of New Public Management-style reforms which have developed into the New Public Governance view. At the same time, recent global financial stress challenges the financial sustainability of governments, both at national and local levels. Financial health is a necessary condition under which governments must operate. Nevertheless, while the literature concentrates on different models of governance within the public sector, there is a lack of research on financial health measurement system. In light of this problem, we juxtapose the analysis of financial health measurement systems with Considine's four governance models (2001) applied to the Italian local governments context. Through a multiple case study approach of four Italian local governments we combine documental analysis of compulsory financial statement indicators and interviews with internal key users aimed to understand the effective use of financial indicators to determine financial health in practice. The purpose is to analyze the extent to which a local government needs to have a specific set of financial performance indicators attuned to the prevalent governance model used for its services delivery. Our hypothesis is that measuring financial health is a contingent issue, which cannot be assessed regardless the prevailing governance setting model implemented. On a theoretical perspective, this study highlights to what extent each governance model requires specific financial health measures, in order to stress that measuring financial health is a contingent issue, which cannot be assessed regardless the prevailing governance setting implemented. Under a practical point of view, this study identifies the features of different types of financial health measurement systems in various governance models.

Key words: Governance Models, Financial Health, Performance Measurement, Italian Local Governments

1. New Public Governance and Financial Health: The Missing Link

Starting from the 80s, New Public Management (NPM) (C. Hood 1991) has heralded a new era for the public sector, but its rationale has rapidly been criticized for its intra-organizational focus (Huse 2003; Rhodes 1996). As response to the increasingly complex and plural nature of public policy implementation and service delivery, a New Public Governance (NPG) idea has emerged (S. P. Osborne 2009: 7), emphasizing the relationship with the external environment and the inter-organizational (between governments and, especially for the provision of services, between public- and private-sector organizations) relationships, called governance of networks (Kickert 1993; Considine 1999).

At the same time, some scholars (Guthrie et al. 1999; Guthrie et al. 2005) have concentrated their attention on “the technical lifeblood of NPM organisational structures” (Guthrie et al. 1999: 211), accounting techniques, financial management, and different tools that could be implemented to support managerial reform agendas, called New Public Financial Management (NPFM). Special attention has been paid to financial sustainability and the consideration of financial health: no services will be properly delivered if governments have not the appropriate resources.

One key point in the study of financial health assessment is the need to consider the blurring boundaries of public sector organizations and their relationships with other entities which are involved in policy implementation and service delivery. Nonetheless nowadays most public organization, especially local governments (LGs) still have nothing to do with this idea of networking, and appear more as stand-alone organizations. Some scholars, embracing a contingency approach, have identified and characterized different governance models (Considine and Lewis 2003; Considine 2001, 1999).

Even if some studies have already highlighted the connection between financial condition and service delivery (Jones and Walker 2007, Calamar Andersen and Mortesen 2009) there is a gap in the literature concerning the link between financial health assessment and governance model adopted by LGs. This study aims to fill this gap analyzing financial health measurement systems juxtaposing them with Considine’s four governance models seeing which source of information key actors employ in the different governance models in use for service delivery. More precisely, we hypothesise that a standard set of indicators or even a standard source of information, as is provided by the Italian law to detect fiscal distress, could not be effective for all LGs; each kind of governance model requires the consideration of different aspects to monitor, i.e. different type of accounting information to assess financial health, in order to prevent fiscal distress and assure the sustainability of a certain level of services.

In order to achieve our research goal, as in any juxtaposition, we provide a brief overview of the literature concerning financial health in local government (section 2), as well as different governance models (section 3). Afterwards, we spread out a contingency approach to financial health (section 4). After having introduced the Italian context (section 5) a multiple case study is presented (section 6). Findings show that local government needs to avail itself of a specific measurement system consonant with the prevalent

governance model adopted for its services delivery. Discussion and further development of the research is provided in the last section.

2. Financial Health Measurement in Local Governments

A first point that clearly comes out from literature is that the definition of financial health or what is sometimes called, highlighting its negative side, “fiscal distress”, “financial risk”, “fiscal crisis”, or “fiscal strain”, is not unique. Some authors have considered that municipal governments’ financial health is defined or determined, and therefore measured, by socioeconomic forces (Peterson 1976) or, under a more limited approach, by the municipal bond market (Petersen 1974). Downing has demonstrated that situations perceived by urban counties’ public officials “to have the highest validity as indicators of fiscal stress are (1) inability to meet payrolls when due and (2) default on repayment of bonded debt” (Downing 1991: 323). This latter point of view has been predominant for some European authors, who have focused their research onto LGs’ credit ratings and solvency assessment (López 2003; Alijarde and López 2001; Manes Rossi 2009). Financial distress has also been defined considering its dynamic nature as an “incomplete adaptation to changing resources and problems confronting a municipality” (Clark 1977: 55). Others have discriminated short-term, represented by a LG’s ability to meet its payroll and generally make payments in a timely manner, from long-term, where the point of view is more on the trends in a LG’s tax base relative to its expenditures and commitments (Kloha et al. 2005). Therefore, there are several options for measuring financial health, and thus the measures used to assess LGs’ financial health are several (Andersen et Mortesen 2010). These techniques range from basic approaches such as accounting information and financial reporting analysis (e.g. Kleine et al. 2003; Dothan et Thompson 2009) eventually added of qualitative analysis by reviewing audit reports, LGs reporting, or information gathered from discussions or regional workshops (Honadle 2003), to more sophisticated statistical modelling approaches (e.g. Murray and Dollery 2005). An important aspect of these quantitative works is the proxy used in order to discriminate financially unhealthy LGs from the healthy ones. Several variables have been proposed for this purpose such as ratio indicators (Clark 1977; ICMA 2003), the incidence of mergers or amalgamations, the quantity or quality of service delivery and the cost of restoring infrastructure assets to satisfactory condition (Jones and Walker 2007; Zafra-Gómez et al. 2009).

The problem of measuring financial health is tightly intertwined with accounting information availability. Internationally, there has been a growing pressure about the implementation of accrual accounting replacing or adding to the traditional budgetary cash-based or modified accrual accounting (Guthrie et al. 2005). This has been in answer to the call for suitable accounting systems to generate information to feed the need of tools to measure and monitor economic quantities. At the local level, fiscal autonomy has acted as the utmost affecting driver, since the object of control has moved from the “correct use of governmental grants” to the “efficient and effective use of local citizens taxes” (Caperchione and Mussari 2000). However, there are several examples of introduction of accrual accounting without a factual

market-oriented management style which have resulted in low-quality accrual accounting information (Pina et al. 2009).

3. Governance in Local Governments: A Contingency Approach to Financial Health Analysis

The three common ideas about governance are that “governance reflects the growth of social, economic and political interdependencies, it is a matter of public as well private actors; and dividing lines between public and private sectors become blurred” (Kooiman 2001: 72). Under this perspective governance can be considered as “most expansively... social-political governance as an over-arching theory of institutional relationship within society” (S. P. Osborne 2006: 381).

Approaches of governance differ mainly by focusing on a particular form or aspect such as network , multi-level or participatory, or directing themselves at a particular level, such as local, European or global governance (Kooiman 1993, 2001). In the present work, we refer to the Public governance literature (Agranoff 2007, O’Toole 1997, Milward, Provan and Else 1993), distinguishing from Corporate governance (Cornforth 2003) or “good governance”, concerning the promulgation of normative models of social, political and administrative governance by supranational bodies (Leftwich 1993; S.P. Osborne and Kaposvari 1997; Rhodes 1997). Within public governance we consider a particular strand, that is the inner workings of NPM, and particularly the governance of contractual relationship in the delivery of public services. In this feature, Kettl argues that contract state has become responsible for public service delivery systems over which they have little control (Kettl, 1993:207, Kettl, 2000).

A possible description of governance changes in the public sector can be analyzed in light of the Four governance model framework by Considine (2001) which can be considered as a systemization of other conceptualizations developed by authors over time (Hutt and Walcott 1990; Peters 1996; Pierre 1999; English et al. 2005). Each ideal type formulation of the role of public organizations have a central claim. The first three types are procedural governance, corporate governance, and market governance and correspond to phases in the development of public governance in OECD countries, from its emergence to its periods of transformation in the 1990s. The fourth ideal type, network governance, is also identified (Considine 1996) in postbureaucratic organization (Barzeley 1992; D. Osborne and Gaebler 1992), and is evident to some degree in specific policy fields such as city management (Considine and Lewis 2003: 133), but because it functions also without government to provide public services (Denters and Rose, 2005) it is less frequent in unitary and regulatory states, and more present in plural and pluralist (Osborne, 2010). Each of Considine’s four models (procedural, corporate, market, and network) has a distinct source of rationality, form of control, primary virtue, and service delivery focus, as shown in Exhibit 1.

Exhibit 1

The four governance model

Model	Source of rationality	Form of control	Primary virtue	Service delivery focus
Procedural Governance	Law	Rules	Reliability	Universal treatments
Corporate Governance	Management	Plans	Goal-driven	Targets
Market Governance	Competition	Contracts	Cost-driven	Prices
Network Governance	Relationships	Co-production	Flexibility	Brokerage

Source: Considine (2001).

Core attributes of the procedural governance are defined as the following of rules and protocols, high reliance on supervision, and an expectation that tasks and decisions will be well scripted, including by information technology systems used in the organization.

As Hood (1990) points out, in 1980s a new corporate governance model emerged in several countries viewing public organizations as “corporations” run by business managers, with a perception that the procedural government did not fit with a variety of administrative requirements for outsourcing, mainly the need to maintain greater control over public expenditures (Pallot 1992; Pierre and Peters 2000). In addition, procedural governance model was not able to deal with the increasing complexity of government (Lapsley 1988), and the need to target some services for a subset of the citizenry. In corporate governance model planning, budgeting, and reporting have a considerable importance, and a public administration using it concentrates on outputs instead of inputs, focusing on specific groups of citizens who are receiving services. Great emphasis is given to the shift from following rules to achieving results.

In the third model of market governance, contracting out, competitive tenders, and principal-agent separation were employed to respond to financial signals and competitive pressures. In this model competition among potential vendors is encouraged, and it develops contracts that stress quality as well as cost, and place considerable emphasis on meeting citizen needs (Pierre and Peters 2000), to define relationships (English et al. 2005). To that aim there is a need of arrangements with commercial companies, public authorities, and/or nonprofit organization (Goldsmith and Eggers 2004; Pollitt 2003), whilst in other cases public institutions uses its corporate *habitus* for directly running its business activities, or sells relevant assets to an external entities (Broadbent and Guthrie 2008). Even if market dynamism and increased autonomy should help ensuring accountable managerial behavior, it emerges an appropriate set of reporting and feedback relationships build up to that aim (D. Osborne and Gaebler 1992). Moreover in many public entities, developing the requisite management control system runs contrary to their long-standing, input-based, managerial cultures, and therefore is a difficult transition to make (Padovani and Young 2008).

In the fourth model of networks, a government continues to rely on outside agencies, but in a form of stronger strategic partnership, and competition and confidentiality of contracts is supplanted by joint action. This model emerges to increase competition so as to help contain costs, its contracts generally focus on just one service. It is considered inappropriate when some outsourced services need to be coordinated with others. The network governance model is designed to overcome this limitation. Within this form networkers are interested in building trust, and clients, suppliers, and producers are linked together as co-producers (network governance). In place of fixed organizational boundaries and roles, the system promotes a new rationality based on the creation of a shared organizational culture.

Discussing about governance of outsourcing, some authors (F. Farneti et al. 2009) have stressed the idea that a public entity should not be attempting to move from the procedural to the network model for service delivery deliberately. Instead, the Four governance model framework is a contingent tool that helps in considering which model is appropriate to the nature of the service delivery being outsourced. In the same vein, we can assert that in a whole public organization may prevail a model over others in consideration of its specific context. Consequently, we may analyze these four governance models considering two variables.

The first variable is the involvement of external providers in service delivery, while the second is the nature of relationship in use with external jurisdictions. There is a variety of institutional arrangements used to supply public services with external providers, ranging from intergovernmental agreements to franchises. While each has its own operating model where specific relationships occur among three actors, namely consumer, producer, and arranger (Savas 1987), we may argue that not all outsourcings can be really considered as “real” outsourcings, i.e. those settings where the producer differs from the original arranger (the actor who assigns the producer to the consumer or vice versa). It is of evidence in countries, as well as Italy, where new autonomous public organizations have been established at the local government level, in order to foster, using Considine’s terms, a corporate governance model. Corporations, authorities and agencies owned by the same so called “municipal group”, in which the producer of service is a legally distinct jurisdiction, but controlled by the same municipal government (Grossi and Mussari 2008).

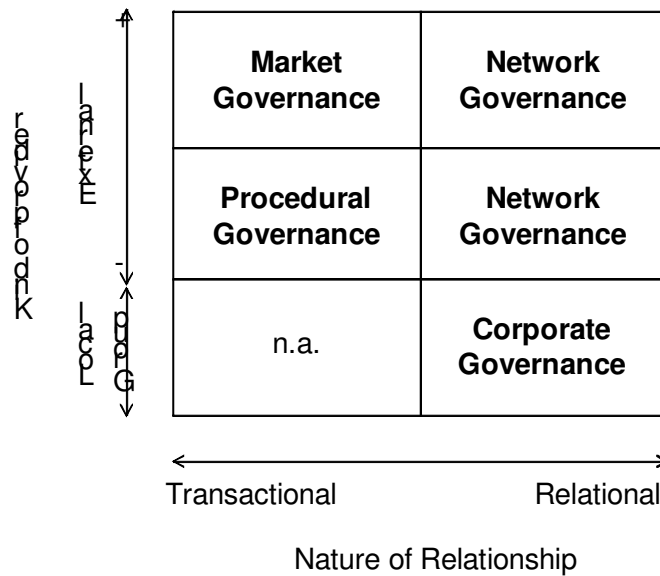
In order to identify key aspects of the relationships which had developed between governments and its vendors, we use a framework developed from the work of MacNeil. (MacNeil 1978, 1985). It conceptualizes possible contractual relationships in terms of two ideal types. The first is called a ‘transactional approach’ to contractual governance. This involves a formal adversarial relationship between brokers and participants characterized by economic exchange, short-termism and zero-sum conflict of interest in which integration and control are achieved through the implementation of contractual specifications and the discipline of (quasi-) market forces. In contrast, a ‘relational approach’ to contractual governance entails long-term social exchange between parties, mutual trust, interpersonal attachment, commitment to specific partners, altruism and co-operative problem solving (Blau 1964; MacNeil 1978; Rousseau and Parks 1993; Darwin 1994). A relational approach is closely associated with partnerships and strategic alliances (Jorde and Teece 1989; Kanter 1989; Lynch 1993) with contractors who avoid adversarial approaches to contract management (Lorenz 1991; Stinchcombe 1986; Teubner 1991) by emphasizing the

“stable bonding mechanisms” (Bolton et al. 1994) which entail long-term collaborative arrangements based on informality, shared problem solving, reciprocity and high trust.

We consider that putting together these two variables brings us to the same four governance models of outsourcing considered above (Exhibit 2).

Exhibit 2

The Four Governance Models for Service Delivery



When the involvement of external providers is low and the relationship mechanism is mainly transactional, we are in presence of a procedural model, with outsourcing mechanisms used incidentally and, in any case, managed under a more traditional perspective. When the involvement of external providers is high and the relationship mechanism is mainly transactional, a market governance model is taking place. When the relationship between government and external supplier is managed under a relational approach, we have a network governance model, no matter of the intensity of external providers involved in services production. As discussed earlier, we also need to consider that external providers are sometimes represented by separate jurisdictions which, nevertheless, are fully or in majority controlled by the government itself (local or municipal group). In this case, the governance of the outsourcing relationship takes place with the typical tools of private corporations, giving raise to the corporate model.

Combining financial health measurement systems with the modified Considine’s Four Governance Model framework presented it gives rise to our contingency approach. The purpose is to understand the extent to which a local government needs to have a specific set of financial performance indicators attuned to the prevalent governance model used for its services delivery. Differently from previous literature which has discussed, financial health measurement systems in local governments as an all-compassing tool, this

stresses the idea that measuring financial health is a contingent issue, which cannot be assessed regardless the prevailing governance setting model implemented.

4. Methodology

A field study approach is adopted in this research. In particular, to investigate our empirical issue we conducted a multiple case-study research, so as to undertake comparison and replication, thus identifying common patterns and extendible results (Eisenhardt 1989; Yin 1984). The aim of our research is not to generalize findings; rather, we believe that some illuminating observations drawn from only a few municipalities can suggest some highly useful conclusions about some important issues in measuring financial health. Indeed, if the information obtained from our research can lead to some concepts that “resonate” with municipality managers, as we believe will be the case, then the conclusions we draw have validity for improved financial health measurement in a wide variety of municipalities.

We focus our attention on Italian municipalities as they are nowadays facing the need to reframe their control systems to ensure financial health which has considerably been worsened in the last years. Secondly, we focused our attention on local services in order to keep under control those characteristics that, according to Brown and Potosky (2003), can affect the control choices, such as measurability and programmability, and consequently governance – as definite in this work – settings. In particular, we selected four Italian municipalities, which we will call Municipality A, Municipality B, Municipality C and Municipality D to ensure anonymity. Since our work follows an exploratory perspective, the selection of the cases has been based only on the willingness to participate to the project by each government, on their availability to give researchers the opportunity to collect any financial information available, and an high level of knowledge of each single context by researchers. A brief summary of the relevant features of the case selected is contained in Exhibit 3, while a brief analysis of each case is presented in the sixth section.

Exhibit 3

Relevant Features of the Four Cases Analyzed

Relevant Features	Municipality A	Municipality B	Municipality C	Municipality D
Population (rounded)	29,000(3)	83,000	53,000	23,900
No. of employees	286	1,210	292	
Current expenditure (million Euros)	30.6	91.7	40.2(1)	14.9
Local taxes and fees	23.9	48.3	29.2(1)	9.9
Loans	43.3	39.8	53.9(2)	6.3
Shares in public or public-private owned corporations and consortiums: number of entities with municipal shares	17	3	5	7
Shares in public or public-private owned corporations and consortiums: entities with a municipal share of over than 50%	2	0	0	1
Current Expenditures of public or public-private owned corporations and consortiums (shares > 50%) <i>pro quota</i> ÷ Municipal Current Expenditures	4.2%	0%	0%	19.5%
Expenditures for Services Provision ÷ Municipal Current Expenses	53%(4)	30%	47.5%(1)	44%
Prevailing Governance Model	Market Governance	Procedural Governance	Market Governance	Market & Corporate Governance

Source: official statistics, official websites and financial reports by municipalities. Financial data are related to fiscal year 2008, except for Municipality C: (1) = 2007, (2) = 2006; (3) = Municipality A is a touristic site with over than 3,5 million room nights concentrated in summer; (4) = estimated costs for the waste collection and disposal services which are provided under a franchise contract (and therefore are not included in the municipal report) are included.

Municipalities were classified in terms of the prevailing governance model on the basis of two parameters. The first parameter is the percentage of current expenditures of municipal owned corporations and consortiums with a share of more than 50 per cent, computed *pro quota*, out of the total current expenditures within the municipal financial report. The higher is the parameter the more is the weight of what we have labeled “local groups” in delivering municipal services. The second parameter is the percentage of current expenditures allocated for service provision, as proxy of the width of municipal reliability on external providers. Comparatively speaking, Municipality A and Municipality C are typical examples of Market Governance, Municipality B has a Procedural Governance in place, while Municipality D’s profile relates to both Market and Corporate Governance. As underline above, we could not catch an example of Network Governance model, as the relational approach with external providers is actually an ideal relationship to work towards, within regulatory states, as well as Italy is (Osborne 2010).

Data were collected through documentary analysis, extensive semi-structured interviews and participant observation. In particular, first we analyzed primary documents such as budgets, financial reports, executive committees' minutes and reports. Our aim was to collect preliminary information about the control mechanisms of financial health. Second, for each municipality we extensively interviewed such key-actors of financial management as city managers, chiefs of financial departments, and auditors, and realized periods of participant observation through the use of field notes for each setting. On the one hand, the data collected through documentary analysis were integrated by data collected through interviews and participant observation; on the other hand, the use of these different methods allowed triangulation of data, thus increasing the reliability of our evidence.

During the interviews we tried to “read between the lines”, i.e. to grasp what was considered most relevant to be measured for keeping financial conditions under control. We wanted to understand which were the performance measures *used* for monitoring – as opposed to other aims such as allocation of resources, improvement of performance and for accountability reasons – within the financial function of a municipality (Bouckaert and Halligan, 2008: 93). For this reason, our semi-structured interview was intended to touch the following aspects: (1) Which is the most important strength of the financial management of your municipality? (2) Which is the most important weakness of the financial management of your municipality? (3) What does give rigidity to any financial maneuvers aimed at improving financial health? (4) What does give flexibility to any financial maneuvers aimed at improving financial health? (5) Which might be the first financial maneuver to be adopted for any need of improvement of financial health? Answering these questions respondents implicitly provide those financial performance measures which are considered critical factors in monitoring financial health. Only after having answered these questions, we asked further comments on the financial aspects concerning outsourced activities and local groups. Answers were then triangulated with the information gathered from documents and participatory observation.

In order to conceptualize the differences in terms of the two dimensions analyzed in this study – i.e. governance models and type of information used to assess financial health – and to test our hypothesis – i.e. each kind of governance model requires the consideration of different types of accounting information to assess financial health – a double-entry matrix has been used to classify the cases. Building upon a framework suggested to compare the different scopes of financial health assessment of local governments internationally (Padovani and Scorsone, 2011), the first dimension of this matrix is the type of accounting information used to assess financial health. This dimension is divided into the options (1) cash accounting or modified accrual, i.e. the traditional budgetary accounting, plus the minimum nonfinancial information required by law, (2) cash accounting or modified accrual plus extended nonfinancial information and (3) cash accounting or modified accrual plus full accrual and nonfinancial information. The second dimension is the type of governance model, which may be (1) procedural governance, (2) market governance, and (3) corporate governance. Our hypothesis is that cases locate in the boxes signed with “x” (Exhibit 4).

Exhibit 4

Type of Information Used to Assess Financial Health related to Governance Model: A Contingency Model

<i>Type of information used</i>	Cash accounting or modified accrual accounting + minimum nonfinancial information (required by law)	Cash accounting or modified accrual accounting + extended nonfinancial information	Cash accounting or modified accrual accounting + nonfinancial information + full accrual accounting
<i>Governance Model</i>			
Procedural Governance	x		
Market Governance	x	x	
Corporate Governance		x	x

5. The Italian Municipalities Context

Our study focuses on the Italian context, a country with a Napoleonic culture characterized as having an initial suspicion towards managerial reforms because of its strong legal-code orientation and its traditional state bureaucracies. Despite late adoption of NPM postulates, studies show that cases of best practices in accounting and management technologies do exist in Italy (Anessi-Pessina et al. 2008).

In the early 1990s, the pressures stemming from the growing public deficit and debt, which reached the dimension of the annual GDP, led to regulatory initiatives derived from French administrative doctrines and NPM ideas. Moreover, the EU reform of structural funds, from the late 1980s, helped introduce new ideas about financial management, planning and evaluation (Bouckaert and Pollitt 2005: 264-69). The reform process, which started with Law 142/90, sought to introduce innovation from many different perspectives: municipality governance system, relations between elected officials and executives, public utilities management, and accounting. Municipalities were given greater financial and organizational autonomy, ensured by allowing municipalities to self-regulate within specific national rules and principles. Within this autonomy, the “managerial culture” became an interest not only to the legislature but, also, to academics (Anselmi 1995; Borgonovi 1996; G. Farneti 1992; Mussari 1994).

One consequence of this organizational autonomy and the parallel impulse towards “liberalization” and “privatization” caused the increasing proliferation of outsourcing (Italian Department of Public Office 2005) and the birth of new autonomous public organizations under the form of agencies, corporations, and authorities owned in majority or in total by local governments. This latter phenomenon has been pervasive. A recent study has discovered that these kinds of organizations has reached approximately 5.800 units and involve about 6 thousands of municipal and provincial governments (Italian Audit Office - Local Governments Bureau 2010)(Italian Audit Office, 2010: 9-10).

In 1995 the reform concerning the accounting system at the local level provided a set of new managerial tools to support managerial control systems, which became mandatory, and a new set of financial and non-financial information was required to measure economy, efficiency, and effectiveness, highlighting the need to connect PMS and managerial control system (G. Farneti et al. 1996; Garlatti and Pezzani 2000; Mussari 2001; Department of Public Office 2007).

Until 1995, budgeting was the only relevant phase of the accounting cycle. As a consequence, municipality accounting was based on budgetary accounting or commitment-based accounting emphasised by a single entry system in bookkeeping. In 1995, local government accounting was reformed by the introduction of accrual accounting concepts to supplement, but not replace, the existing commitment-based accounting system. The introduction of accrual-based reporting in Italian municipalities was phased gradually, starting from 1997 for bigger municipalities and ending in 2003. Municipalities are asked either to implement double-entry bookkeeping or to derive their balance sheet and operating statements from their budgetary accounting statements through a complex system of year-end adjustments.

The current financial accounting system in Italian municipalities is still structured only according to the commitment basis of accounting, and double-entry bookkeeping is not mandatory. Only 15,6 percent of municipal governments have voluntarily introduced a double-entry bookkeeping system, while the majority of them (77,6 percent) derive their accrual accounting balance sheets and operating statements from their budgetary accounting statements with year-end adjustments (6,8 percent of municipalities have not introduced any accrual accounting statements yet). Also, while management control system, which has introduced by law in all public sector organizations, requires some form of cost accounting system, only 27 percent declare to have introduced it (Pavan et al. 2009).

The expected consequences of this reform, in terms of costs and benefits, were widely discussed in the Italian literature (G. Farneti 1997; Borgonovi 1996; Pezzani 1997; Anessi-Pessina and Steccolini 2001), while empirical research on actual implementation and effects of the reform is still rather scarce (Steccolini 2004; Caperchione 2003; Anessi-Pessina and Steccolini 2007; Caccia and Steccolini 2005; Orelli and Visani 2004). However, it seems that these NPM reforms have not been as successfully implemented as in other countries (Bouckaert and Pollitt 2005; Mussari 2005) and evidence provided so far affirms that the quality of accrual-based reporting in Italian municipalities is rather scant and has a marginal role in decision-making and accountability.

One point that has clearly emerged during the last five years is the increasing financial difficulty which has affected several local governments, especially municipalities. Two have been the main symptoms. The first one is related to the recent derivatives scandal in which several municipalities have resorted to derivatives and other financial instruments to obtain extra funds with a concomitant increase in their exposure to financial risk (Trudu 2008; De Dominicis 2009). Second, a recent study by the Italian State General Accounting Department has revealed several symptoms of financial stress, from difficulty to obtain cash from receivables to deficits in current balance (Italian State General Accounting Department, 2009).

In Italy, there are three public institutions which are in charge to audit and therefore provide conceptualizations and analysis for municipal governments financial distress. These are the Ministry of the Interior, the State General Accounting Department within the Ministry of Economic and Finance, and the Audit Office. According to the LGA, article no. 242, the Ministry of the Interior in accordance with the LGs' association states every three years those financial ratios which are then used to identify those municipal governments under a pre-financial distress situation. These performance indicators, whose last release was issued in September 2009 (ministerial decree of 29 September 2009), basically refer to the followings: Annual total deficit / total current revenues; Credits related to annual local revenues / annual local revenues; Debts related to current expenditure / annual current expenditures; Enforcing judgements amount / current expenditures; Personnel expenditures / current revenues; Long term debt / current revenues; Past expenditures not covered by appropriations / current revenues; Treasury overdraft not reimbursed.

Part of these ratios, among others, are also considered by the Audit Office which, with its independent regional branches, is responsible of financial health audit towards municipal councils. The regional branch of Tuscany, which is considered one of the most up-to-date branches, has been the first instance of identification of a system of forty-three financial ratios (Italian Audit Office - Regional Branch of Tuscany 2006), then followed by other regional branches such as Abruzzo, which expanded to several dozens the financial indicators used (Italian Audit Office - Regional Branch of Abruzzo 2007).

Based on inspections upon 116 municipalities, a recent report by the (Italian Ministry of Economic and Finance - State General Accounting Department 2009), has highlighted five critical factors of municipal finance: Current expenditure trend; Current balance; Cash balance; Sort term credits; Amount and truthfulness or total surplus.

Beyond institutional reports, a very few literature is available on the measures used for financial distress purposes. Cimbolini and Moriconi (2009), thoroughly discuss about pathologies in municipal finances but do not provide indicators. Manes Rossi (2009) presents a possible grid of indicators, limiting her analysis to assess solvability. The study of Farneti and Padovani (2003) attempts to portray a system of indicators which can be computed starting from publicly available data and thus useful for large scale analysis aiming at comparing financial health on a national basis. More recently, a multinational corporation has issued a comprehensive financial health rating system based on ten financial indicators that can be computed from public available information (G. Farneti and Padovani 2010).

6. Findings and Discussion

6.1 Municipality A

Municipality A is a local government of a touristic coastal town situated in Northern-east Italy with about 29 thousands inhabitants and a touristic flow of 3,5 million room nights per year, mainly concentrated in summer. This generates a specific development of cultural and touristic services and the need of organizing municipal services so as to satisfy moments of peak population in summer. It has a current budget of 30,6 million Euros of current expenditures covered by 23,9 million Euros of local taxes and fees, and 43,3 Euros of loans. It has 286 employees.

The central weakness which emerges from both documents and interviews is the presence of a *current deficit* of roughly 8 per cent of current expenditures. According to the chief of accounting department, this current deficit seems to be “originated by the increasing of welfare state expenditures over time and which has reached an unsustainable level”. While this deficit has repeatedly been covered by such extraordinary revenues as the ones related to the construction permits (a practice which is allowed by laws), in the last years of economic crisis – which has also affected the building market – this has generated a financial stress which needs a global re-thinking of current equilibriums settings. This pressure has recently been discussed at the executive committee level in view of the next budgeting cycle.

According to all key actors interviewed, most of *current expenditures* are considered *rigid*. “In relative terms, *personnel expenditures* are much higher than other similar municipal governments”, the chief of accounting department said. This is also confirmed by national statistics¹. Social services are usually managed through contracts which are either lump sum basis contracts or on-a-per-unit basis contracts; while the first type is rigid by definition, in the second case Municipality A has *neither power nor capacity to control over units of service, ending into a constant increase of costs*. Other rigid costs are represented by cultural, tourism-related and maintenance of public gardens and street: since Municipality A is a touristic site, these are considered a priority by the mayor and the executive committee. This has received even further evidence in the recent new strategic planning process, where all the services related to tourism were ranked as priorities.

On the other side, according to the chief of accounting department, Municipality A’s strength is the ability to *collect local taxes and fees*, keeping down the amount of *credits from receivables* not collected. Coupled with a good supervision of expenditures, this allows to have a well-balanced *cash management* with the ability to face temporary delays of cash inflows without treasury overdraft use and to preserve a very low delay of payment to suppliers (only 20 days).

Possible budgetary measures to improve the financial health identified by the executive committee member in charge for the municipal budget and discussed during executive committee’s meetings are related

¹ According to the dataset AIDA PA, the National average ratio of personnel expenditure ÷ current revenues is 0.30 while in Municipality A is 0.34.

to the followings. From the *municipal revenues* side: increasing of parking fees or broadening of fee-paying car park areas coupled the possibility of an in-sourcing process which would bring a positive balance; increasing of franchise tax for the use of public areas; improving the organization of local police department so as to raise the amount of money collected from traffic rules sanctions; measures against local tax evasion (property tax, franchise tax for the use of public areas, advertisement tax). As to the expenditures side: freezing of *current grants*; keeping under control the amount of *expenditures related to procurements* so as to have a maximum increase equals to the rate of inflation; partial freezing of *personnel* turn-over; resorting to *project financing* and *assets sales* instead of loans and other long term debts.

In the last few years, Municipality A has experienced a growing process of outsourcing to public and private-public owned corporations and other authorities in the area of waste management, water and sewerage, social services, maintenance, culture and tourism. Most of these providers, which are 17 in total, are external since Municipality A has no control on them, i.e. while most of the service providers are partially owned by Municipality A these shares do not allow to have power on decision-making. One external provider, a multi-utility listed in the stock exchange market, is also partially owned (a share of less than 1 percent) and distributes about 0,4 million Euros of dividend per year out of 24 million Euros of total current revenues. “This is not a big deal, since the amounts of dividend earned is less than 2 per cent of the current budget and the municipality council cannot intervenes in the decision making process of revenue distribution since our share is very minimal; therefore dividends do not receive too much attention neither by the council nor by the management”, the city manager said. According to the chief of accounting department, another external provider with minority shares “a deficit has recently showed, but the amount that [Municipality A] will need to cover will not affect [its] financial health”.

Only two jurisdictions can be considered of being part of the municipal group since they are owned in majority by Municipality A. They both operate in the area of culture and tourism: one has suffered losses in the last two years, while the other one is risking to have losses in the near future because of a new national law. One corporation belonging to the local group has subscribed a derivative contract of 2 million Euros, but without producing losses and with a very low level of risk. Generally speaking, these two entities are not considered influencing in any way the financial health of Municipality A.

6.2 Municipality B

Town B is located within a 4,4 million population metropolitan area of Southern Italy and has about 83 thousands inhabitants and has one of the highest population density rate of Europe: 1.930,71 pop./sqm. Other than an important industrial area, Municipality B has a residential and touristic vocation, and is characterized by the presence of Roman and Greek ruins, and a commercial and touristic port not as well-developed as it could be. There are 1.210 employees, i.e. each employee serves about 69 citizens. Total current expenditures are 91,7 million Euros, local tax and fees are 48,3 million Euros, and loans amount to 39,8 million Euros.

Municipality B shows a structural current deficit. According to the key actors interviewed, the determining element has been identified in *personnel expenses*, which add up to almost 50% of current expenses: actually, this situation has been caused by a long story of social policy to sustain occupation in this geographic area, and this situation has created an high degree of *rigidity of current expenditure*. Nevertheless, as the auditor explained, this point of weakness could turn in the next six/seven years, when many employees will retire, and expenses will be reduced to 40%, releasing a large amount of resources and giving, above all, a growing flexibility to current expenses. Furthermore, as the chief of financial department pointed out, the municipality presents remarkable *difficulties in collecting local taxes* (mainly property and waste tax) ending into a very high amount of receivables not collected. In relation to financial costs, the Municipality has subscribed three *interest rate swap* agreements, in order to reduce the impact of interests paid on annual results. The first one was duly honored. The second was renewed, thus producing the third one, which, due to some illegitimate clauses, originated a lawsuit. In the end of 2010, the Municipality obtained the annulment of the contracts, saving more than 1 million euro in terms of interests to pay. Despite permanent financial tension, “we are able to *contain the amount of interests paid* within the measure of 3%, compared to our current expenses”, the chief of financial department declared.

The financial reporting disclose a positive financial result, even if the amount of *uncollected revenues* is very high and might compromise financial equilibrium, even in the short term.

Another point of weakness, as chief of financial department pointed out during the interview, is the expend of extraordinary revenues related to the construction permits to cover current expenditure: even if in a certain measure this kind of solution is consistent with law requirement, there is a risk that, in the long term, the reduction in these revenues might cause inability to cover some services and might negatively affect the condition of infrastructures, due to poor state of repair. Furthermore, this approach reduces dramatically the opportunities for building the new infrastructures which would be to the direct benefit of citizens, or the potential for services production.

Looking at the model adopted in services organization, over the last two years most services have been outsourced to public and private contractors: nowadays only few (mainly social ones) are produced internally, whereas the main activities (i.e. waste, water, maintenance activities, revenues collection) are outsourced to other entities through a number of contracts and the municipality does not have any power to control them, even in those three cases in which providers are companies partially owned. The change was not profitable as has not brought about any real cost reductions because employees were not shifted: the solution adopted, as the chief of financial department underlines, “neither reduced costs for service delivery nor improve ability to meet citizens’ need”.

Possible financial measure to improve Municipality B’s financial situation identified during the interview by the executive committee member in charge for the municipal budget, require some political change. First of all, a serious *fight against tax evasion*, that include a revision of database related to property. A second remedial measure to be taken is the exploitation of the public area: the Municipality B has a large

market places that could guarantee higher revenues by franchise tax. From the municipal expenses side, progressive reduction of personnel expenses coupled to project financing and assets sales already decided, together with freezing welfare expenditure, could improve financial health.

6.3 Municipality C

Municipality C is located not far from Rome and has some 53 thousands inhabitants. It has 292 employees, i.e. a citizen/employee rate of 181,5. Total current expenditures are 40,2 million Euros, local tax and fees are 29,2 million Euros, and loans amount to 53,9 million Euros.

Municipality C officially declared its financial distress in 2009. According to the Regional Audit Office, the main problem lies in the *unreliability* of its *accounting system*, particularly in relation to revenues expectation, which was totally unrealistic. This caused a large amount of *uncollected revenues* (especially from taxes, sometimes dated back to 1955!) that combined to determine an apparently positive financial result; however, the actual financial result was remarkably different. Nonetheless, the spurious results were used at various times to cover effective expenses (often unpaid). In addition, in order to obtain new resources, in 2004 the municipality issued a guarantee for a *loan* which had been applied for by its totally controlled company while, at the same time, handing over credit to the same company. This transaction, which is a sort of *securitization*, was contrived to get around the rigid rule that the law provides for in this respect. However, the cost of the double financial operation was fully on the municipality. Furthermore, the municipality partially owned another company, involved in the production and delivery of most public services, which had a high level of losses. As auditors underline in their relation to the declaration of distress, even if the percentage in one of the owned corporations was less than 30%, the amount of losses were so high to provoke an hard negative effect on Municipality C's annual result, neither improved the quality or the quantity of services delivered, as the city manager explained. Furthermore, the steps taken (mainly new cash advance facilities) made its financial health still worse, causing it to slide down into financial distress. During the interview, the chief of accounting department clarified that any kind of control was adopted in order to contain or simply verify the management of the owned company.

The situation already described, according with the exams of financial reporting and relations presented by auditors, was repeatedly denounced by the same auditors, chiefs of financial departments and the Regional Audit Office, who asked for devaluation of all uncollected revenues, especially the oldest ones. The unreliability of the accounting system, combined with a unrealistic overestimation of revenues in the budget, were surely the main cause of financial distress. On the other hand, as noticed by the chief of auditors, for long time politicians were not able to choose for a radical change of course: an high level of personnel expenses, a clearly illegal accounting system, an irregular use of long term debts, an indebt use of corporations (partially) owned, asked for strong and deep change, neither vaguely adumbrated. Summarizing, in this case the falsification of accounting date, the inertia by politicians combined with a manifestly unsustainable modality of services' organization caused a so serious distress that auditors

declared : “A vigorous and laborious process to strengthen revenues and dramatically cut expenses could not be delayed anymore and new source have to be found to cover the immense amount of debts still unpaid”.

6.3 Municipality D

With its 23,900 inhabitants, the Municipality D is situated in Northern Italy within a urban area of about 200,000 pop. It has a current budget of 14.9 million Euros covered by 9.9 million Euros of local taxes and fees, and 6.3 Euros of loans. 44 per cent of its current expenditures is allocated to the provision of services from external providers, while it has one wholly owned corporation which runs two municipal pharmacies and the municipal kindergarten (with its ancillary services, amongst which restoration) whose current expenditures are about one fifth of the current expenditures incurred in the municipal budget.

From council and executives meetings reports, public documents available online, and key-actor interviews, it clearly emerges that the financial health is very high due to its very low *personnel expenses/current expenditures* ratio – with its 27 per cent the municipality locates amongst the best 35 per cent of municipalities of the same dimensions in Italy – and *current surplus* – with its 7 per cent out of current expenditures it is above the 15 percentile. Furthermore, the separate *profit and loss of the wholly owned enterprise for municipal pharmacies and kindergarten*, shows profits over years, “demonstrating that there is a fruitful cross-subsidization from the profitable pharmacies to the at-loss kindergarten service” (reported the city manager).

This is contrasted by a consistent *loss* presented by the *profit and loss report* under the accrual accounting system. Since this is the sole financial performance indicator presenting a poor performance, this has been the indicator used by the minority at the city council meetings to complaint about financial mismanagement of the political majority in power. Since the accrual accounting reports (statement of financial positions and statement of financial performance) have been produced by translating financial information from the traditional budgetary commitment-based system instead of by compiling accrual accounting, this has recently led the management to start refining the methodology to get this information. But the city manager believes that this is “just window dressing, since what is important is to have been capable to keep under control tax evasion raising annual *municipal tax revenues* of about 3 millions in the last legislature”.

One evidence of good financial health situation is the ability to prepare and pass the annual budget by the end of the previous year. While this may seem irrelevant for most international readers, it must be stressed that in Italy the majority of local governments procrastinate the annual budget issue well after the beginning of the year. This is usually due to difficulties in providing for a balance between revenues and expenditures due to fiscal stress which may be caused by several factors, amongst which decrease in grants from the central governments and the Internal stability pact national law.

This latter aspect represents “the only difficulty” for the city manager and the chief of accounting department. Even if Municipality D is able to approve the annual budget in due time, *collects local taxes and fees* keeping down the amount of *credits from receivables* not collected, and have a well-balanced *cash management*, the contingencies of the *Internal stability pact* rules impede to have a good new infrastructure management. According to the executive committee’s member the Internal stability pacts causes a “day-by-day management of infrastructure building process” since it provides for specific thresholds for payment of capital expenses during the year.

The effect of the Internal stability pact rules and the reduction of central government grants has pushed the municipality to start structuring a *cost accounting information* systems to take under control the efficiency of different services provided. “We need to stress the idea that cost management is a priority if the financial health is to be kept under control for the next future, so we need to provide an extensive management accounting information systems to all departments and a *benchmarking* exercises of *costs and output of a few selected services* with our neighborhood”, the city manager affirmed during an interview.

While Municipality D has a somewhat average degree of outsourcing, interviews and document analysis seem to demonstrate that there is not much attention on outsourced services in terms of their financial impact. This with the exception of the only one jurisdiction which is wholly owned by Municipality D. As specified earlier, it runs two pharmacies and the municipal kindergarten and it operates at a profit. “We do not do performance measurement and do not have a management control system, because it is not necessary to manage our business; what is important is that we do not produce losses” the city manager said. Furthermore, according to the chief of accounting office under a financial point of view “not to have a loss is a key success factor if we want to maintain fiscal benefits allowed by law”.

7. Conclusion and Further Developments

Previous literature has discussed financial health measurement systems in local governments as an all-compassing tool. Instead, the analysis of the three cases above stresses the idea that measuring financial health is a contingent issue, which cannot be assessed regardless the prevailing governance setting model implemented. Juxtaposing the financial health measurement systems which came out from the document analysis and interviews, with the modified Considine’s Four Governance Model framework presented, has given rise to our contingency approach. As a matter of fact, we argue that each governance model requires specific financial health measures, i.e. no single set of financial indicators is sufficiently valid to assess financial health for every organizational model of service delivery in place.

Comparatively speaking the analysis shows that only for Municipality D there is a tendency to use more nonfinancial measures and accrual accounting information, while for municipalities A, B, and C the assessment of financial health is considered to be limited to the measurement of key indicators from the traditional commitment-based accounting system (see Exhibit 5).

Exhibit 5

Categorization of the Cases Analyzed

<i>Type of information used</i>	Cash accounting or modified accrual accounting + minimum nonfinancial information (required by law)	Cash accounting or modified accrual accounting + extended nonfinancial information	Cash accounting or modified accrual accounting + nonfinancial information + full accrual accounting
<i>Governance Model</i>			
Procedural Governance	Municipality B		
Market Governance	Municipalities A & C		
Corporate Governance			Municipality D

Municipality D seems to be inclined to a more nonfinancial and accrual accounting information to assess its financial health basically for two reasons. On one hand, the loss figure is the only negative indicator which is used by minorities within the city council to complaint about majority’s mismanagement. According to law, even Municipalities A, B, and C provide for the profit and loss information, but it has never been used when reporting the financial health situation or cited during interviews. On the other hand, the accrual accounting information is used to assess the financial health of the wholly owned entity for pharmacies and kindergarten, which supports our idea of being – comparatively speaking – within a more corporate governance approach.

Municipality B seems to limit its attention on traditional commitment based accounting as they tried to develop a performance measurement system, but limiting this effort to build some indicators employing financial data. Even if Municipality A and Municipality C presents slightly differences in their financial situations, both of them do not use any kind of extensive nonfinancial measurement to assess their financial situation, and both of them have a prevalent model of market governance.

We may conclude that the hypothesis of different financial performance measurements for different governance models is only partially proved. Actually only in one case there is the tendency to be more inclined to a more “non-traditional” performance measurement of financial health. But evidence shows that this is due not only because of the presence of a corporate governance model. The good performance of all the traditional financial indicators led the majority to look at the only one indicators performing in a negative way. Therefore further developments would be needed to assess which are the concurrent factors which affect the extension of financial performance measures from the traditional commitment-based accounting to nonfinancial and accrual accounting information.

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