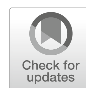
Monitoring Local Government Financial Sustainability: A Dutch-English Comparison



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Abstract Monitoring of local public finance is an essential part of fiscal regulation, although national approaches interact with political and economic environments. England and the Netherlands provide telling similarities and differences in their local government contexts and approaches to such indicators. After a brief discussion of theoretical issues, this chapter compares the use of financial sustainability indicators (FSIs) in Dutch and English local government. It reviews the history, current use, bodies involved, the indicators themselves, and approaches to monitoring. In England, a long history of central oversight of local government, focused upon performance, came to an end in 2010. Ever since, there has been no systematic FSI monitoring, as central government has not implemented its own model, the NAO has not been legitimated, and the local government sector itself has only recently started focusing on financial resilience. The Netherlands has traditionally placed its focus with respect to FSI monitoring on fiscal rules, which are monitored at the regional level of the provinces. More than in England, the Dutch local government association has supported the development of FSIs whilst local government reporting on FSIs is mandatory. Finally, we show how different fiscal rules and governmental characteristics have resulted in contrasting developments of indicators and monitoring.

1 Introduction

Monitoring of local government (LG) finances is an essential part of regulation, as without monitoring, compliance with fiscal rules cannot be verified and regulation will fail. The idea of monitoring has been attempted with considerable variation and effectiveness since the 1990s but a widely agreed and applicable approach remains

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R. Geissler et al. (eds.), *Local Public Finance*,
https://doi.org/10.1007/978-3-030-67466-3_8

elusive. Scholars suggest that effective approaches need to interact with political and fiscal environments, which vary widely between jurisdictions (Jacob and Hendrick 2012). Therefore, this chapter assesses how two European countries, England and the Netherlands, monitor LG finances via financial sustainability indicators (FSIs). Both countries traditionally emphasise the avoidance of budget deficits as the most critical aspect of LG financial sustainability but have taken different monitoring approaches in practice. After reviewing and comparing each country's approach, we assess the extent to which those different approaches reflect country-specific conditions including perceptions of risk.

Most developed states practice monitoring of LG financial sustainability (García-Sánchez et al. 2012). Systems have been in development since at least the 1990s, led by scholars and practitioners in the USA, stimulated by high profile LG financial crises in the 1970s, such as New York's fiscal crisis in 1975 (Listokin and Burchell 1981). The primary purpose is to detect leading indicators of fiscal stress, thereby enabling remedial action in order to avert a crisis. However, debate on critical issues, including what constitutes fiscal stress and which measures are most effective to identify it, in particular, early enough to enable corrective steps, has been ongoing throughout. Most approaches focus on indicators of solvency (variously defined). Methods have been developed encompassing both short-term (e.g., liquidity measures such as the quick ratio and operating measures such as fund balances and deficits) and long-term indicators (e.g. long-term liability ratios including liabilities per capita). Many US states implement those indicators, for example, in the popular Financial Condition Index (Wang et al. 2007). The latter sometimes includes assessing long-term changes in population to reflect changes in the local tax base (Kloha et al. 2005; García-Sánchez et al. 2012; Jacob and Hendrick 2012) and reliance upon external grants and so exposure to changes in higher-level government policy (Cohen et al. 2017; Rivenbark and Roenigk 2011; Trussel and Patrick 2009).

In addition to which particular indicators to use, debate has focused on whether they may be combined into one single overall indicator (Clarke 2015) and whether reference points should be absolute (an acceptable specific level of solvency) or relative (to either a reference group and/or over time) (García-Sánchez et al. 2012). Many empirical approaches, both in the USA and Europe, apply regression analysis to identify whether a suggested combination of indicators is effective in practice. However, more recently some scholars identified that some well-established monitoring regimes demonstrated no correlation with identifying fiscally distressed LGs (Spreen and Cheek 2016) and assessed such approaches as not meeting suitable tests of reliability and validity (Clarke 2015). Underpinning many of these debates is the issue of whether solvency, however, defined, is in and of itself an adequate concept to define financial sustainability. Obviously, there is a tension between solvency and service levels with research suggesting a positive correlation between high solvency and low service levels and vice versa (Zafra-Gómez et al. 2009).

Recently experts argued that use of indicators alone is misplaced, as financial sustainability, viewed from an open systems perspective, results from a dynamic process, where internal decisions by LGs interact with the external environment. Decisions being taken in the present time can affect future sustainability, requiring

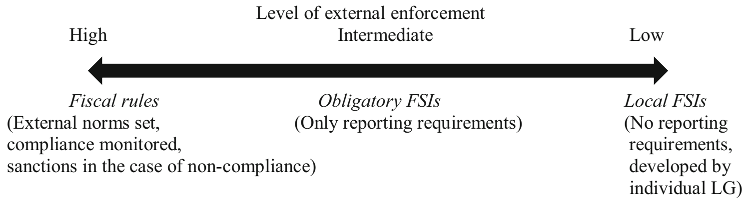

Fig. 1 Financial sustainability indicators (FSIs) and extent of external enforcement

an additional focus on decision-making processes (Jacob and Hendrick 2012). From this perspective, there is no single best strategy for assessing LG financial sustainability, but approaches need to be analysed against the background of the political and fiscal environment of any jurisdiction (Jacob and Hendrick 2012). In addition to this complexity, countries differ significantly in constitutional, legal and fiscal structures, which all affect LG accountability, LG funding and LG service demands. There is a great variety of LGs and circumstances. However, comparing approaches taken in different states, understanding how they reflect country-specific risks and assessing their efficacy enables both scholars and practitioners to better judge which approaches best suit their circumstances and those of each LG being monitored.

The purpose of this chapter is to review the current use of financial sustainability indicators (FSIs) for LGs in two contrasting countries—England and the Netherlands—and assess how far they reflect country-specific risks. In both countries, local government is responsible for roughly one-quarter of public spending and offers telling institutional contrasts to enable a comparison: England is a majoritarian system having no formal constitutional protection for local government, whereas the Netherlands is a decentralised unitary state where local government is embedded in a consensual-corporatist system (De Widt and Laffin 2018). Some of the FSIs we analyse are in use as fiscal rules—with authorities' performance against these rules expected to indicate critical information on their financial sustainability. However, not all FSIs applied to analyse LG finances are fiscal rules that are enforced by regulators. LGs may be legally obliged to report their performance on certain FSIs, without any norms set externally, whilst LGs themselves may also develop FSIs (e.g., to incorporate risk factors that are important but unique to the local authority). Hence, as illustrated in Fig. 1, FSIs can be analysed on a continuum, showing the extent to which external bodies monitor or enforce their use, and whether FSIs are linked to externally set norms.

The remainder of this chapter details the use of FSIs in England and the Netherlands. The chapter looks at the organisations involved in the monitoring of LG finances and the FSIs in use, including in some specific cases of municipal financial distress. Subsequently, we compare and contrast these approaches. We consider how far differences reflect the political and fiscal environments of each country and country-specific perceptions of risk. Finally, we summarise our conclusions and identify areas for further research.

2 England

2.1 Constitutional Arrangements

In England, LGs have limited scope to raise their own revenues and highly depend upon transfers from central government. These transfers have reduced considerably since 2010 leading to severe financial pressures on English LGs and raising concerns about their financial sustainability (NAO 2018). English LGs are institutionally heterogeneous including 'single-tier' LGs in some areas, 'two-tier' counties and district councils in others. Some regions also have directly elected mayors. Whilst LGs are able to incur budget deficits, they are unable to borrow to fund current expenditure. For any individual LG, the budgeted expenditure for any one year cannot exceed the total amount it intends to raise from taxation, central government transfers, other revenue and the revenue reserves it has at the beginning of the year. The chief financial officer in each LG must identify the required corrective actions by councillors if an unbalanced budget situation occurs. Following the scaling back and subsequent abolition of the Audit Commission, after 2010, systematic central publicly available monitoring of LG finances ceased. In the absence of a systematic and transparent national approach, the UK's public finance accountancy organisation (the Chartered Institute of Public Finance & Accountancy, or CIPFA) recently developed schemes to provide such an approach using publicly available information provided by LGs.

2.2 History on Use of FSIs

From 2002 onwards, the Audit Commission developed a system of Comprehensive Performance Assessment (CPA). It reported on how well a council was performing against a broad set of indicators including service, corporate as well as financial performance. Councils were placed in criteria-based categories both for current and expected future performance. 'League tables' were published annually to compare LGs' performances.

The financial standing of an LG formed a major part of this approach and consisted of several elements based upon an auditor's opinion and drawing upon their annual audit work. These elements included setting a balanced budget, setting a capital programme, financial monitoring and reporting, meeting financial targets and financial reserves. After 2008, a system of Comprehensive Area Assessments replaced the CPA, designed to include other public sector providers in an assessment of an LG area continuing to include financial assessments. However, a new government announced the abolition of the Audit Commission in 2010, and immediately the assessment approach was abandoned. This ended any comprehensive central and public monitoring of the finances of LGs.

2.3 Current State of the Use of FSIs

LGs annually submit a range of (unaudited) financial data to the Ministry of Housing, Communities and Local Government (MHCLG), which is publicly available. It does not provide FSIs, as this requires the processing of data to provide ratios, comparisons and trends. Such processing is undertaken by MHCLG and CIPFA on an ongoing basis, by the National Audit Office (NAO) as part of occasional reports on LG finances and, occasionally, by an LG's auditor.

MHCLG

The Ministry uses information from a range of sources including budget outturn data from each LG submitted annually (publicly available) to monitor LG financial health. However, there is no published scheme of FSIs and neither does the Ministry publish information on LG financial health. The NAO criticised this approach and described it in 2014 as 'limited' concluding the Ministry 'does not know enough about whether local authorities are close to failing financially' (NAO 2014, pp. 33–34). A further review by the NAO in 2018 stated:

> The Department... has developed a local authority sustainability tool, which models the share of 'inflexible spend' (on social care and debt servicing) by each authority against the scale of its reserves. Authorities with higher shares of inflexible spend and lower levels of reserves are less financially resilient. It then investigates authorities in more detail. (NAO 2018)

However, neither the detailed methodology nor the resulting information is publicly available.

Some criticism of the approach has continued. In 2019, a parliamentary LG committee concluded that the government needs a more regularised and consistent approach to monitor LG financial sustainability. However, in its response, the Ministry argued that the resilience index recently provided by CIPFA (below) was sufficient.

National Audit Office (NAO)

With the exception of work undertaken as part of compiling periodic audit reports on the LG sector as a whole, the UK's NAO has no function in compiling or monitoring local government FSIs. However, in its 2018 periodic report on the financial sustainability of local authorities, it highlighted two financial measures: overspending (i.e. in-year variances between planned services, budgets and outturns, requiring correction via financing from reserves, savings in non-service budgets or extra income) and trends in and size of total reserves. The report also showed how LGs with social care responsibilities (which are increasing long term due to demographic changes) had increased proportionate spending in their hard-to-reduce social care budgets resulting in reducing future flexibility (arguably itself an FSI). The NAO concluded, 'These trends are not financially sustainable over the medium term' (NAO 2018, p. 8).

In addition to those measures, the NAO reviewed 'service sustainability' showing how continuous reductions in spending on services actually reduced service levels

(albeit finding that the impact on service users was uncertain); thus, effectively using a fourth FSI as suggested by the more broadly based models of financial sustainability (NAO 2018).

Auditors

In accordance with the UK's Code of Audit Practice 2015, auditors must satisfy that the audited body '. . .has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources'. NAO guidance identifies 'sustainable resource deployment' as an area that the auditor may wish to consider as part of their audit coverage and 'financial sustainability pressures' as a key risk. There is no requirement for auditors to use any specific FSIs as part of their work. However, in 2019 the government commissioned an independent review of English local authority financial reporting and external auditing (the Redmond Review). It is widely expected to include consideration of how auditors can be more effective in highlighting risks of financial sustainability. This report followed increasing concern about English LGs' financial sustainability and the limited role of auditors in identifying sustainability concerns.

CIPFA's Measurement of Resilience

From 2019, responding to concerns about financial resilience in the local government sector, CIPFA published a Financial Resilience Index. It consists of a set of nine primary (and seven secondary) 'indicators of financial stress', in addition to the external auditor's Value for Money assessment and a Children's Social Care Judgement (provided by the social care inspectorate) for each LG using publicly available information (the annual returns each LG submits to the MHCLG).[1] There is no single, overall, indicator, but each indicator is placed on a risk chart showing the level of risk that this indicator suggests. Each LG is compared to similar LGs in a comparator group analysis. The details on how the risk assessments are determined are not publicly available. Table 1 lists the primary indicators.

In launching the indicators in December 2019, CIPFA found that the majority of councils were not showing signs of stress but about 10% showed 'some signs of potential risk to their financial stability' (Public Finance 2019). However, the index received a mixed reception from LGs. They were concerned it could be misinterpreted, that it was too crude and looking back might overrate an LGs financial health as it does not take into account future financial plans (LGC 2019). These views reinforced concerns expressed by the English Local Government Association (LGA) that a handful of indicators could not adequately summarise and forecast the financial health of large and complex organisations such as local authorities (LGA 2018). Table 2 summarises the current use of explicit FSIs by bodies at a national level.

[1]The Financial Resilience Index is freely accessible on CIPFA's website: https://www.cipfa.org/services/financial-resilience-index/financial-resilience.

Table 1 Indicators from CIPFA financial resilience index

CIPFA primary indicator	Definition
Reserves sustainability measure	Ratio between the current level of reserves and the average change in reserves in each of the past 3 years
Level of reserves	Ratio of the current level of reserves (total useable) to net revenue expenditure
Change in reserves	Average percentage change in reserves over the past 3 years
Interest payable/net revenue expenditure	Ratio of interest payable and net revenue expenditure
Gross external debt	Gross external debt amount
Social care	Ratio of total spending on adult and children's social care to net revenue expenditure
Fees and charges to service expenditure ratio	Proportion of fees and charges to net revenue expenditure
Council tax requirement to net revenue expenditure	Ratio of council tax as proportion of net expenditure
Growth above baseline	Difference between the baseline funding level and retained rates income, over the baseline funding level

Source: CIPFA (2019)

Table 2 Local government FSIs in use at the national level, England

Body	FSIs used	Notes
MHCLG	• Inflexible spend (debt servicing + social care)/reserves	This is the only indicator officially acknowledged by central government; there are likely to be others
NAO	Overspending (i.e. in-year variances between planned service budgets and outturns) + trends in and size of total reserves + increasing inflexible spend (social care) + service level	Used in periodic reviews of sector finances
CIPFA	• Reserve ratios (level; changes; sustainability calculation) • Interest ratio + gross debt • Social care ratio • Income ratios	Published since 2019 each year on a comparative basis

Source: Own composition

2.4 *Case Study: Northamptonshire County Council*

English law requires the chief financial officer of a local authority to issue a Section 114 Notice if he/she anticipates an unbalanced budget. Since 2000, there has only been one Section 114 Notice issued in an English LG: Northamptonshire County Council (NCC) in February 2018. In January 2018, MHCLG had already decided to intervene in the financial affairs of NCC through the appointment of a team to inspect the council. Legislation enabled Ministers to enforce such an inspection if they felt that the council was failing in its duty to provide 'best

value' in its services. Subsequently in 2019, MHCLG appointed commissioners to run the council, a situation still in effect in 2020.

At the beginning of 2018, the Council reached a point where it was unable to set a credible balanced budget for the following year. This followed 3 years of financial mismanagement in which NCC, continually failing to reduce expenditure to match revenues, only managed to balance its budget by the use of one-off funds including the use of capital receipts thereby flouting the fiscal rules. Amongst the reasons for this situation were poor financial planning and control resulting from a complex, devolved, organisational structure and a culture lacking in accountability (Caller 2018).

Table 3 shows the CIPFA financial resilience index data for NCC in the 2 years preceding the crisis (2015/16 and 2016/17). This data was only published subsequently in 2019. Two measures were not applicable as they relied on 3-year averages, whereas the index only reverted to 2015/2016. The table suggests that CIPFA produces its risk-level assessment for each LG on a comparative basis, using county councils as a comparator group for NCC. Two indicators, 'level of reserves' and 'interest payable/net revenue expenditure', clearly indicate a high risk (in fact, indicating the lowest reserves and highest interest payable compared to all county councils in both years). Reserves had fallen significantly from 7.09% of net revenue expenditure to 4.68% between 2015/2016 and 2016/2017, suggesting that the 'change in reserves' indicator, if assessed, would also indicate high risk. The 'social care' ratio (indicating inflexible spend) also deteriorated, suggesting a higher-risk assessment. 'Gross external debt' continued to increase over 2 years, contrary to the trend amongst all county councils. However, other indicators do not appear to suggest high or increasing risk.

CIPFA's index does not include overspending (outturn compared to budget), which is used by the NAO in its occasional reports and widely used in the international literature. However, NCC managed to disguise its overspending on services by virements from one-off funds including the use of capital receipts. This happened even though social care spending consistently exceeded planned budgets and would otherwise have led to an overspend overall (Caller 2018).

The Council received adverse audit value for money judgements for 2015/2016 and 2016/2017, which is unusual in English LGs and should have sounded alarm bells, whilst a 'peer review' carried out by the LGA of NCC's finances in September 2017 was highly critical of the situation. Again, no action was taken (LGA 2017).

3 The Netherlands

3.1 Constitutional Arrangements

Local government in the Netherlands exists within a 'small consensual–corporatist state, where decision-making is about "eternal" deliberation, consultation and compromising' (Kickert 2012, p. 300). Policymaking in the Dutch

Table 3 CIPFA financial resilience index applied to Northamptonshire County Council

CIPFA primary indicator	NCC risk level 2016/2017	NCC score 2016/2017	Minimum comparator group county councils 2016/2017	Maximum comparator group county councils 2016/2017	NCC risk level NCC score 2015/2016	NCC score 2015/2016	Minimum comparator group county councils 2015/2016	Maximum comparator group county councils 2015/2016
Reserves sustainability measure	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Level of reserves	High	4.68%	4.68%	53.89%	High	7.09%	7.09%	53.41%
Change in reserves	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Interest payable/ net revenue expenditure	High	10.93%	1.03%	10.93%	High	8.04%	1.6%	8.04%
Gross external debt	Medium-High	£714,013k	£158,023k	£1,210,502k	Medium-high	£647,725k	£222,761k	£1,227,580k
Social care	Medium-high	69.3%	57.27%	70.86%	Medium	64.71%	54.27%	69.23%
Fees and charges to service expenditure ratio	Medium-low	7.75%	5.12%	15.38%	Medium-low	7.71%	4.82%	10.9%
Council tax requirement to net revenue expenditure	Medium	58.88%	53.25%	75.82%	Medium-high	53.56%	51.28%	71.7%
Growth above baseline	Medium	3.00%	-1%	5%	Medium-High	2.00%	-2.00%	3.00%

Source: Own composition, based on the CIPFA financial resilience index database (https://www.cipfa.org/services/financial-resilience-index/financial-resilience)

intergovernmental system emphasises equality in public service provision (Goedhart 1989), which is reflected in a sophisticated local government funding system that is characterised by a high degree of redistribution. The local institutional landscape is highly homogenous in the Netherlands, with all 355 Dutch LGs having the similar legal position of municipality (*gemeente*) and demonstrating a high degree of homogeneity in their duties and tasks. In the Dutch system, the provincial level carries the main responsibility for monitoring LG finances. The 12 Dutch provinces conduct local financial supervision on behalf of the Ministry of the Interior and Kingdom Relations (hereafter referred to as the 'Interior Ministry') but do enjoy a high level of autonomy in conducting their supervision.

In recent years, municipal finances have received growing attention. The 2008 financial crisis significantly impacted Dutch local finances, especially by putting real-estate investments at risk in which many Dutch municipalities had become extraordinary active since the 1990s (Ten Have 2010). In addition, three major social welfare tasks were decentralised to the municipal level in 2015. As a post-2008 austerity measure, central government reduced the original budget related to these tasks of EUR 15.6 billion by EUR 6 billion. There has been increasing reporting that these new tasks increased financial pressures at the local level (AEF 2017). This context has stimulated the development and increased application of FSIs in the Netherlands in recent years.

3.2 History on Use of FSIs

Traditionally, the main regulation in the Dutch system to prevent municipal financial risk has been the balanced budget rule. Dutch LGs are required to set a materially balanced budget, which indicates that structural income covers structural costs, whereby the term 'structural' refers to a period of 3 years. Therefore, an LG is allowed to show a budget deficit in the current or next budgetary year but should be able to present a balanced budget in its 3-year estimates. At least, in theory, this implies a municipality is able to set a continuously unbalanced budget without getting into trouble with the provincial regulator, as long as it can present a balanced budget in its 3-year forecasts (De Widt 2017).

Provincial regulators formally review two additional indicators when deciding upon a municipality's supervision status. These additional indicators were introduced in 2000 as part of a new law on the financing of subnational governments, called *Wet Fido*. The new law tightened the relatively liberal Dutch subnational treasury framework, which had shown shortcomings following the secret commercial banking activities by the province of South Holland in the 1990s leading to a loss of more than EUR 20 million. To mitigate risks arising from holding short-term liquidity, Fido introduced a cash limit (*kasgeldlimiet*), which determines that short-term debt may not exceed 8.5% of the total municipal exploitation costs. Fido also introduced an interest risk norm (*renterisiconorm*), which prohibits LGs from refinancing debt exceeding 20% of their total annual budget. The interest risk

norm aims at reducing risks that may emerge by having to refinance large sums of long-term debt in any particular year. By doing so, Dutch LGs pay attention to a proper spread of the maturity of their debt portfolio in time (Zanten-Lagendaal and Wijnands 2001).

The monitoring focus of the provinces and especially the strong focus by the provinces on the materially balanced budget when deciding on the supervision status of a municipality have drawn significant criticism (e.g. Rfv 2017). It has also incentivised the development of additional FSIs in recent years.

3.3 *Current State of Use of FSIs*

Role of the Interior Ministry and Provincial Supervisors

As the supervision of municipalities is a responsibility of the provinces, the main role of the Interior Ministry, with regard to local finances, is to ensure that the legal framework in which municipalities operate contributes to the financial sustainability of the intergovernmental financial system as a whole. There is debate as to which specific tasks the Ministry requires in order to fulfil its ‘system responsibility’. Nonetheless, the department currently exercises the following roles in relation to municipal finances.

The Ministry interacts directly with municipalities following its responsibility for the Section 12 support system, which is a temporary additional annual funding allocation municipalities can apply for if they face financial distress. In order to decide whether a municipality is entitled to a Section 12 bailout, inspectors from the Interior Ministry will scrutinise a municipality’s income and expenditure levels against a set of comparator municipalities. In addition, it will investigate whether the municipality is disadvantaged in terms of having a lower than average income or higher than average expenditure on non-discretionary budget posts. Only if the municipal deficit exceeds two per cent of what the municipality receives from the Dutch Municipal Fund can it be considered for Section 12 emergency support. An income threshold is also in place demanding that the local property tax is set at a rate at least 20% above the national average and fees for sewage systems and refuse collection are cost-covering (BZK 2017).

Together with the provincial supervisors, inspectors from the Interior Ministry will offer municipalities the opportunity of a budget scan. By providing an in-depth analysis of a municipality’s finances by comparing it to a set of comparator LGs, the scan largely uses the same methodology as applied by Section 12 inspectors. The report containing the scan’s results is then sent to the municipality, and, unless the municipality objects, it will be published. The report often provides recommendations for the municipality as to how it could strengthen its financial position. Although a municipality cannot be obliged to implement the report’s recommendations, the municipal council is required to provide a written response on the budget scan’s results. The Interior Ministry is able to subsequently monitor the extent to which the municipality implements its recommendations. However, it is only once a

municipality receives Section 12 support that it must comply with directives from intergovernmental regulators.

In recent years, the Interior Ministry also tried to bring more uniformity in the supervisory approach. Whilst there has been some improvement in this regard (e.g. BZK 2008; Joint Provinces 2020), provincial monitoring continues to be characterised by differences. The report on the results of provincial supervision, which the Interior Minister sends to the Dutch Lower House annually, reflects this finding. The report builds on provincial reports and shows significant differences in the level of detail of provincial financial supervision (e.g. BZK 2016). The quality of provincial financial supervision has faced criticism for lacking critical mass (in terms of both staff numbers and staff expertise), whilst an independent review showed that provinces often demonstrate shortcomings in preventing municipalities from having to apply for Section 12 support (Rfv 2017). The provincial approach may relate to the fact that provinces do not bear any financial consequences if municipal finances derail, as it is the collective of municipalities paying for Section 12 bailouts, through the Dutch Municipal Fund. Hence, several proposals for alternative supervisory models have been made, including setting up a single national body to regulate municipal finances (Van der Lei 2019).

In cooperation with the Finance Ministry, the Interior Ministry is also responsible for maintaining the institutional mechanisms and distribution criteria used for the allocation of general grants, which constitute the main revenue source for most Dutch LGs. As part of this responsibility, the Interior Ministry carries out regular reviews of grant features that may cause municipal financial stress. In addition, the Interior Ministry uses observations made with Section 12 municipalities to refine the distribution system. This partly explains the substantial reduction in Section 12 LGs over the past decades. For instance, in the 1950s, the majority of Dutch LGs received Section 12 support, but since 2000, the number has varied between two and five LGs annually (Financial Relations Council 1996).[2]

The Interior Ministry also commissioned reviews in relation to the decentralisation of welfare duties and tasks mentioned previously. This included a study on the causes of municipal deficits in youth care spending, which resulted in significant additional funding (e.g. EUR 420 million for 2019 alone).[3] Since the reporting year 2016, the Interior Ministry has also annually employed a consultancy organisation to analyse financial trends emerging from municipal accounts. This analysis concentrates on social expenditure, including how these expenditures impact on the timeliness of the submission of municipal financial statements. Finally, the Interior Ministry commissions reviews in collaboration with other organisations—for example, with the Association of Dutch Municipalities (VNG), and the Ministry of Infrastructure and Environment into the effects on municipal finances of the crisis

[2] https://www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/financieel-toezicht-gemeenten-en-provincies/artikel-12-gemeenten

[3] https://www.rijksoverheid.nl/actueel/nieuws/2019/05/27/extra-geld-voor-jeugdzorg-en-geestelijke-gezondheidszorg

at municipal real-estate companies (e.g. Deloitte 2013). Findings from these reviews were partly instrumental for the decision taken to extend the period in which municipal budgets need to be balanced from the standard 3 years to up to 10 years (with a possibility for further extension) in the case that a municipality's deficit is due to problems with its real-estate portfolio (Commissie BBV 2019).

Additional FSIs

In addition to the *Wet Fido*, other relevant legislation in relation to FSIs is included in the BBV (*Besluit Begroting en Verantwoording Provincies en Gemeenten*—Decision Budget and Reporting Provinces and Municipalities). The BBV came into effect in the financial year (FY) 2004 following some changes in the political structure of Dutch LGs, which also resulted in changes to municipalities' budgeting and reporting regulations. Following the 2008 financial crisis, a widespread need was felt to strengthen financial scrutiny of municipal councils. This resulted in a review of the BBV in 2014 by an advisory commission appointed by the VNG. Several of the commission's recommendations have subsequently been incorporated into a revised BBV, published in 2015 (see BZK 2015); including the requirement for Dutch LGs to report financial ratios in their budget documents from 2016 onwards and in their annual reports since 2015. By providing a uniform calculation basis, the ratios, listed in Table 4, facilitate easier comparisons amongst municipalities and aim to enhance insight into a municipality's financial position, especially for council members.

In line with recommendations made by the VNG appointed advisory commission, the ratios are not externally standardised. As shown in Table 5, the Interior Ministry and the provinces have agreed on signal values, which are divided into three categories—A, B and C—with A indicating least risk, and C most risk (Joint Provinces 2020). To improve comparability and transparency, the Interior Ministry also developed an online and publicly accessible database containing all municipal (and provincial) financial ratios since 2018, as included in both their budget documents and annual accounts.[4] However, both the Interior Ministry and the provinces have abstained from developing explicit norms and have made it the responsibility of local councils to decide upon how to use the ratios and whether to standardise them internally. Whilst this liberal approach resembles the wider Dutch subnational accounting framework, the absence of explicit standards has restrained the active use of ratios in municipal policymaking (Van Rees 2017).

To enhance the role of FSIs, several tests have been developed in recent years. These tests should help municipalities to better interpret their financial position by providing more guidance for important ratios. This is especially important for local councillors amongst whom there is limited financial expertise. Most of these tests use the obligatory ratios from the BBV, often combined with additional ratios. An example is the financial condition index developed by the VNG, which uses the

[4]See Findo – Financial Data Subnational Governments (*Data Financiën Decentrale Overheden*): https://www.findo.nl/

Table 4 FSIs in use in the Dutch system—signal values between brackets, if applicable

Main regulations—Local Government Law (*Gemeentewet*) (1851/1994) & Law on the Financing of Subnational Governments (*Wet Fido*) (2000)	BBV ratios (compulsory since 2015)	Ratios Association of Dutch Municipalities (VNG) (available since 2013)
Structurally balanced budget (*non-compliant if budget is unbalanced in 3-year forecasts*)	Structural operating result (*if % ↑, risk ↓*)	Structural operating result (*if <0% in at least one of two FYs preceding current FY + current FY, risk ↑*)
Interest risk norm (*non-compliant if annual refinancing debt is >20% of total exploitation costs*)	Net debt quote (*if % ↓, risk ↓*)	Net debt quote (*if >130%), risk ↑*)
Cash limit (*non-compliant if short-term debt is >8.5% of total exploitation costs*)	Net debt quote corrected for all externally issued loans (*if % ↓, risk ↓*)	Effective net debt ratio (*individualised signal value*)[a]
	Solvency ratio (*if % ↑, risk ↓*)	Solvency ratio (*if <5%, risk ↑*)
	Unused tax capacity (*if % ↓, risk ↓*)	Unused tax capacity OZB (*if OZB tariff >140% of the weighted average rate of all municipalities in preceding FY, risk ↑*)
	Land exploitation (*if % ↓, risk ↓*)	Fast increasing debt (*if net debt quote, effective net debt ratio, solvency ratio and structural operating result exceed signal values, risk ↑*)
		Short-term liquidity ratio (*if >20%, risk ↑*)
		Grant dependency ratio (*if >70% of total income, risk ↑*)
		Net investment quote (*if <1% OR >5%, risk ↑*)
		Net consumer expenses per inhabitant (p/i) (*signal values differ for categories of municipalities—category 1 municipalities, if > EUR 1.751 p/i, risk ↑; category 2, if > EUR 2.135 p/i, risk ↑; category 3, if > EUR 2.983 p/i, risk ↑*)[b]
		Sustainability quote—indicates cuts required in bad weather scenario for sustainable finances (*if >26%, risk ↑*)

Source: Own composition

[a]Due to large interlocal differences in the amount of externally issued loans and municipal stocks held, the VNG test does use municipal specific signal values to calculate the effective net debt ratio, which are then confronted with the municipality's net debt quote. For further details, see VNG 2019

[b]The categories rest on those developed by the Interior Ministry. They are based on the municipal social structure and whether it fulfils a regional function

Table 5 Municipalities under preventive supervision in 2018 (upper part of table), and with lowest score on VNG financial condition index (bottom part of table), all figures relate to 2018 annual accounts

Province	Municipality (population size)	Reason to be placed under preventive supervision	Net debt quote Cat. A: <90% B: 90–130% C: >130%	Net debt quote corrected for all externally issued loans A: <90% B: 90–130% C: >130%	Solvency ratio A: >50% B: 20–50% C: <20%	Structural operating result A: >0% B: 0% C: <0%	Tax capacity A: <95% B: 95–105% C: >105%	Land exploitation A: <20% B: 20–35% C: >35%	Score LG on VNG financial condition index (1=very poor to 10=outstanding)
National municipal average			56.5%	48.2%	34.9%	1.3%	101.9%	13.7%	8.0
Groningen	Ten Boer (7,292)	Negative general reserves following Section 12 allocation	69.3%	67.4%	-8.3%	1.5%	124.1%	14.8%	n/a
Overijssel	Almelo (72,629)	Since 2016 due to materially non-balanced budget	83.0%	73.0%	5.0%	-2.0%	108.0%	18.0%	7.5
	Twenterand (33,903)	Since 2018 due to materially non-balanced budget	58.7%	39.2%	29.5%	-0.5%	93.9%	13.6%	7.0
Limburg	Sittard-Geleen (92,956)	Since 2018 due to materially non-balanced budget	111.0%	107.0%	12.0%	1.0%	102.0%	3.0%	7.5
Zeeland	Middelburg (48,303)	Since 2016 due to materially non-balanced budget	113.4%	105.2%	15.8%	-1.0%	92.0%	36.9%	7.5

(continued)

Table 5 (continued)

Province	Municipality (population size)	Reason to be placed under preventive supervision	Net debt quote Cat. A: <90% B: 90–130% C: >130%	Net debt quote corrected for all externally issued loans A: <90% B: 90–130% C: >130%	Solvency ratio A: >50% B: 20–50% C: <20%	Structural operating result A: >0% B: 0% C: <0%	Tax capacity A: <95% B: 95–105% C: >105%	Land exploitation A: <20% B: 20–35% C: >35%	Score LG on VNG financial condition index (1=very poor to 10=outstanding)
	Vlissingen (44,485)	Since 2016 due to materially non-balanced budget	84.0%	85.0%	-55.0%	-1.9%	117.0%	4.0%	5.0
Financial ratios of municipalities with failing score based on VNG financial condition index									
Groningen	Groningen (202,810)		136.6%	100.5%	13.0%	0.4%	102.8%	7.3%	4.5
Gelderland	Arnhem (157,223)		85.2%	75.8%	16.4%	-2.0%	100.0%	5.4%	5.5
Utrecht	Eemnes (9,112)		80.0%	47.4%	25.5%	0.3%	101.3%	4.1%	5.0
North Holland	Oostzaan (9,735)		146.2%	143.4%	13.2%	0.0%	118.4%	0.5%	4.5
South Holland	Rijswijk (52,208)		164.3%	162.3%	9.5%	0.0%	98.0%	92.4%	5.0
South Holland	Schiedam (77,907)		162.8%	154.4%	14.6%	2.4%	103.6%	1.5%	4.0
Limburg	Vaals (9,874)		96.0%	95.0%	16.0%	-1.9%	96.0%	24.0%	4.5

Sources: Municipal accounts, BZK website, VNG index, CBS (for population statistics)

BBV ratios combined with six additional ratios (see Table 4). All ratios are perceived as significant determinants of the budgeting flexibility of Dutch LGs. Each ratio links to a signal value, with the municipality's score on each individual ratio calculated on the basis of three different scenarios: (1) a trend scenario where income and expenditure remain constant, (2) a 'bad weather' scenario where income reduces whilst expenditure increases, or (3) an individually chosen scenario. The municipality's scores on the individual ratios are then combined into an overall score that, using a traffic light score methodology, results in either a green (low financial risk), amber (medium risk) or red (high risk) overall score. The use of the VNG stress test has become increasingly widespread amongst Dutch LGs. In many cases, external consultancy firms support the implementation and translation of results into strategic municipal actions (Schilder and Bouwmeester 2016).

Both the BBV ratios and most municipal stress tests emphasise the impact that debt may exert upon a municipality's financial position. In line with this, the Dutch Council for Public Administration has emphasised that intergovernmental regulators should apply explicit debt norms. Therefore, LGs and municipal council members should develop greater awareness of financial risks and face stronger incentives to reduce debt levels if their municipality exceeds the regulator's norm. The Council also advised the Interior Ministry to use a municipality's debt quote as an additional criterion when deciding on the allocation of Section 12 support, since, so the Council stated, the ability of municipalities to absorb future setbacks is greatly determined by their debt burden (Rfv 2015).

3.4 FSIs and Recent Cases of Intensified Supervision

If a municipality is unable to present a structurally balanced budget, or provincial supervisors are not convinced that the budget forecasts are attainable, the provincial authorities are legally obliged to put the municipality under intensified supervision. Under this regime, the municipality must acquire prior approval from the province for any budget changes it intends to make during the budgetary year. The financial position of LGs placed under intensified provincial supervision is clearly considered to be in need of adjustment. However, is this reflected also in the FSIs of these municipalities? In 2018, six municipalities spread across four Dutch provinces faced intensified provincial supervision. Table 5 lists those municipalities, together with the Dutch municipal average for reference purposes. For most ratios, the municipalities under intensified supervision underperformed compared to the average of the Dutch municipalities. Looking at the municipal debt ratios (in both measurements), however, only two out of six municipalities showed debt ratios that were not Category A—low risk. Compared to the national municipal average, these municipalities performed worst regarding their operating result, which is unsurprising

given the fact that the operating result constitutes the provinces main criterion for deciding upon a municipality's supervision status.[5] Regarding the tax capacity ratio, four of six municipalities had a rating of either A or B, indicating that they still had space to increase their tax revenues by increasing rates (and they would need to utilise this tax space should they wish to apply for Section 12 support). Risks attached to real-estate investments (indicator 'land exploitation') were of limited relevance to LGs under intensified supervision, as all municipalities except Middelburg had a category A rating.

When including the financial condition index developed by the VNG, most municipalities under intensified supervision showed a remarkably high score of seven or above, indicating ample resilience. When we list municipalities with an insufficient/failing financial condition score (below 6) according to the VNG index, which totalled eight based upon the 2018 accounts, only Vlissingen appears subjected to intensified provincial supervision. The lack of overlap between municipalities placed under intensified supervision and those failing the VNG's sustainability test indicates the different weight put on various indicators. In particular, the VNG test gives greater weight to municipal debt, which is reflected by a significantly higher average of debt held by municipalities that failed the VNG's test compared to those under intensified provincial supervision.

4 Conclusions

A body of recent international literature on FSIs has emphasised their contingent nature, arguing that a 'one-size-fits-all' approach cannot work due to different governments operating in quite dissimilar circumstances (Jacob and Hendrick 2012). The comparison of England and the Netherlands shows this in practice.

At a national level, England and the Netherlands exhibit some fundamental similarities in the context of LG finances, but, despite this, different fiscal rules result in contrasting approaches to the development of FSIs. English and Dutch LGs are both highly dependent on fiscal transfers from central government, driven by an emphasis on equity of service levels amongst LGs. However, fiscal rules governing LG financial management are substantially different: in England LGs are forbidden either to budget for a deficit in their general funds or to borrow for their annual budgets, resulting in an emphasis on reserves to ensure balancing income and expenditure. In the Netherlands the requirement to set a structurally balanced budget (i.e. over 3 years) and the ability to borrow to support that budget result in more flexibility. Therefore, Dutch FSIs emphasise debt levels and liquidity.

[5]Sittard-Geleen reports a positive operating result in its annual accounts for 2018–2019 (1.0%); however, it is the *budgeted* operating result that is the focus of provincial supervision, and Sittard-Geleen forecasted a negative operating result in its budget for 2018–2019 (-1.0%), explaining the intensification of provincial supervision. Ten Boer reported negative operating results in both its budgets and annual accounts prior to receiving Section 12 emergency support.

Although important intergovernmental arrangements remain in place to ensure the local level complies with fiscal rules, both countries put increasing emphasis on the responsibility of local actors to incorporate financial sustainability considerations into local decision-making processes. Subsequently, the use of FSIs has become more common. In England, the primary FSI is the requirement for each LG to ensure that budgeted expenditure for any single year does not exceed the total of the revenue it intends to raise during the year and the revenue reserves that it has at the beginning of the year. If an LG looks likely, via forecasting, to breach this indicator, action must be taken by the LG to correct the projected imbalance. If suitable action is not taken, external intervention by central government can be triggered. This strict approach reduces the risk that an English LG body cannot meet its liabilities. The emphasis of FSIs (such as the current CIPFA resilience index) has consequently been to highlight where the possibility of an imbalanced budget situation might develop—hence the emphasis on reserve levels and the ratio of 'inflexible' spend (including debt servicing) to net revenue/spending. In the Netherlands, in contrast, the emphasis is on ensuring LGs' borrowing and borrowing costs remain sustainable by including related concepts of debt quotes, solvency and liquidity.

The history of FSIs between England and the Netherlands contrasts markedly. England saw the development of FSIs as part of the Audit Commission's annual comprehensive assessment of LGs in the 1990s and 2000s. However, the specific motivation was to foster continuous improvement in the economy, efficiency and effectiveness of LGs rather than financial sustainability defined in terms of a balanced budget. As such, the approach was abandoned in 2010 alongside performance management of LGs with the emphasis remaining on balanced budget indicators. In the Netherlands, however, the more liberal fiscal rules coupled with financial pressures post 2008 and growing criticism of municipal financial supervision as conducted by the provinces, led to rising interest in FSIs, resulting in their systematic development through the BBV by the Interior Ministry and the municipalities from 2015.

Currently, the use of FSIs is arguably more widely spread in Dutch compared to English LGs. This difference is likely due to the reporting of FSIs having become a legal requirement in the Dutch system, the monitoring of those indicators by the provinces and the supporting role of the Dutch Interior Ministry and local government association in the local use of FSIs. Nonetheless, the use of FSIs has remained controversial in both countries. In England, the approach of the Audit Commission before 2010 was unpopular due to the burden it placed on LGs participation in the annual assessment process and public resources consumed by the Commission. When the detailed evaluation of LG finances within the national system was abandoned, criticism followed, but the development of a system of FSIs by CIPFA since 2018 has itself been controversial. In the Netherlands, the local government community has been relatively supportive of the introduction of FSIs, however, on the condition that the indicators do not link to externally set norms. Whilst this approach fits well in the Dutch tradition of municipal autonomy and may better help to account for inter-municipal differences, it has reduced the signalling role of FSIs

and so restrained their active use by municipal councillors, that is, their primary intended user group.

Inter-local differences are particularly relevant when it comes to explaining scepticism about the utility of FSIs in England, given the large institutional heterogeneity in types of LGs, which is partly reflected in different financial conditions (De Widt 2021). More generally, the inherent inability of past information to predict the future is another source of controversy, that is also reflected in the international literature (Jacob and Hendrick 2012). Despite this controversy, the single case of an officially fiscally distressed LG in England suggests that FSIs, such as those published by CIPFA, could indeed be effective in providing an early warning. However, in the Netherlands, there is no correlation between LGs under intensified supervision and the VNG financial condition index, which equally raises questions about the efficacy of FSIs and the appropriateness of the traditional focus of regulators.

The differing approaches in England and the Netherlands mirror different perceptions of risk in each country as defined in the primary LG fiscal rules. In England, tough fiscal rules reduce the likelihood of an LG fiscal crisis. FSIs highlight the likelihood of the primary fiscal rule being breached if declining reserves, and limited scope to reduce spending, suggest it may become difficult to achieve the balanced budget rule. By contrast, in the Netherlands, where the primary fiscal rules allow annual deficits and borrowing within broad limits, FSIs focus on changes to deficits, debt and solvency levels with set thresholds in the VNG ratios. These aim to identify LGs where increasing deficits, debts and solvency measures suggest forthcoming fiscal stress.

Comparing England and the Netherlands to the international literature, they reflect the popularity of debt and short-term solvency-type indicators (i.e. can the LG continue to pay its bills?) and do not include longer-term and broader-type indicators such as sociodemographic developments underpinning long-term revenue and demand. Apart from England's 2018 NAO review, neither do the approaches consider service level indicators (indicating whether service levels are acceptable or are increasing/decreasing). Despite their relatively narrow focus, the comparison shows FSIs could play an important role in helping to translate and summarise relatively complex financial information in a more manageable format. FSIs provide helpful tools in identifying an LG's financial position, but the interpretation of figures, including their mutual coherence, is key and should be complemented by additional information. This should include broadly based and qualitative approaches, which can evaluate what is actually occurring in an LG and how current or past decisions can affect future sustainability (Jacob and Hendrick 2012).

A more fundamental challenge to the use of FSIs at the local level is which particular financial sustainability risk these indicators aim to capture. In the case of the corporate sector, the real presence of corporate insolvency gives a clear overall focus on financial ratios. Since Altman's (1968) pioneering work, a rich theoretical and empirical body of literature has emerged on corporate finance ratios. Despite their more pluralistic objectives and an opaque risk of insolvency, public sector organisations and their use of FSIs would benefit from more systematic and large-

scale empirical analyses. Similarly, research into how LGs use FSIs in decision-making processes in different country contexts is likely to carry great value for scholars and policymakers alike.

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