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## **Canton of Lucerne**

# **Analysis of the cantonal financial management using the PEFA framework**

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## **Performance Report on Public Financial Management in a Swiss canton**

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## Glossary

In the following glossary, terms related to the fiscal management of the Canton of Lucerne are based on the definitions given by the Canton of Lucerne.

<i>Absorption costing</i>	Account drawn up according to the principles of cost accounting recording all costs incurred in providing a service or an entire service group. Absorption costing gives a transparent view of the full costs of each individual service group or service of an administrative unit. Internal invoicing is a necessary element of absorption costing.
<i>Accrual accounting</i>	Accounting principle underlying the HAM, whereby accounts payable and receivable are allocated to the period in which they occur, irrespective of the time at which the corresponding payment is made or received.
<i>Administrative assets</i>	Administrative assets are all assets used to fulfil administrative tasks defined under public law. Administrative assets are divided into “administrative assets in the narrower sense” (e.g. schools, hospitals, administrative buildings) and “items for common use” (e.g. roads). Administrative assets also include non-returnable grants to third parties, redeemed via the Statement of Investments. It is thus irrelevant whether the investment forms the basis for ownership by the political unit.
<i>Balance of the financing statement</i>	Net investments less depreciation and less net revenue or plus net expenses from the Operating Statement. If net investments prevail, there is a financing deficit, otherwise there is a financing surplus.
<i>Basic contract</i>	See Performance contract
<i>Budget credit</i>	Budget credits are the approved performance budgets per service group, the state grants and the investments of service units, the courts and the service groups across courts and service units in accordance with the budget. They are binding. They are forfeited if not used up by the end of the year.
<i>Cantonal Council</i>	Cantonal Parliament: Legislative body comprising 150 Cantonal Councillors.
<i>Cash-effective receipts and expenditure</i>	Operating Statement result (operating balance), adjusted by non-cash items such as depreciation, fund deposits, transitory contributions and internal charging, as well as investments without loans and shareholdings.
<i>COFOG</i>	COFOG (Classification of the Functions of Government) is a United Nations functional classification system. The standardization of the functional classification seeks to facilitate international comparisons in the allocation of resources.
<i>Credit</i>	Approval of an expense (Operating Statement) or capital expenditure (Statement of Investments).
<i>Credit transfer</i>	For accounts payable that have been charged to a budget credit, reserves as well as credit transfers for pre-financing of planned investments may be made.
<i>Debt service</i>	Interest expenses, plus ordinary depreciation on the administrative assets, less investment income.
<i>Debt service portion</i>	The portion of state taxes used to service debts (net interest plus ordinary depreciation on administrative assets and any balance sheet deficit as a percentage of the net state tax income).

<i>Depreciation</i>	Depreciation is the decline in value of fixed assets that are not used up within a fiscal period. The reason for depreciation may be technical (wear and tear through utilization), economic (market changes) or temporal (expiration of licences, authorizations, etc.). Under the Canton of Lucerne's Public Finance Act, at least ten percent of the residual book value of administrative assets must be depreciated each year.
<i>DFID</i>	The UK government's Department for International Development is a PEFA partner.
<i>Expenses</i>	The decline in value of the Operating Statement in a fiscal year.
<i>Executive Council</i>	Government of the Canton of Lucerne: an executive body with five members.
<i>Financial assets</i>	Financial assets are all of a public authority's assets that are not used for administrative tasks defined under public law. Financial assets may be disposed of in accordance with standard business practice. The deciding criterion is realizability. Assets are realizable if they can be used without breaching any legal or other public-law obligation, i.e. they can be sold at any time without impacting on the performance of public tasks (e.g. securities as a purely financial investment).
<i>Financing result</i>	See: Balance of the Financing Statement.
<i>FHG</i>	German abbreviation for Public Finance Act
<i>Further credit</i>	If the budgeted loans are not sufficient, a request for further credit should be submitted to the Cantonal Council in good time. Additional expenses/expenditure due to inflation or for earmarked expenses or expenditure does not require further credit.
<i>HAM</i>	Harmonized Accounting Model. Bookkeeping model used by the Swiss cantons and municipalities, based on the private-sector accounting system. It distinguishes between operating expenses (posted in its Operating Statement) and investment or capital expenditure (posted in its Statement of Investments). In particular, the Operating Statement also includes depreciation as well as prepaid expenses and deferred income. The HAM also includes a Statement of Finance Position (Balance Sheet).
<i>ICS</i>	Internal Control System
<i>IFTP</i>	The IFTP (Integrated Financial and Task Plan) is a four-year rolling plan updated annually. It is broken down by task area and provides an overview of expenses (including investments) and expected revenues. The IFTP also contains financial key figures and statements on the evolution of the tax rate. Specifically, details are given on the targets and measures derived from the legislative programme and the expected changes in resources. The IFTP is the actual planning instrument of the government and Parliament.
<i>Internal financing (cash flow)</i>	Internal financing indicates which investments (absolute amount) the canton can fund through its own means (sum of the balances from the Operating Statement and the deposits to and withdrawals from special and pre-financing funds plus depreciation on the administrative assets and the balance sheet deficit).
<i>Internal financing ratio</i>	Internal financing as a percentage of net investment (balance between investment expenditure and receipts). This figure indicates the portion of net investments that can be self-funded.

<i>Internal invoicing</i>	Costs and proceeds between service units are settled by means of internal invoicing. Settlement is made on the basis of a performance contract between the service provider and recipient.
<i>Legislative programme</i>	The legislative programme is presented to Parliament by the Executive Council within six months after the start of a legislative period. This provides information on the general intentions and considerations by which the Executive Council is guided during its term of office and the measures planned for their implementation; it also gives information on important new tasks and the additional resources required for these, the order of priority in which important drafts are to be submitted to the Grand Council. Parliament can record its opinion on the legislative programme in the form of comments and set any other focal points.
<i>Net indebtedness</i>	Debt capital less financial assets.
<i>Net interest</i>	Interest expenses less capital and investment income
<i>Net investments</i>	Balance between investment receipts and investment expenditure. The adjusted net investments do not include the granting or repayment of loans and holdings or the depreciation taken from the Operating Statement.
<i>Operating Statement</i>	A statement of the current fiscal year, broken down by cost type, showing the current status of the individual cost types with respect to the budget and utilization. The Operating Statement corresponds to a profit and loss account used in the private sector.
<i>PEFA</i>	The PEFA programme (Public Expenditure and Financial Accountability) was set up in 2001 by the PEFA partner institutes in association with the Organization for Economic Cooperation and Development (OECD). PEFA's partners are the World Bank, the EU (European Commission), Switzerland (State Secretariat for Economic Affairs SECO), Norway (Ministry of Foreign Affairs), France (Ministry of Foreign Affairs) and the International Monetary Fund. The programme is implemented via a Secretariat based at the World Bank in Washington, DC. PEFA gives the public sector an analysis tool that can be used to measure the quality of administrative systems for public finances and compare these at an international level. It aims to support reform processes in the management of public finances and state the results of such reforms in concrete terms.
<i>Performance budget</i>	Form of budgeting without a fixed allocation of resources to specific accounts. The apportionment of resources is left up to the individual administrative unit. The decisive factor is the balance of revenue and expenses, which is disclosed in the budget for each service group and passed by the Cantonal Council. The performance budget is an integral component of the performance contract.
<i>Performance contract</i>	The budget entails a consolidated (summarized) service agreement per service unit, known as the performance contract. The following elements of the performance contract form part of the Cantonal Council's approval of the budget: the performance budget per service group, the investments and the state grants. The remaining contents of the performance contract serve the Cantonal Council for informational purposes.
<i>Revenue</i>	The increase in value of the Operating Statement in a fiscal year.
<i>SECO</i>	State Secretariat for Economic Affairs of the Swiss Confederation.

<i>Service agreement</i>	Compilation of the services (summarized in service groups) of an administrative unit with cost, performance and impact targets and the corresponding indicators. The service agreement also includes the performance budget for each service group. The service agreement is drawn up in the planning process by the administrative unit, agreed on with the appropriate department and passed by the Executive Council.
<i>Service group</i>	The ten main functions of the canton are divided into 66 task areas, which are then broken down into some 300 service groups, making up the state's individual services. The performance budgets are drawn up for each service group. As a rule, service units are responsible for several service groups.
<i>Special credit</i>	Special credits are necessary for unconditional expenses and unconditional capital expenditure if they exceed CHF 3 million or have not been approved in the budget or as further credit.
<i>Special financing</i>	With special financing, certain revenues are used to fulfil defined tasks, based on the corresponding legal guidelines.
<i>Statement of Financial Position</i>	Balance Sheet. Shows the asset and liability positions on a particular cut-off date.
<i>Task and Financial Plan (TFP)</i>	The TFP is the medium-term planning instrument in accordance with the proposed law on the management of finances and services in the Canton of Lucerne. From 2011, this should show the expected growth in finances and services for the budget year and the next three planned years and replace the Integrated Financial and Task Plan (IFTP) used to date. As a new feature, the budget will then be already included in the TFP.
<i>Transitory contributions</i>	Grants that the canton receives from other public authorities (primarily the Confederation) to be forwarded to third parties. These are tasks that the canton fulfils without having to fund such expenses itself (e.g. unemployment benefits, direct agricultural payments). As the canton has very little influence in this respect, transitory contributions are excluded from the consolidated overview.

## Overview of indicators

	<b>A. Credibility of the budget</b>	<b>Score</b>
PI -1	Aggregate expense out-turn compared to original approved budget	A
PI -2	Composition of expense out-turn compared to original approved budget	A
PI -3	Aggregate revenue out-turn compared to original approved budget	A
PI -4	Stock and monitoring of expenditure payment arrears	B+
	<b>B. Comprehensiveness and transparency</b>	
PI -5	Classification of the budget	B
PI -6	Comprehensiveness of information included in budget documentation	A
PI -7	Extent of unreported government operations	A
PI -8	Transparency of inter-governmental fiscal relations	B
PI -9	Oversight of aggregate fiscal risk from other public sector entities	C+
PI -10	Public access to key fiscal information	B
	<b>C. Budget cycle</b>	
	<b>C-I Policy-based budgeting</b>	
PI -11	Orderliness and participation in the annual budget process	A
PI -12	Multi-year perspective in fiscal planning, expenditure policy and budgeting	B
	<b>C-II Predictability and control in budget execution</b>	
PI -13	Transparency of taxpayer obligations and liabilities	B+
PI -14	Effectiveness of measures for taxpayer registration and tax assessment	B
PI -15	Effectiveness in collection of tax payments	NS
PI -16	Predictability in the availability of funds for commitment of expenditures	A
PI -17	Recording and management of cash balances, debt and guarantees	A
PI -18	Effectiveness of payroll controls	C+
PI -19	Competition, value for money and controls in procurement	B
PI -20	Effectiveness of internal controls for non-salary expenditure	A
PI -21	Effectiveness of internal audit	A
	<b>C-III Accounting, recording and reporting</b>	
PI -22	Timeliness and regularity of accounts reconciliation	A
PI -23	Availability of information on resources received by service delivery units	B
PI -24	Quality and timeliness of in-year budget reports	C+
PI -25	Quality and timeliness of annual financial statements	D+
	<b>C-IV External scrutiny and audit</b>	
PI -26	Scope, nature and follow-up of external audit	B+
PI -27	Legislative scrutiny of the annual budget law	A
PI -28	Legislative scrutiny of external audit reports	A
	<b>HLG Fiscal relations with higher level government</b>	
HLG-1	Predictability of transfers from the Confederation	D+

## Management Summary

This analysis of the Public Financial Management of the Canton of Lucerne is devoted to the medium state level of the Swiss Confederation, a country with a strongly federal tradition where public sector entities at all state levels have a high degree of responsibility for their own finances. The Canton of Lucerne was one of Switzerland's pioneer cantons in switching its administration to New Public Management. This study was conducted between October and December 2008. It refers to the years 2005-2007. The Annex contains a rapid-read overview of the results of the analysis in the form of a table as well as a summary of the findings in brief. The following outlines the distinctive features and risks of the cantonal financial management and presents the reforms that are currently planned or already introduced.

### **(i) Distinctive features and risks of the cantonal financial management**

#### *Credibility of the budget*

The PEFA analysis found a high degree of accuracy of the budget forecasts, in terms of both revenue and expenses. The budget was not exceeded by any negative developments. On the contrary, during the period under review, the budget regularly underestimated the revenue and yet was very accurate in forecasting expenses. The net effect suggests a rather prudent approach to budgeting, but it also results from the economic boom during that period. Although, in general, any extra revenue should always be a welcome result, a certain amount of criticism is also appropriate. If revenues are consistently underestimated, this may, over time, be viewed as a desired strategy and thus undermine the budget discipline.

The high credibility of the budget is confirmed by an analysis of the trend in payment arrears. The expenses side of the budget was not simply adhered to by omitting to make certain payments. On the contrary, payments arrears are at a perfectly acceptable level, and it is gratifying to note that the trend is even decreasing. However, payment arrears are only supervised centrally for the core area of the canton and not for the extended circle, covering, for instance, the hospitals. If management responsibility in service areas in the extended circle is outsourced to service providers, resulting in a certain loss of control, this may create higher risks for the canton, making it harder to detect problems at an early stage. These risks have to be offset by the efficiency gained through outsourcing.

#### *Cross-disciplinary interests*

On various occasions, the PEFA analysis finds potential for improving transparency in financial management. Transparent decision and control documents are an important prerequisite for the efficient allocation of resources and for operational efficiency in service performance.

Only a few elements are missing from the budget presentation: macroeconomic planning assumptions and the allocation of investment spending to the second level of the functional classification. Parliament has a very good level of information in drawing up the budget.

The fiscal relations with the municipalities as important partners of the canton are extensively regulated. However, the municipalities need to receive fiscal information at an early stage as, given the complexity of the rules, they cannot calculate important state contributions by themselves. The bigger municipalities, in particular, tend to receive the fiscal information only after they have started the detailed phase of their budget formulation. The budgeting process could be facilitated for these municipalities if they received such information at an earlier stage. The fact that the canton's financial statistics for the municipalities refer to only the actual figures and not the budgeted figures can be viewed as a loss of transparency. Nonetheless, the

system requires that the canton exercise only minimum supervision of the municipalities. Such circumstances do not entail any risk for the canton.

A risk assessment is carried out annually in public enterprises. Unlike in the core administration, however, this risk assessment in public enterprises is not consolidated. The canton thus does not have a complete overview of all risks incurred. As with the unrecorded payment arrears in outsourced service areas, the risks here are not fully monitored.

PEFA finds some loopholes in the fiscal information made available to the public. The most obvious is the fact that the State Account does not include an audit report. However, it would not be fair to the Canton of Lucerne to overlook the huge volume of information on service performance in accordance with the principles of New Public Management simply on account of the lack of transparency found.

### *Budget cycle*

The PEFA analysis on the budget cycle extends from budget formulation to commitment of expenditures as well as reporting and auditing. A well functioning budget cycle calls for transparency in each phase; only then can a high degree of credibility of the finance management be expected.

#### Policy-based budgeting

The budget cycle is well established and contains both top-down and bottom-up elements, as appropriate. However, some improvement is needed in terms of the budget's reference to multi-year planning. The budget comments upon deviations with respect to the previous year's budget but not with respect to the planned value for the budget year as given in the IFTP.

The policy-based budgeting could be enhanced again if the IFTP, as a link between the strategy and budget, corresponded more explicitly with this strategy (=legislative programme). The canton is aware of this situation, and there are plans to make adjustments.

#### Predictability and control in budget execution

*Tax system:* The tax liability is clearly enshrined in the law, and access to tax-relevant information is particularly user-friendly. The existing discretionary powers are relatively limited. The general willingness to pay taxes is not likely to suffer for this, even if the taxpayers do occasionally express a certain degree of discontent. The tax register is well secured. Correct assessment is supported by the imposition of penalty taxes; cooperation between the tax office and the population control system largely guarantees that the assessments are complete. The tax collection system has a functioning control mechanism for accounts payable. The tax arrears raise some concerns mainly because there is no age profile of the arrears available. Due to the way the system operates, the taxes received are not immediately available to the canton, as they are collected by the municipalities. The tax system lacks a quality management system. This point needs further attention as the tax system is of great strategic significance for the canton, especially in light of the tax competition from neighbouring cantons.

*Liquidity management:* Liquidity management and monitoring is at a good level. As only the larger cash balances are entered daily, there is some potential for saving liquidity costs in cash management, particularly if interest rates were to rise again.

*Internal controls and internal audit:* The internal controls of payroll spending are technically well secured and there are clear authorizations for entering changes to personnel data. The main weakness lies in the fact that the manner in which authorizations for personnel modifications

are handled is not subject to an audit. Also, the personnel expenditures overall are not verified on a regular basis. The existence of “ghost workers” can therefore not be ruled out. No deficiencies were found in the internal audit of non-salary expenditures. With respect to the otherwise perfectly regulated public procurement system, there is a lack of evidence that this is indeed always used, as there is no specific monitoring of the procedures for the awarding of contracts. No deficiencies were found in the internal audit.

#### Accounting, recording and reporting

The timely and regular account reconciliation with the accounting system is well regulated. The information on the availability of resources received by service delivery units is not explicitly collected but is available indirectly via the cost and performance accounting. This situation does not raise much of a problem in practical terms for the canton. The in-year budget comparisons show only the larger projects and their financial status. However, there is no comprehensive project list in the manner of a verification of credit lines. A comprehensive verification of credit lines would enhance the quality of the reporting. There is some uncertainty surrounding the lack of consolidation in the financial reporting. The canton does not use IPSAS but the HAM standards. The planned switch to HAM2, however, would allow for consolidated reporting and thus a better overview of the canton’s financial situation.<sup>1</sup>

#### External scrutiny and audit

The processes here run well to a large extent. The analysis did not find any need for action in this respect.

### **(ii) Possible risks in the area of cantonal financial management**

Two risks are worthy of particular attention: supervisory risks and political control risks.

#### *Supervisory risks*

*Supervisory risks* exist in various areas. In some cases, these result from service delivery units not forming part of the core administration:

- annual financial statements not fully consolidated (PI-25)
- no control of accounts payable outside of the core administration (PI-4)
- no risk consolidation outside of the core administration (PI-9)
- financial reporting not conducted as defined in IPSAS (PI-25)

In some cases, supervisory risks also occur within the core administration:

- no supervision of compliance with the legal requirements in the cantonal procurement system (PI-19)
- no in-year control of credit lines (PI-24)
- no supervision of the updating of personnel data (PI-18)
- no quality management system in taxation / no age profile for tax arrears (PI-14 / PI-15)
- lack of clarity in the transfer payments from the Confederation by type and time-specific availability (HLG-1)

In the event of risks that are not detected and overcome in good time due to the lack of control routines, this may hamper both the allocative and operational efficiency of the cantonal budget and also the intertemporal distribution: undesired resource transfers between individual task

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<sup>1</sup> Cf. Annex 5: Comparison between IPSAS and HAM2

areas, lack of resources for strategically important tasks, lack of economic efficiency, unlawful use of resources, increased indebtedness and thereby limited scope for manoeuvre for subsequent years or even generations.

#### *Political control risks*

To a certain extent, there are also *political control risks*. This means that the allocation of resources cannot be optimized within the meaning of the canton's strategic priorities. The following circumstances could generate this risk:

- insufficient connection between the IFTP and the legislative programme (PI-12)
- budget not explicitly oriented to the planned values in the IFTP (PI-12)
- Statement of Investments broken down to only one level (PI-5)
- lack of transparency concerning the forward expenditures of programmes and investments for the political decision-makers (PI-12)

However, apart from the risks mentioned above, it has to be remembered that the Canton of Lucerne has been consistent in its implementation of the New Public Management model. This gives the political decision-makers important information, particularly at the service level, about planned or attained performance targets and the use of resources directly connected to the individual service.

#### **(iii) Prospects for reform planning and implementation**

In strategic terms, the Canton of Lucerne has to face tax competition from neighbouring cantons. For this reason, it wants to lower taxes gradually towards the Swiss average, without having to reduce its level of support. Nonetheless, the mix of public services is to be further reviewed, the service provision optimized and structures adjusted. Meanwhile, the canton wants to raise the quality of its location, first to become more attractive for new taxpayers and also to ensure that economic production in the canton can grow at a stronger pace.

The implementation of HAM2 is on the agenda at an operational level. This implementation falls under the scope of a complete revision of the Public Finance Act. The consultation process on this new law was started in May 2009. Introduction is scheduled for 2011. Topics of particular interest with respect to PEFA are the possibility of consolidation as well as the disclosure of the financial situation as a "true and fair" view and the explicit linkage between the budget and the medium-term planning in the Task and Financial Plan (TFP). In addition, the project LU-Tax will enhance the transparency of data flows in taxation. With respect to the modification of personnel data, an Internal Control System (ICS) will be introduced.

# 1. Introduction

## *PEFA in brief*

PEFA (Public Expenditure and Financial Accountability) is the name given to a programme in operation throughout the world that provides a diagnostics tool to measure the quality of administrative systems in public finances and compare these at an international level. It aims to support reform processes in public financial management and report on the results of such reforms in concrete terms. PEFA works with a limited number of clearly defined indicators, taking a comprehensive view of public financial management. The analysis tool enjoys widespread recognition and has already been used in many countries. It is particularly appreciated for its simplicity and lucidity but also because of the relatively low level of analytical work involved and its holistic perspective. PEFA lays down three main requirements for sound financial management: public finances must be dealt with in a disciplined manner, resources must be allocated in accordance with the state's strategic objectives, and tasks must be performed efficiently.

Launched in 2001, the PEFA programme was developed by the PEFA partner institutes in association with the OECD/DAC. PEFA's partners are the World Bank, the EU (European Commission), Switzerland (State Secretariat for Economic Affairs SECO), Norway (Ministry of Foreign Affairs), France (Ministry of Foreign Affairs) and the International Monetary Fund. The representatives of these organizations form the steering committee and manage the programme. The programme is implemented via a Secretariat based at the World Bank in Washington, DC.

PEFA is restricted solely to the analysis of public finances in terms of procedure. Issues concerning the content of the receipts and expenditure policy do not fall within the scope of PEFA. Similarly, the analysis does not cover the sustainability of fiscal policy or its effectiveness and efficiency with respect to policy initiatives.

## *Objectives of the PEFA analysis in the Canton of Lucerne*

### *The objectives of the Canton of Lucerne*

With the PEFA study, the Canton of Lucerne wants to analyse and evaluate its budgetary and financial processes on the basis of internationally recognized standards. The strengths and weaknesses of its public financial management (PFM) are to be identified. This external viewpoint may then provide the impetus for future reforms and, if need be, support ongoing reforms. In subjecting itself to international benchmarking and thus creating transparency, the Canton of Lucerne is hoping to act as a role model within Switzerland. By using the PEFA framework, the Canton of Lucerne also wants to prove its openness to the world and express its solidarity with developing and transitional countries undergoing reforms.

### *The objectives of SECO*

Through its international cooperation efforts, SECO has been involved in the formation and funding of the PEFA instrument and its development from the start. Switzerland's position in providing technical support for developing and transitional countries in the area of budgetary assistance can be strengthened if PEFA is successfully implemented in its own country. SECO is particularly interested in the application of PEFA at a sub-national level, as this level is of huge importance in federal states such as Switzerland. At an international level, the PEFA

instrument has already been successfully applied in many countries. SECO now wants to make PEFA a familiar concept among Switzerland's cantons too.

### *Process*

This report has been drafted by a team of experts from the Universities of Applied Sciences of Lucerne and Zurich in cooperation with the Department of Finance of the Canton of Lucerne. The Canton of Lucerne has designated a coordinator for the PEFA study, who is in charge of forwarding enquiries to the relevant internal service unit or directly providing the requested information.

As a condition of the Canton of Lucerne's Head of Finance agreeing to this analysis, it was decided that the degree of involvement of the canton's employees was to be kept to a minimum. With the staff already working to capacity, they were not to be burdened with a lot of additional work. Thanks to the efficient cooperation with the cantonal coordinator and the good information situation, this requirement was fulfilled.

The PEFA analysis in the Canton of Lucerne comprises the following steps:

1. Kick-off meeting with the Canton of Lucerne to clarify the procedure, schedule and roles of those involved.
2. Implementation of the PEFA analysis by external experts and creation of an initial draft of the PFM Performance Report.
3. Examination of the report by the Canton of Lucerne and PEFA's Secretariat. Discussion of possible discrepancies between the external experts and the canton.
4. Reworking of the report by the external experts on the basis of the recommendations made by the canton and the PEFA Secretariat.
5. Presentation and publication of the final report.

### *Methodology*

The assessment of the PFM of the Canton of Lucerne is based on the PEFA instrument and the guidelines for its application at sub-national level<sup>2</sup>. The PEFA instrument works with a set of 29 clearly defined indicators, taking an overall view of PFM. It is a retrospective assessment based on actual, provable facts. It does not look into the causes of any possible weaknesses of PFM.

The new guidelines for application of the PEFA instrument at sub-national level were used in this study for the first time. These guidelines have been slightly modified with respect to the "normal" PEFA guidelines and adapted to the particular circumstances of the sub-national government level.

Each indicator is assessed on a scale from A to D. The score is given on the basis of the minimum conditions for each indicator. Many of the indicators have two or more dimensions, which produce an overall score in accordance with the M1 or M2 scoring method defined by PEFA. For Method 1 (M1), the weakest dimension is decisive, i.e. the overall score is that of the dimension with the lowest score. For Method 2 (M2), the average of the individual

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<sup>2</sup> PEFA (2008): Guidelines for application of the PEFA Performance Measurement Framework at the Sub National Government Level. Volume 1 and 2.

dimensions is used to work out the overall score (see the PEFA Framework, “Scoring Methodology”).

As agreed with the Head of Finance, the external experts based their assessment primarily on information in the public domain or specifically made available for this purpose. Where necessary, this information was subsequently supplemented in discussions with experts from the Canton of Lucerne. The canton did not perform a self-assessment of the indicators, given the heavy workload already on its staff.

#### *Scope of the assessment*

This report is limited to an analysis of the PFM of the Canton of Lucerne. All 29 indicators have been assessed; the three additional indicators on donor performance were not applied as the Canton of Lucerne does not receive donor support.

This report does not seek to assess the PFM of the Confederation or of municipalities. Nonetheless, the Canton of Lucerne’s positioning within Switzerland’s federal structure is described in detail in Section 2.<sup>3</sup>

The years 2005 to 2007 were defined as the reference period for the report. Any changes only introduced in 2008 or planned for 2009 or later have not been taken into account for the analysis.

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<sup>3</sup> Performance indicator 8 also examines the fiscal relations between the canton and the municipalities, while the supplementary indicator HLG-1 examines the fiscal relations between the Confederation and the canton.

## 2. Background Information

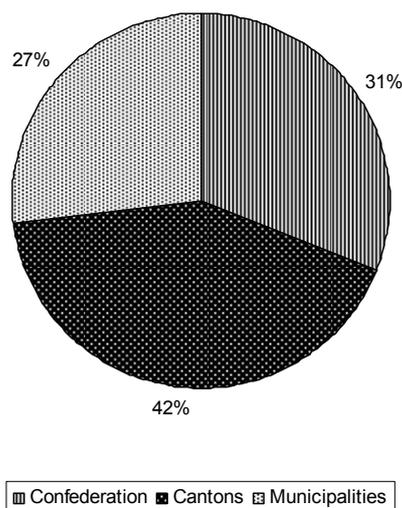
Section 2 Background Information looks at the importance of the role played by the sub-national government level in Switzerland. Its significance is clear not only from the extent of expenditure but also from the allocation of powers and the relatively autonomous financing of the sub-national level. The most recent reform of the fiscal equalization system and task allocation between the federal government and the cantons has reinforced Switzerland's federal structure. The second half of this section outlines the economic situation of the Canton of Lucerne, the design of its government system and the key reforms that have been carried out or initiated in recent years. Taking the canton in question as an example, this highlights the fact that federalism at a cantonal level, down to the municipalities, has also undergone major reforms recently and thus been further strengthened.

### 2.1. Significance, organization, financing and reform of the sub-national sector in Switzerland

The Swiss Confederation has three government levels: first the federal, i.e. national, level, then the cantons, and finally the municipalities. The sub-national level thus comprises the 26 Swiss cantons and some 2800 municipalities.

Switzerland is a markedly federal state, with the cantons holding a very strong position. In accordance with Art. 3 of the Federal Constitution, the cantons exercise all rights that they have not themselves transferred to the Confederation. Furthermore, the Federal Constitution upholds the principle of subsidiarity, whereby, in principle, tasks should be assigned to the lowest possible level of government. The distribution of spending in Fig. 1 shows the weight of each government level in terms of financial policy. The overall weight of spending of the sub-national level amounts to 69%. The individual cantons decide which tasks are assumed by the municipalities.

Figure 1: Distribution of spending of the Confederation, cantons and municipalities in 2006



Source: Federal Finance Administration, 2008

The sub-national level is largely funded by cantonal and local taxes and fees alone. In 2006, this portion came to 72.6% for the cantons and 83.7% for the municipalities (see Table 1). The cantons enjoy a broad range of freedoms in creating their fiscal policy. There is harmonization only with respect to tax liability, the taxed objects, the time-based assessment of taxation, procedural law and the law regarding fiscal offences. However, the cantons are free to rule on the setting of tax scales, deductions and tax rates. The municipalities are obliged to follow their canton's tax law with respect to tax scales and deductions but may set their tax rates autonomously. Thus, taxpayers with otherwise the same basic conditions, such as income or wealth, may have a very different tax burden from one canton to another and from one municipality to another.

*Table 1: Receipts and the breakdown for cantons and municipalities in 2006*

	Cantons		Municipalities	
	in 1000 CHF	in %	in 1000 CHF	in %
Current receipts excl. double entries at the same level	70,868,420	100%	46,179,596	100%
Taxes	35,326,187	49.8%	22,133,798	47.9%
Royalties	833,600	1.2%	117,842	0.3%
Investment income	4,360,872	6.2%	3,242,826	7.0%
Payments (fees, etc.)	10,907,431	15.4%	13,156,302	25.8%
Grants from other state levels	19,440,329	27.4%	7,528,827	16.3%

Source: Federal Finance Administration, 2008

The allocation of tasks among the various state levels has developed historically, becoming increasingly complex over time. Eventually, it no longer complied with the principle of subsidiarity, and the emerging task allocation began to infringe upon the principle of fiscal equivalence. The fiscal flows between the individual government levels were not sufficiently transparent and could not be specifically controlled by policy means. With effect from 2008, the cantons and municipalities thus implemented a reallocation of tasks and finances between the Confederation and the cantons, developed in a joint project.<sup>4</sup>

Table 2 shows the breakdown of overall expenditure in the cantons and municipalities in the year of comparison 2006 by main task area according to a functional classification. From the figures, it can be seen that there was substantial overlap among the task areas and thus multiple responsibilities. Alongside Education, the areas of Health and Social Welfare are where most expenditure is made at the level of the canton and municipalities. The latter two task areas show strong momentum, which is also considerably influenced by demographic growth. The cantons' volume of expenditure amounts to approximately one and a half times that of the municipalities.

<sup>4</sup> An important objective of the new fiscal equalization system is to maximize the disentanglement of tasks. Where this is not possible, dedicated forms of cooperation were to be introduced vertically between the Confederation and the cantons. Among the cantons themselves, there is to be horizontal cooperation with equalization of burdens for tasks to be solved jointly. Fiscal equalization itself is supposed to improve the balance of income and spending discrepancies among the cantons with a new instrument. This contributes to resource levelling, on the one hand, and also helps to overcome socio-demographic and topographic differences (Federal Department of Finance, 2007).

Table 2: Expenditure and its breakdown for cantons and municipalities in 2006

	Cantons		Municipalities	
	in CHF k	in %	in CHF k	in %
Total expenditure incl. double entries	71,678,162	100%	45,853,923	100%
General Administration	3,577,736	5.0%	3,920,339	8.5%
Courts, Police, Fire Service	5,669,766	7.9%	2,171,728	4.7%
National Defence	210,059	0.3%	213,496	0.5%
Education	17,862,446	24.9%	9,916,553	21.6%
Culture and Recreation	1,343,655	1.9%	2,630,547	5.7%
Health	13,349,497	18.6%	9,139,875	19.9%
Social Welfare	13,836,695	19.3%	7,567,654	16.5%
Transportation	6,769,577	9.4%	3,419,620	7.5%
Environment and Spatial Policy	1,299,644	1.8%	3,622,183	7.9%
Economy	4,105,792	5.7%	643,111	1.4%
Finance and Taxes	3,653,295	5.1%	2,608,816	5.7%

Source: Federal Finance Administration, 2008

## 2.2. Characteristics of the Canton of Lucerne

With a population of some 360,000, the Canton of Lucerne, lying on the northern rim of the Swiss Pre-Alps, is the sixth-largest of Switzerland's 26 cantons. Around half of its population live in the Lucerne agglomeration. The remainder live in rural areas, some of which also have regional concentrations. In terms of surface area (1,493 square kilometres), Lucerne is the ninth-largest canton. Surrounded by other cantons on all sides, the Canton of Lucerne lies at the geographical heart of Switzerland. It acts as a focal point in Central Switzerland, as reflected in its above-average number of facilities in education (university, technical college), culture (museums, concert halls, orchestras) and healthcare (range of hospitals).

### 2.2.1. Description of the economic situation in the Canton of Lucerne

Thanks to the outstanding quality of its landscape and the wealth of its history, Lucerne is known throughout the world as a tourist destination. The largest firm operating internationally from the Canton of Lucerne is the lift manufacturer Schindler. The canton's industrial sector also includes Switzerland's quality steel industry, as well as firms in the fields of life sciences, foods and timber processing. In the services sector, health insurance companies and the Swiss accident insurance company are based in the canton, as are some leading market research institutes.

Table 3: Employment by economic sector in 2005

	Total	% Sector 1	Ranking Sector 1	% Sector 2	Ranking Sector 2	% Sector 3	Ranking Sector 3
Lucerne	185,321	8.9	9	26.4	19	64.7	10
Switzerland	3,903,878	5.3		25.5		69.2	

Source: Statistical Yearbook of the Canton of Lucerne, 2008, p. 466

Table 3 shows the breakdown of employment by economic sector in the Canton of Lucerne in comparison with Switzerland as a whole.

Compared with the country as a whole, a higher proportion of the working population of the Canton of Lucerne are in the primary sector (agriculture and forestry), which is characterized by a lower level of value creation. In the secondary sector (industry), the workforce is slightly above the national average, whereas employment in the tertiary sector is clearly below the Swiss average. The businesses and structures within the sectors tend to operate at the lower levels of value creation: small farms in the primary sector, traditional production with few high-tech solutions and, in some cases, little export orientation in the secondary sector, and trade and tourism in the tertiary sector (estimates from LUSTAT, Statistical Yearbook, 2008, p. 151ff.). All of these circumstances go towards explaining why income per capita in the Canton of Lucerne, at CHF 43,910, has persistently remained at some 80% of the Swiss average of CHF 54,031 (see Table 4).

### *General economic situation*

The general economic upturn since 2004 was also felt in the Canton of Lucerne (see Table 4). This is evident from the real GDP growth rate, as estimated by BAK Basel Economics. Compared with the national average, however, the economy of the Canton of Lucerne performed below average. In part, this can be attributed to the comparatively non-cyclical sector mix. In terms of unemployment, the Canton of Lucerne is traditionally substantially less affected than the Swiss average. The period under review was one of price stability in Switzerland. During these years, the inflation rate remained within the SNB's target range of 0 to 2%.

*Table 4: Macroeconomic growth 2003-07*

	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Real GDP growth in the Canton of Lucerne*	0.6%	4.0%	1.5%	2.7%	2.6%
Real GDP growth in Switzerland**	-0.2%	2.5%	2.5%	3.4%E	3.3%E
Unemployment rate for the Canton of Lucerne**	3%	3%	2.8%	2.5%	1.9%
Unemployment rate for Switzerland**	3.7%	3.9%	3.8%	3.3%	2.8%
Inflation rate (LIK)**	0.6%	0.8%	1.2%	1.1	0.7
Net cantonal income to factor costs in CHF million, Canton of Lucerne**	14,709	15,073	15,622	n.a.	n.a.
Net cantonal income per capita in CHF, Canton of Lucerne**	41,702	42,592	43,910	n.a.	n.a.
PCI as compared to Swiss average**	81.2%	80.9%	81.3%	n.a.	n.a.

Sources:

\* Estimate by BAK Basel Economics

\*\* Federal Office for Statistics

### 2.2.2. System of government and reform strategies

The Executive Council is the executive body of the Canton of Lucerne, comprising five members. The members of the Executive Council are elected by the citizens for a four-year term of office according to the principles of voluntary proportional representation as a multi-party government. The Executive Council is a collegial body, ruling by majority vote. The President of the Executive Council holds the Chair as *primus inter pares* for a year on a rotating basis. The President is elected by Parliament (the Cantonal Council). Each member of the Executive Council heads one of the five departments: Department of Construction, the Environment and the Economy (BUWD), Department of Education and Culture (BKD), Department of Finance (FD), Department of Health and Social Affairs (GSD), Department of Justice and Security (JSD)<sup>5</sup>. The Executive Council draws up the budget and drafts the annual accounts as well as other accounts. It can pass non-recurrent, unconditional expenditures up to the amount defined by law as well as tied (earmarked) expenditures not included in the budget. In addition, the Executive Council is also responsible for the management of financial assets and the procurement of the resources required for the financing.

The Cantonal Council is the Canton of Lucerne's legislative authority, elected by the people according to the principle of proportional representation. Apart from legislation, the Cantonal Council also has important planning and financial responsibilities. Its financial tasks include setting the budget and the tax rate and ruling on expenditure beyond the remit of the Executive Council, as well as approving the annual accounts and other accounts. The Cantonal Council approves annually the financial and task plan, which it receives from the Executive Council at the same time as the budget. It also handles other planning reports, including the government's legislative programme.

The Canton of Lucerne is now fully run according to the principles of New Public Management. The Cantonal Council rules on a performance budget with a performance contract. The budget components that are binding for all service units are the basic contract and the overall objectives, the performance budgets per service group, the state grants and the investments.

The "Lucerne '99" reform project

In 1997, a thorough and far-reaching 10-year cantonal reform project was undertaken, known as "Lucerne '99". The project covered the canton and the municipalities as well as the relationship between municipalities. At the cantonal level, it entailed reducing the government in size from seven to five members, reducing also the size of Parliament as well as partial privatizations and mergers (courts, schools, hospitals, banks). Concerning the relationship between the canton and the municipalities, a new task allocation was introduced, as well as a new fiscal equalization system (similar to the fiscal equalization between the Confederation and the cantons) and a new understanding of state supervision. Municipalities were to be given greater autonomy and responsibility for themselves and the local structures to be strengthened. This was to be done in part by merging municipalities and improving the cooperation between municipalities, but also by means of internal controlling along the lines of general strategic and operational management. New, mandatory instruments (cost and performance accounting; medium-term financial and task plan; annual programme and annual report, in addition to budget and accounts) were introduced to improve autonomous management within the municipalities. The canton's supervision of municipalities is thus restricted to checking that each one has a controlling system meeting the minimum democratic, constitutional, managerial and financial

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<sup>5</sup> See organizational chart in the Annex.

requirements. The minimum financial requirements in the financial supervision are restricted to certain clearly defined key figures. Only if the municipality fails to meet the minimum requirements does the canton take supervisory measures to resolve the situation.

Some of these reforms have been introduced on a gradual basis, e.g. the new inter-cantonal fiscal equalization came into effect in 2003. Under this new fiscal equalization system, the canton no longer guarantees it will assume the municipalities' deficits, as was previously the case. Now there is a minimum financial provision for all municipalities. In addition, a burden equalization system absorbs municipalities' higher socio-demographic and topographical burdens.

A final major project stage was completed on 1 January 2008 under the name "Financial Reform 08". "Financial Reform 08" introduced the new task allocation (and the associated expenditure allocation) between the Canton of Lucerne and its municipalities. This task allocation was strongly influenced by the one between the Confederation and the cantons, newly introduced at the same time. In addition, "Financial Reform 08" also further optimized the new fiscal equalization system already introduced in 2003. The new task allocation and financial reform were guided by the principle that tasks, competencies and responsibilities were to be assigned to one and the same body whenever possible, i.e. either the municipalities or the canton. For common tasks, which, for material reasons, have to be fulfilled jointly by the canton and the municipalities, the financing is shared proportionately by both sides.

### 2.2.3. The development of cantonal finances

#### *Fiscal performance*

As shown in Table 5, cantonal finances posted steady growth in the period under review between 2004 and 2007. The Operating Statement shows a slight increase of just 3% in expenses, coupled with a marked improvement of 9% in revenue. The Operating Statement showed a surplus of almost CHF 200 million in 2007, whereas, in 2004, revenues practically offset all expenses.

The Statement of Investments for the period under review shows a slight increase of just 3.5% in net investments. However, gross investments grew by some 34%. Meanwhile, investment receipts (third-party investment contributions) increased by a good 80%.

The internal financing ratio increased sharply from 109% in 2004 to 219% in 2007. Internal financing (cash flow) mainly comprises the operating result plus depreciation on the administrative assets<sup>6</sup>. The internal financing ratio shows the ratio between internal financing and net investments. The financing surplus is also gratifying, i.e. internal financing less net investments and less deposits in special financing.

In evaluating the result, it must be remembered that the years 2004 to 2007 were boom years for the economy, with, in Swiss terms, relatively high real growth rates for economic production and low inflation (see Table 4). Looking at the canton's finances for the 1990s and the first half of the current decade, it is clear that the cantonal budget has improved substantially in the past four years.

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<sup>6</sup> Internal financing also takes account of additional deposits into or withdrawals from special financing and depreciation in the case of any financing deficit.

Table 5: Development of the cantonal budget 2004-2007 (in CHF million)

	2004	2005	2006	2007
Operating Statement				
Expenses	3306.4	3348.4	3365.2	3403.5
Revenue	3305.4	3437.9	3497.3	3600.5
Net revenue	-1	89.5	132.2	197.0
Statement of Investments				
Capital expenditure	287.0	297.2	283.3	384.6
Receipts	111.1	131.3	107.4	202.7
Net investments	175.9	165.9	175.9	182.0
Internal financing	191.3	257.7	324.6	398.1
Financing surplus	9.1	103.2	150.0	213.9

Sources: 2008 Statistical Yearbook of the Canton of Lucerne and 2007 State Account

According to the results shown in Table 6, the Canton of Lucerne's net indebtedness was hugely reduced in the period under review. This trend reflects the positive performance of the State Account. The particularly noticeable decline in net indebtedness between 2004 and 2005 is explained by the inflow of extraordinary income worth some CHF 800 million in the form of extra distributions from the Swiss National Bank<sup>7</sup> from the sale of gold inventories (2005 State Account). The net interest charge thus became net interest earnings.

Table 6: Additional key figures on debt servicing and indebtedness

	2004	2005	2006	2007
Net interest charge in CHF million	2.6	-18.0	-17.4	-23.5
Interest charge ratio Net interest charge / Net state tax income	0.3%	-2.1%	2.0%	-2.6%
Net debt in CHF million	2,115.1	1,277.8	1,152.5	973.1
Net debt per inhabitant in CHF	5,964	3,586	3,210	2,679

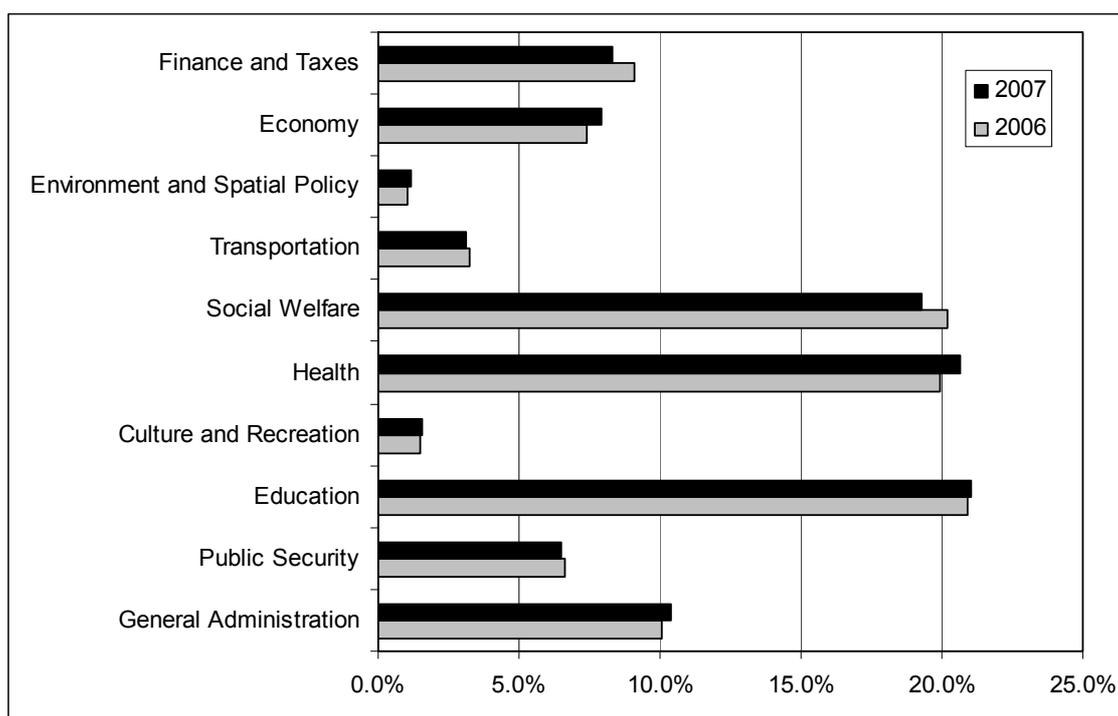
Sources: 2008 Statistical Yearbook of the Canton of Lucerne and 2007 State Account

### Allocation of resources

Figure 2 shows the breakdown of overall expenses by main function of the Canton of Lucerne. The three largest areas, each accounting for some 20% of expenses, are Education, Health and Social Welfare. Education includes cantonal grants to the Volksschule (elementary school, although these are largely financed by the municipalities) as well as vocational schools, cantonal schools, universities and special schools. Health expenses are almost exclusively comprised of grants to hospitals. Social Welfare covers, on the one hand, contributions to the federal social insurance, as well as expenses on social assistance.

<sup>7</sup> Around 55% of the Swiss National Bank (SNB) is owned by the cantons and the cantonal banks.

Fig. 2: Allocation of overall expenses by main function



Data: 2008 Statistical Yearbook of the Canton of Lucerne and 2007 State Account

The function Finance and Taxes comprises grants to the fiscal equalization system as well as asset and debt management. The Economy function primarily covers agricultural expenses. Public Security mainly concerns expenses for the police, the courts and the penal system; Transportation covers mainly expenses for roads and regional public transportation; the Environment and Spatial Policy comprises, apart from spatial planning, other areas such as wastewater treatment, waterways protection and waterway blockages; Culture and Recreation includes spending on cultural institutions such as museums, theatres, etc.

Table 7: Current expenses by economic classification and capital expenditures

	2004	2005	2006	2007
Current expenses from Operating Statement	3,306.4	3,348.4	3,365.2	3,403.5
Wages and salaries	913.3	900.1	890.7	921.6
Goods and services	299.4	322.0	320.3	355.2
Interest payments & depreciation	270.1	256.7	260.0	254.0
Transfers	1,051.7	1,074.1	1,103.8	1,120.1
Others	771.8	795.5	790.3	752.5
Capital expenditures	283.5	293.8	282.1	383.7

Source: 2007 State Account

In the economic classification of Operating Statement expenses, the high level of “Transfers” is particularly noticeable. These are grants to federal social insurance systems, to hospitals and

educational institutions outside of the canton, to municipalities for the elementary school and fiscal equalization, to mixed companies (educational harmonization, public transportation cooperative), to private institutions (homes, vocational schools, culture), to private households (various social welfare benefits) and to the canton's own cultural and educational institutions. "Others" are primarily the transitory contributions, as well as internal charging (offset by internal income) and deposits in special financing and compensation to public authorities. "Wages and salaries" cover salaries, social insurance contributions, uniforms and additional allowances. The fluctuations in this position result from a combination of targeted savings efforts in the years 2005/06 and the "cantonalizations" in education and expansion of hospitals in 2007. These developments in 2007 and the growth of the tertiary educational sector also contributed to raising "Goods and services" in that year. The peak in "Capital expenditures" in 2007 was planned to a certain extent (e.g. the acquisition of large premises for the University and road-construction projects) but also resulted from some unplanned additional expenditures, mainly in road construction, offset by corresponding additional receipts of the Confederation, in particular.

### *Cantonal finances as part of public finances at the sub-national level*

With the Canton of Lucerne's current expenses at CHF 3,365 million and investment spending at CHF 282 million in 2006, this does not by any means show the entire financial scope of the sub-national level within the Canton of Lucerne. For one thing, this does not include Lucerne's municipalities, nor does it include the autonomous entities managed outside of the State Account<sup>8</sup>. In 2006, the Operating Statement expenses for Lucerne's municipalities came to CHF 1,906.3 million, with CHF 199.6 million in investment spending<sup>9</sup>. From the canton's point of view, a complete overview also has to include the following autonomous entities that are not integrated in the canton's Administrative Account<sup>10</sup>: Family Allowance Fund of the Canton of Lucerne with total expenses of CHF 974.2 million<sup>11</sup>, Lucerne Family Allowance Fund for the Self-Employed with total expenses of CHF 6.2 million<sup>12</sup>, the transaction volume of the Cantonal Building Insurance amounting CHF 32.7 million<sup>13</sup> and the transaction volume of the Unemployment Fund of the Canton of Lucerne, which came to CHF 159.5 million in the comparison year.<sup>14</sup>

## **2.3. Description of the legal and institutional framework for PFM**

### *Legal framework*

The legal framework for the cantonal PFM is fundamentally defined by the Public Finance Act (FHG) of the Canton of Lucerne. This framework is further expounded upon through the State Grants Act and the Ordinance on the authorization to dispose of loans and credit decisions. The receipts side is governed by the Tax Act and the Fees Act, both of which are specified by a range of ordinances and supplemented by laws on special taxes (inheritance tax, transfer tax and real estate profit tax), and on tourism duties and royalties. The 2006 Financial Directive passed by the Cantonal Council provides guidance in terms of fiscal policy.

<sup>8</sup> See the observations at the end of the "Legal framework" section below.

<sup>9</sup> Source: Federal Finance Administration: Public Finances in Switzerland, 2006.

<sup>10</sup> See Section 2.3 below.

<sup>11</sup> 2006 Annual Report of the Compensation Fund of Lucerne, p. 20 f.

<sup>12</sup> 2006 Annual Report of the Compensation Fund of Lucerne, p. 37

<sup>13</sup> 2006 Annual Report of the Building Insurance of the Canton of Lucerne, p. 32, of which net profit or reserve deposits of CHF 11.9 million.

<sup>14</sup> Information from the Economy and Labour service unit, Unemployment Fund

The Public Finance Act specifies the layout and presentation of the State Account. Accordingly, this comprises the Administrative Account (Operating Statement and Statement of Investments), the Statement of Financial Position (Balance Sheet) and the Performance Account (Annual Report). The Operating Statement contains the annual expenses for performance of the public contract and the revenue generated during the fiscal year through third-party payments and other asset increases. The Operating Statement is modelled on the profit and loss account used in the private sector and, in addition to direct expenses, also contains depreciation and internal charges (e.g. imputed rent or IT expenses). The Statement of Investments contains capital expenditure and receipts for financial events concerning financial assets with a useful life of more than one year. The financial assets are posted in the Statement of Financial Position at their acquisition or production cost. The market value is only used if it is lower.

In accordance with the FHG, the budget and the State Account meet the criteria of New Public Management. Each service unit shows in the budget and in the State Account the performance contract, the performance budget for each service group, as well as the state contributions, information on financing, on business performance and for all service groups a summary of the expenses and revenue from the Operating Statement and the Statement of Investments. The performance budget, i.e. the balance between expenses and revenue per service group, must be adhered to. The State Account also shows the assets and liabilities of the Statement of Financial Position (Balance Sheet), a breakdown of managed funds, foundations and legacies, an overview of guarantee commitments and contingent liabilities, of guaranteed state contributions and of programme agreements passed with the Confederation.

Special financing is set aside for particular task areas. It is financed by earmarked funds (e.g. lottery proceeds). Special financing is integrated into the Administrative Account and the Statement of Financial Position.

For strategic management, Lucerne's Executive Council draws up a legislative programme and, based on this, as a rolling plan, the Integrated Financial and Task Plan IFTP with a five-year planning horizon. The budget also serves as the first year of the IFTP. The IFTP is broken down by main tasks / task areas and provides an overview of the evolution of expenses and revenue (incl. investments). In a report and a data section, it shows for each task area how the various tasks will develop, which projects have already been passed or planned, and what impact they will have from a financial point of view. By way of a summary, it shows the evolution of the Operating Statement, the Statement of Investments and the state grants as well as the development of the key figures and the tax rate over the planning period. The projects in the financial plan are combined with the legislative objectives. The annual accounts show the extent to which the objectives of the legislative programme and the IFTP have been met.

The FHG is not applied to the Compensation Fund of Lucerne, the Family Allowances Fund of the Canton of Lucerne, the Lucerne Family Allowance Fund for the Self-Employed, the Building Insurance and Unemployment Fund of the Canton of Lucerne.<sup>15</sup> Since 2008, the Lucerne Cantonal Hospital and Lucerne Psychiatric Hospital have not been subject to the FHG either.

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<sup>15</sup> The Conference of Cantonal Financial Directors recommends in the Accounting Handbook for Public Budgets (Vol. I, p. 85) not to include these institutions in the Administrative Account: "Where independent and dependent public institutions in the Cantons fulfil only the task of collecting wage-related contributions for federal insurance purposes and setting or paying annuities or daily benefits, this accounting transfer should not be included in the cantonal budgets (Cantonal Compensation Funds and Family Allowance Funds, Unemployment Insurance)." Building insurance is not regarded as a public task in all cantons. The Handbook thus recommends in the same place that building insurance should not be included in the cantonal accounts, so as to facilitate the comparability of cantonal budgets. - The expansion of the HRM2 (Handbook of the Harmonized Accounting Model from 2008, p. 66), which is planned but not yet implemented, does not call for an obligatory consolidation of these and other institutions.

*Institutional responsibilities*

The Department of Finance is responsible for operational management of the budget. Its tasks include creating drafts of the budget, drawing up the State Account and the IFTP for the attention of the Executive Council, procuring the resources required for fulfilling the cantonal tasks, and securely investing liquid assets. The organizational chart of the Department of Finance in the Annex shows that its area of competence extends far beyond finance alone. In fact, the Canton of Lucerne's Department of Finance should be regarded as a resources department.

The Executive Council presents the Cantonal Council with the legislative programme, the IFTP, the budget and the State Account. It has limited discretionary financial powers, ruling on borrowing, the investment of financial assets and on guarantees. Programme agreements with the Confederation are passed by the Executive Council.

The Cantonal Council deals with the aforementioned planning and accounting reports. It can decide to approve these, in whole or in part, or to reject them, adding its comments. The Executive Council subsequently accounts to the Cantonal Council on the follow-up to the comments. For the budget, the Cantonal Council rules on the performance contract, the performance budget, the state contributions and investments. The other information in the budget is purely for guidance purposes only. Together with the budget, the Cantonal Council also rules on the amount of the tax rate for the budget year.

The service units are responsible for the prudent, efficient, effective and economical use of resources and for performance of their tasks within the scope of their performance budget. They produce cost accounting and investment accounting records.

The Audit function is the highest, independent specialized body of the canton's financial supervision. It supports the Cantonal Council in its supervisory activities of the cantonal administration and courts, the Executive Council, the departments, the State Chancellery and the courts. In particular, it checks that the budget is run in a manner that is orderly, lawful and economical. This includes verifying the State Account, the Internal Control Systems, system tests, project tests, object tests, testing the methodology for profitability and impact accounts and for controlling.

The canton's Tax service unit is responsible for implementing the Tax Act. It works closely with the municipalities in the tax assessment. It issues the directives and orders for a uniform assessment of taxable persons and for a straightforward administrative process, particularly in the exchange of tax-related data between municipalities and the canton.

The municipalities are responsible for the preparatory work required for the assessment of natural persons. They draw up the assessment proposals for natural persons for the attention of the canton's Tax service unit. Self-employed persons and legal entities are generally assessed by the Tax service unit itself. The Tax service unit may grant qualified municipalities the powers to assess all natural persons in its municipality area or certain categories of persons, provided that these municipalities fulfil certain requirements laid down by the Executive Board<sup>16</sup>. The Tax service unit is subject to the supervision of the Department of Finance. The state tax (cantonal tax) is collected by the municipalities at the same time as the municipality tax. The state tax portion is transferred by the municipalities to the canton within a short, defined period of time.

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<sup>16</sup> According to information received from the Tax service unit, over 88% of all cases related to corporate tax were assessed by tax offices with their own assessment powers in the period under review. This will be over 90% from 1 March 2009 on.

### 3. Assessment of the cantonal PFM system, processes and institutions

#### 3.1. Credibility of the budget

Budget credibility is of great importance for the citizens, investors and, of course, for all those implementing the budget. The deviation between the budget approved by the cantonal parliament and actual expenses and revenue is an indicator of the credibility of the budget and thus a good standard for measuring PFM performance at a high level.

**PI 1: Aggregate expenses out-turn compared to original approved budget**

PI 1	Scoring Method M1: In none of the last three years have actual expenses under the State Account deviated from the budget by more than 5%.	A
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(i) Table 8 shows a comparison of actual and budgeted expenses for the years 2005 – 2007. The figures show that the deviations vary in absolute values between 0.5% and 1.3% and are thus very low. Note that the largest deviation (1.3%), in 2007, resulted from actual expenses coming in lower than budgeted expenses.

Table 8: Comparison of budgeted and actual expenses (in CHF million)

Year	Budget*	Accounts*	Deviation (+/-) in %
2005	3,256	3,290	1.0
2006	3,299	3,316	0.5
2007	3,398	3,355	1.3

\* excluding interest payable; Source: Canton of Lucerne, State Account for 2005, 2006, 2007

As specified in the PEFA guidelines, expenses for debt service payments (interest payable) were deducted from both the budget and the accounts. However, even if debt service payments were taken into account, this would not make any major change to the results from Table 8. In any case, the deviations are well within the 5% tolerance range for an A rating.

**PI 2: Composition of expense out-turn compared to original approved budget**

PI 2	Scoring Method M1: The weighted deviation in expense items did not differ from the budget by more than 5% of the total deviation in any of the last three years.	A
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(i) If the budget is to be a useful policy instrument, the composition of actual expenses should not vary substantially from the budget. Table 9 shows the variance of the composition of expenses in the budget for the last three years, according to a functional classification.

Table 9: Deviation of expense items in the budget from those in the State Account (in CHF million)

Functional classification	2005			2006			2007		
	B	SA	(+/-) in %	B	SA	(+/-) in %	B	SA	(+/-) in %
General Administration	338	358	6.1	356	332	6.8	386	355	8.2
Public Security	221	229	3.5	222	223	0.7	227	221	2.7
Education	674	694	2.9	697	706	1.2	732	717	2.1
Culture and Recreation	46	53	13.6	45	51	13.0	45	54	20.4
Health	632	640	1.2	664	672	1.2	684	702	2.7
Social Welfare	684	684	0.0	717	682	4.8	693	656	5.2
Transportation	113	105	7.0	107	109	2.0	111	105	5.0
Environment and Spatial Policy	27	31	15.5	36	34	5.0	37	40	9.2
Economy	239	243	1.9	240	250	4.2	254	269	6.2
Finance and Taxes <sup>1</sup>	283	254	10.3	217	259	19.3	230	235	2.5
Total <sup>1</sup>	3,256	3,290	1.0	3,299	3,316	0.5	3,398	3,355	1.3
Weighted average deviation			3.3			4.2			4.3
<b>Difference:</b>									
<b>Weighted – Total deviation</b>			<b>2.3</b>			<b>3.7</b>			<b>3.1</b>

<sup>1</sup> excl. interest payable: B = Budget, SA = State Account

Source: Canton of Lucerne, State Account for 2005, 2006, 2007

Overall, the weighted deviation of the individual expense items varied between 3.3% in 2005 and 4.3% in 2007. The difference between the weighted and the total deviation, of relevance for assessing this indicator, is even smaller. The maximum difference was 3.7% in 2006, which clearly lies within the limit for a score of A for this indicator.

When analysing the individual expense items, it can be seen that actual expenses on “Culture and Recreation” deviated substantially from the budget every year in the period under review. However, this deviation is not so serious as, in absolute terms, these are relatively small differences in each case. Nonetheless, the reasons for such systematic underestimation of the expenses in this area need to be further analysed.

Another point of note, this time more positive, is the fact that actual expenses for “General Administration” fell below the budgeted figure in both 2006 and 2007. Expenses on this item of the budget were even reduced slightly between 2005 and 2007.

The Public Finance Act governs further and supplementary credit. During the period under review, the level of further credit was very low and had no major impact on the credibility of the budget (cf. PI 16, iii). Overall, therefore, the budget is a very reliable planning instrument.

**PI 3: Aggregate revenue out-turn compared to original approved budget**

PI 3	Scoring Method M1: Actual revenue collection as per the State Account was substantially above the budgeted estimates and thus above the PEFA threshold of 97% in each of the last three years.	A
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Table 10 shows actual revenue compared with the approved budget, classified by the various revenue types. Only the revenue under the canton's direct influence is included<sup>17</sup>. The calculation does not incorporate the following revenue types:

- unconditional grants (federal receipts)
- reimbursements from public authorities (Confederation, cantons, municipalities, authorities abroad)
- own contributions from the Confederation, cantons, municipalities and others
- transitory contributions from the Confederation, municipalities and private institutions

Furthermore, revenues from internal charging are not included either, as these do not generate any additional revenues for the canton.

Table 10: Aggregate revenue out-turn compared to original approved budget (in CHF million)

	2005			2006			2007		
	B	SA	in %	B	SA	in %	B	SA	in %
Taxes	1,029	1,022	99	987	1,039	105	1,008	1,080	107
Income tax and wealth tax	759	748	99	731	733	100	737	774	105
Profits tax and capital levy	118	125	106	114	154	135	123	142	115
Land tax	11	11	106	11	12	113	12	13	105
Capital earnings tax	11	14	124	11	15	137	15	18	122
Asset transfer taxes	22	24	109	22	28	124	24	31	129
Inheritance taxes	12	15	122	12	12	97	13	16	128
Property and expense taxes	94	82	88	85	84	100	85	86	101
Royalties and licences	17	20	119	18	24	133	19	26	140
Investment income	81	106	131	79	124	157	113	135	120
Remunerations	508	563	111	552	581	105	569	624	110
Withdrawal from special financing	13	25	198	16	22	140	4	8	226
<b>Total</b>	<b>1,648</b>	<b>1,737</b>	<b>105</b>	<b>1,653</b>	<b>1,792</b>	<b>108</b>	<b>1,711</b>	<b>1,873</b>	<b>109</b>

<sup>1</sup> excluding unconditional grants and contributions (federal receipts), reimbursements from public authorities, own contributions from the Confederation, cantons, municipalities and others, transitory contributions from the Confederation, municipalities and private institutions, internal charges, disposal of tangible assets, third-party loan repayments

B = Budget, SA = State Account

Source: Canton of Lucerne, State Account for 2005, 2006, 2007

As can be seen in Table 10, the budgeted revenues were clearly exceeded in all three years. Revenues were higher than forecast for almost all revenue types. Despite the fall in the applicable tax rate for 2006, tax revenues were some CHF 12 million higher than in 2005. Thanks to the favourable economy, tax revenues rose again in 2007.<sup>18</sup>

<sup>17</sup> The PEFA guidelines for the sub-national government level specify that transfers from central government (Confederation) should not be included in the assessment of Indicator 3.

<sup>18</sup> Canton of Lucerne (2008): 2007 State Account, p. 83

**PI 4: Stock and monitoring of expenditure payment arrears**

PI4	<p>Scoring Method M1:</p> <p>(i) At 0.45%, the stock of arrears at end-2007 is clearly below the threshold of 2% (A).</p> <p>(ii) The canton does not systematically monitor all accounts payable. Data on individual cantonal institutions, such as the hospitals, is not recorded in SAP and thus escapes the routine control. (B)</p>	(B+)
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The Canton of Lucerne was regarded as a poor “payer” for many years and thus came under political pressure to improve its observance of payment deadlines. The situation on payment deadlines for 2007 is assessed using sub-indicators on (i) the stock of payment arrears and (ii) the availability of data for monitoring the stock of expenditure payment arrears.

(i) At the end of 2007, there were 1522 arrears, i.e. payments for which the payment deadline had already passed. The arrears amounted to a total of CHF 9.19 million (cf. Table 11). This corresponds to some 0.45% of the accounts payable recorded in SAP in 2007<sup>19</sup>. Moreover, of the 1522 arrears, 1258 (CHF 5.68 million) were overdue, i.e. more than five days late, according to the definition used by the Canton of Lucerne. In 2007, the average delay of all accounts payable recorded in SAP was approximately 4.5 days. This was an improvement of 1.5 days compared with 2005 and 0.4 days since 2006. With an average delay of 12.2 days, the items for immediate payment were the worst by far in 2007. In part, this results from the imprecise input of deadlines for internal payments<sup>20</sup>. There were no outstanding items at the end of 2007 in terms of wages and salaries, annuities and rental.

Table 11: Stock of arrears at end-2007 (in CHF million)

Year	Total accounts payable entered in SAP in 2007	Total stock of arrears as at 31 December 2007	Arrears/Total expenditure (%)	Average delay in 2007 (days)
2007	2,051.24	9.19	0.45	4.5

Source: Canton of Lucerne, SAP analyses

At 0.45%, the stock of arrears is well below the PEFA threshold of 2% for an A score. Given the extent of outstanding items for payments not entered in SAP, amounting to some CHF 40 million, it can be assumed that the threshold would still not be met even if the unrecorded payments were included<sup>21</sup>.

(ii) Data on the observance of payment deadlines and on the stock of arrears is generated continually. The following analyses of payments recorded in SAP are routinely conducted:

- Monthly: Due-date analysis of outstanding items per “company code”
- Quarterly: Calculation of average delay

<sup>19</sup> Payments of hospitals, courts, the road traffic office and special-needs schools are not recorded in SAP. Neither are wages and salaries recorded in SAP. Wages and salaries are paid on the 25<sup>th</sup> of each month (or the preceding weekday). In the past few years, these have never been late by more than one day.

<sup>20</sup> According to Ms S. Weber, Head of Accounting, this problem had been identified. New guidelines for handling payment conditions were thus entered under Accounts Payable in SAP.

<sup>21</sup> Outstanding items worth some CHF 140 million were entered in SAP. However, of this, only CHF 9.19 million was due.

- End of year: Calculation of the average delay for each payment condition

For dealing with accounts payable, three binding directives were drawn up:

- Directive on the Internal Control System (ICS), sub-section of Accounts Payable
- Directive on dealing with payment conditions in SAP Accounts Payable
- Directive on the ICS, monthly controls for the sub-section of Accounts Payable

The cantonal Department of Finance does not systematically conduct assessments concerning observance of due dates for payments that are not recorded in SAP. The checking of payment deadlines is thus incomplete. In accordance with the PEFA criteria, the fact that the analysis is incomplete results in a score of B.

### 3.2. Interdisciplinary issues: Comprehensiveness and transparency

#### *PI 5: Classification of the budget*

PI 5	<p>Scoring Method M1:</p> <p>The budget formulation and execution is based on administrative, economic and functional classification. The functional classification does not follow the COFOG standard but the Swiss HAM model, which is largely compatible with COFOG. The budget for the Operating Statement is presented at two levels in the functional classification, and just one level for the Statement of Investments. Rating: B.</p>	B
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The budget of the Canton of Lucerne is presented in accordance with the requirements of both the Harmonized Accounting Model<sup>22</sup> and the NPM. With the budget presented according to the NPM criteria, it provides, in addition to the financial data, key information on the performance contract and on the targets of each service unit and on their business performance. The budget on the Administrative Account is presented differently for the Operating Statement and the Statement of Investments. Both the Operating Statement and the Statement of Investments use an administrative classification based on the structure of the administration, an economic classification and a functional classification. The functional classification contains 10 main functions at the first level. For each main function, the budget of the Operating Statement is broken down into sub-functions (second level). In the Statement of Investments, however, the budget is not broken down at the second level. The economic classification and the functional classification are laid down in the Harmonized Accounting Model. The Harmonized Accounting Model was developed for the Swiss cantons and municipalities in the 1970s and gradually introduced at the sub-national level until becoming standard practice for all cantons and municipalities.

<sup>22</sup> Cf. Conference of Cantonal Financial Directors. (1981). Handbook of Accounting for Public Budgets. Vol. I and Vol. II. Berne. Paul Haupt.

Strictly speaking, the functional classification according to the HAM does not correspond to the COFOG<sup>23</sup> classification, which is why an A score would be doubtful. However, it does at least reflect the same logic as COFOG, classifying tasks according to similar task areas. It should be largely possible to allocate the HAM accounts to COFOG accounts. For instance, COFOG has a main function called “06 Housing and community amenities”. According to the HAM, “Social Housing” is a sub-function of the main function “05 Social Welfare”. Also, although the HAM does not have the main function “02 Defence”, it includes under the main function “01 Public Security” the two sub-functions “15 Military Defence” and “16 Civil Defence”. Furthermore, PEFA would require a two-level budget classification for an A score, which is not the case with the Statement of Investments.

As the functional classification using HAM still reflects the COFOG classification to a certain degree, the rating is B.

**PI 6: Comprehensiveness of information included in budget documentation**

PI 6	Scoring Method M1: The available budget information is very user-friendly and transparent. Only a little information on the macro-economic assumptions is missing from the budget documents. The information on debt and assets is in the State Account. Rating: A.	A
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The budget of the Canton of Lucerne is embedded in the Integrated Financial and Task Plan (IFTP). The Executive Council submits the IFTP to the Cantonal Council at the same time as the budget. The macro-economic framework conditions on the budget are explicitly set forth in the IFTP. The information requirements as per PEFA are met as follows:

1. Macro-economic assumptions: The IFTP and budget are based on explicit assumptions with respect to GDP and inflation (Budget, p. 23; IFTP, p. 6), but on the economic growth at national level and not cantonal level, as required by PEFA. It must be noted, however, that Switzerland does not have any official GDP and inflation forecasts for individual cantons. (Furthermore, at the IFTP 2007 meeting, Lucerne’s Cantonal Council decided – in a comment on the IFTP – not to use a separate wage index for Lucerne and, in future, to follow the national index for consumer prices.) There are also some assumptions missing in the IFTP and in the budget on the evolution of exchange rates. The first criterion is thus not met in full.

2. and 3. The budget assumes a budget surplus.<sup>24</sup> Criterion 2 (information on fiscal deficit) and Criterion 3 (information on deficit financing) therefore do not apply. Criteria 2 and 3 are not relevant.

4. The budget does not include any information on the cantonal debt stock at the beginning of the current year. The information on debt is in the Statement of Financial Position, however, which was presented in the spring of the current year in the previous year’s State Account. Criterion 4 is thus met.

<sup>23</sup> COFOG: International UN standard on the classification of the functions of government.

<sup>24</sup> 2008 state budget, p. 6.

5. The Statement of Financial Position presented in association with the State Account for the previous year contains in the Annex a detailed list of financial assets at the end of the previous year. The detailed information on the financial assets is certainly available in dealing with the budget and easily accessible to all interested parties, but is missing from both the budget and the IFTP. Criterion 5 is thus met.

6. The prior year's budget out-turn is presented in the budget document in the same format as the new budget proposal. This is the case for the Operating Statement, the Statement of Investments and the Financing Statement as well as the performance budget by service group for the service units. Criterion 6 is thus met.

7. The current year's budget is presented in the budget document in the same format as the new budget proposal. This is the case for the Operating Statement, the Statement of Investments and the Financing Statement as well as the performance budget by service group for the service units. Criterion 9 is thus met.

8. The budget is presented for both the Operating Statement and the Statement of Investments according to the administrative classification, the economic classification and the functional classification, compared in each case with the current year's budget and the prior year's out-turn. The same applies for the performance budgets. In all cases, both the expenses and revenue (or capital expenditure and receipts) are entered. Criterion 8 is thus met.

9. The budget presents the financial implications of new or modified policy initiatives, in detail and as a summary.<sup>25</sup> The information part of the performance budget shows further details. Criterion 9 is thus met.

Result: Six out of seven relevant benchmarks are met. Extrapolated to nine criteria, this results in a score of 7.7, which corresponds to an A rating.

***PI 7: Extent of unreported government operations***

PI 7	Scoring Method M1: (i) The level of extra-budgetary expenditure is insignificant. Special financing and special accounts are integrated into the budget and the State Account. Rating: A.  (ii) Not relevant	A
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(i) Dimension (i) calls for any extra-budgetary activities financed by extra-budgetary funds or unbudgeted receipts to be of no significance, or for any sizable expenditure in extra-budgetary activities to be posted in the financial reports.

The Canton of Lucerne currently has only a small level of funds for its own purposes, i.e. in the areas of education and culture as well as social welfare. The assets at the beginning and the end of the fiscal year and the receipts and expenditure of these funds during the fiscal year are listed in the Annex to the State Account. However, the total spending of all funds together, at around

<sup>25</sup> 2008 state budget, p. 24-29.

CHF 87,900, is completely insignificant in comparison with the overall budget (the Operating Statement alone is around CHF 3.4 billion).

The “special financing” (earmarked receipts with a clearly defined purpose laid down by law, e.g. lottery funds) is integrated into the budget and the State Account, as are liabilities for special accounts (particularly for the canton’s pension fund commitments for its staff).

The rating for Dimension (i) is A.

(ii) The Canton of Lucerne does not have any donor-financed projects.

Dimension (ii) is not relevant.

The overall rating for both dimensions is A.

**PI 8: Transparency of inter-governmental fiscal relations**

PI 8	<p>Scoring Method M2:</p> <p>(i) Four transfers alone make up more than 91% of all transfers to the municipalities. For all of these allocations, the requirement of a transparent and rules-based system is met. Rating: A.</p> <p>(ii) The canton’s financial information to municipalities is not sent to all municipalities before the start of their detailed budget process, although it is sent ahead of completing their budget proposals. Rating: B.</p> <p>(iii) As the municipalities’ financial statistics show actual values only, the rating here is C.</p>	B
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Indicator 8 refers to the transparency of the financial relations between the canton and municipalities. It includes only top-down transfers and not those made the other way around.

(i) The first dimension checks whether the allocation of the canton’s funds to the individual municipalities is made according to clear rules. For a score of A, at least 90% of the allocations must be made according to transparent and rules-based systems.

The allocations to the municipalities can be derived from the State Account. Each service unit lists here the overall total of its outgoing transfers and breaks it down by recipient. The overall total of transfers to the municipalities came to CHF 343.7 million in 2007. Table 12 below shows the most important transfers to the municipalities and comments on their rules systems.

Table 12: Overview of the most important transfers to the municipalities and their rules systems

Type	Rules system	Amount in CHF million	Percentage of overall total
Fiscal equalization	Equalization is made according to a clear but complex rules system. The rules are defined in the law on the fiscal equalization system and the associated ordinance on fiscal equalization. The municipalities can verify the transfers ex post. An accurate ex-ante calculation from the municipalities' point of view is not possible, however, on account of the variability of some key bases of assessment (most recent developments for all municipalities in terms of resource potential and socio-demographic indicators). For medium-term financial planning, the municipalities must thus rely on their own estimates. Transparency does exist, however, as the calculations are disclosed and checkable.	162.9	47.4%
Elementary school	The elementary school system is what is known as a common task, performed jointly by the municipalities and the canton. The canton contributes to financing with graduated per-capita grants for pupils at the various education levels. The extent of the grants is adapted annually to the expected change in costs for the coming year. Each year, the relevant department and Lucerne's Association of Municipalities engage in talks to this end. The per-capita grants are fixed in accordance with the Elementary	126.8	36.9%
	School Act such that the municipalities bear a total of 77.5% and the canton 22.5% of the operating costs. The grants for each		

	municipality are calculated according to the number of pupils at each level of schooling in the municipality and the corresponding per-capita grants. The formula used is simple and transparent.		
Transitory contributions of the cantonal social security office	Charging for social security payments to municipalities outside of the canton as per §33 Social Security Act and §18f. Social Security Ordinance and based on the federal law on the responsibility to support the needy. The canton operates as a clearing house. The municipalities know what they can charge and receive back. <sup>26</sup>	17.5	5.1%
Grant to the Local Public Transport system	The members of the Local Public Transport association are the municipalities in the agglomeration of Lucerne and the Canton of Lucerne. The Local Public Transport system runs the public transport service for the agglomeration. The deficit is borne by the association members in accordance with the clearly defined cost allocation system. In 2007 the canton's grant was set at 20% under the law on the public transport system for the agglomeration. The municipalities together assume 80% of the deficit. The state grant is thus made under a transparent and rules-based system.	5.8	1.7%

The above four cantonal contributions alone account for 91.1% of the overall total of cantonal contributions to the municipalities. All four cantonal grants meet the requirement of transparent and rules-based systems. Dimension (i) thus has a rating of A.<sup>27</sup>

<sup>26</sup> Information: Cantonal social security office

<sup>27</sup> This needs to be put into perspective, however. The cantonal fiscal policy can create problems in two ways at the level of local finances. First, gradual tax alleviations, as the canton has considered and is still envisaging as an answer to the tax competition between cantons, result in losses in the tax base, for the municipalities too, without all municipalities then being able to offset such losses with greater economic growth and an increase in the number of new, good taxpayers. Secondly, cantonal savings packages could result in municipalities having to bear additional burdens. In view of the revision of the Tax Act in 2011, the Association of Municipalities of Lucerne has, as already in previous years, expressed the municipalities' fears in this respect and its thoughts on a municipality referendum (VLG-Newsletter, 9/08).

(ii) The second dimension looks at whether the municipalities receive reliable information on the cantonal grants in sufficient time to be able to integrate this information early enough into their local budget formulation process.

In June, the municipalities receive an order on the fiscal equalization payments for the following year. They receive further information on the volume of the cantonal grants on a step-by-step basis. The first information is given at the end of April, with more at the start of July and possibly more still at a later stage.<sup>28</sup>

Not all municipalities commence their budget formulation process at the same time. For some of the smaller municipalities, an information deadline by the start of July is just in time before they start their detailed budget formulation process. The larger municipalities, however, start their budget formulation process considerably earlier than that. The City of Lucerne is probably the first municipality to start the budget cycle, starting its draft budget in early March; the detailed budget formulation process for the City of Lucerne is carried out between the start of May and the end of October.

An A rating for Dimension (ii) would require the canton's budget information to be sent to the municipalities before commencement of the detailed budgeting phase in the municipalities. This condition is not met for all municipalities. However, the information system does sufficiently meet the requirements for a B score, as the cantonal budgeting information on the cantonal grants does reach the municipalities before they complete their budget proposals.

(iii) The third dimension relates to the overall picture of the municipalities' finances. The question here is how soon and how complete the canton collects and reports the information on receipts and expenses at municipality level in a consolidated format and whether they present both the budgeted amounts as well as the account out-turns.

According to the law on municipalities, the Cantonal Council presents the accounts to the voting citizens (or the local parliament, where this exists) no later than June. The data on the municipality financial statements is then forwarded by the municipalities to the Statistics Office of the Canton of Lucerne (LUSTAT). The Statistics Office conducts plausibility checks during the summer, together with the Regional Governors. The local accounts are then consolidated by LUSTAT. Preliminary results are available online by end-October at the latest. The complete, detailed report contains, in addition to information on how the financial figures have evolved, an illustration of spending growth in accordance with a functional classification and an economic classification. The detailed report is available in electronic format by the end of the year. However, the information assessed refers only to the account figures and not also to budgeted amounts.<sup>29</sup>

With respect to the information on the actual figures (account figures), the requirements for an A score are practically met. The information is available in October, i.e. approximately ten months after the end of the fiscal year. However, as the budgeted figures are not included in the report, only a rating of C can be given. This score requires that the consolidated local financial data be collected within 24 months of the end of the fiscal year with respect to the actual values for at least 60% of the overall volume. The requirements for a C score are thus met.

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<sup>28</sup> The Department Secretariat of the Department of Finance points out that the canton organized budget information events for the municipalities in the period from end-May to the start of June. According to this information, it is not possible to draw up the budget information any sooner as the necessary data is not yet available, specifically as a result of dependencies on the Confederation.

<sup>29</sup> Information: LUSTAT.

Using Scoring Method M2, the overall rating for all three dimensions, with individual ratings of ABC, is B.

***PI 9: Oversight of aggregate fiscal risk from other public sector entities***

PI 9	<p>Scoring Method M1:</p> <p>(i) The autonomous government agencies (AGAs) and public enterprises (PEs) submit fiscal reports annually. A risk assessment is currently conducted but is not consolidated. (C)</p> <p>(ii) As the canton is not liable for the liabilities of municipalities, the rating here is A.</p>	C+
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(i) Dimension (i) looks at the manner in which the canton monitors the fiscal risk of AGAs/PEs and the extent to which the canton presents these risks periodically in a consolidated report.

In December 2007, the Executive Council of the Canton of Lucerne passed the Participation and Grant Controlling Plan (Controlling Plan) for the monitoring and control of outsourced cantonal tasks<sup>30</sup>. In addition to ensuring the basic provision and the strategic management of the participations and creating transparency of these participations, this Plan also seeks to systematically record the political and financial risks incurred with the participations / grants. The Plan calls for graded controlling instruments, according to the intensity of the canton's influence, with five groups being defined: 1. Service units of the canton, 2. Majority participations, 3. Minority participations and concordats, 4. Contractual service providers and external grant recipients, 5. Other participations of primarily financial interest. The higher the level of cantonal influence, the more directive the guidelines can be on participation.

The first group, the service units, are not subject to participation and grant controlling. For majority participations (second group), the following documents must be provided to the Executive Council after completion of the fiscal year: Report from the Board of Directors or the Institution Board on the attainment of strategic targets; Annual Report (minimum content as defined in company law); Auditor's Report; Internal Audit Report on any assessments conducted specific to financial supervision. For minority participations (third group), a distinction is made between financial participations and concordats. In the case of concordats, the overall Executive Council has, in principle, no controlling powers. It assumes these indirectly via a delegated member in the Concordat Council. Financial participations / participations of a primarily financial interest (fifth group) are monitored outside of the Department of Finance's participation and grant controlling. The controlling of grants to contractual service providers and external recipients (fourth group) falls under the remit of the Department of Finance.

The Controlling Plan states that a risk analysis is conducted for the participations in each group, with financial and political risks being taken into account, as well as the canton's influence and the degree of freedom for the task obligation. The risk assessment is conducted using the two dimensions of probability of occurrence of the event and potential damage. Finally, the Plan contains a cantonal participation overview, reviewed on a rolling basis.

<sup>30</sup> Minutes No. 1630 of the Executive Council meeting held on 13 December 2007. The minutes outline the essential features of the Participation and Grant Controlling Plan. The Plan itself is not available for viewing.

A rating of A would require that all AGAs/PEs submit a report on the revised end-of-year reports at least half-yearly and that a consolidated report on the fiscal risk assessment be published annually. A B rating calls for the revised reports to be submitted annually. This annual reporting is envisaged for the majority participations. The Lucerne Pension Fund also draws up quarterly reports.<sup>31</sup> Moreover, the B rating calls for an annual consolidated report on the fiscal risks. The Plan described envisages a participation overview, in which<sup>32</sup> risk assessments on the participations are also offered<sup>33</sup>. However, a consolidation of the risks is not part of the participation overview. The rating is thus C, as the consolidation of the fiscal risks for AGAs/PEs is missing or incomplete. Nonetheless, it should be noted that, in accordance with the Participation and Grant Controlling Plan, the canton assesses risks beyond the group of these majority participations and thus monitors political as well as financial risks (e.g. with respect to security of supply). Rating: C.

(ii) Dimension (ii) highlights the canton's fiscal monitoring of the municipalities and the cantonal liability. The Canton of Lucerne's financial supervision of the municipalities calls upon the municipalities to meet certain minimum requirements (Municipalities Act §102 (1c)). The minimum requirements include that the budget and the annual programme, the financial and task plan and the accounts and the annual report should be compatible with the higher-level law, particularly with the bookkeeping requirements and the requested key figures. The minimum requirements also specify that certain key figures be adhered to, so as to ensure the municipality a sound financial budget. Only if these minimum requirements are not met does the canton take supervisory measures to remedy the situation. The minimum requirements and any supervisory measures are stated in the Municipalities Act (§103 (2)). The canton deliberately does not wish to exercise any financial supervision that goes into detail. This would contravene the principle of the municipalities' autonomy, as set forth in §68 (2) of the cantonal constitution. The municipalities' own financial responsibility is associated with this high local autonomy status. Any liability by the canton would go against the system and is not envisaged.

The Canton of Lucerne has never had a case of a municipality becoming bankrupt. However, such a case did occur in the 1990s in the municipality of Leukerbad in the Canton of Valais. The municipality had expanded its tourism infrastructure far beyond its financial means and was heavily indebted until becoming completely insolvent. The auditor of the Canton of Valais had neglected its responsibility. In a ruling that was unique of its kind, the Swiss Federal Supreme Court decided in 2003 that the Canton of Valais could nonetheless not be held liable as there was no causal relationship between the municipality's insolvency and the fact that the auditing had been negligent and, in particular, as the canton did not give any guarantee. With this ruling, the Federal Supreme Court essentially confirmed the municipalities' responsibility for their own finances, even though the relationship between a canton and its municipalities in terms of cantonal supervision differs from one canton to another.<sup>34</sup>

As the business activities of Lucerne's municipalities cannot result in any liabilities for the Canton of Lucerne, the rating for Dimension (ii) is A.

Using the Scoring Method M1 and a rating of C for Dimension (i) and A for Dimension (ii), the overall rating is C+.

### ***PI 10: Public access to key fiscal information***

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<sup>31</sup> Written information from B. Elmiger, Department of Finance, in an e-mail sent on 18 December 2008

<sup>32</sup> Document not consultable for the analysis.

<sup>33</sup> Information from B. Elmiger, Department of Finance, 17 Dec. 2008.

<sup>34</sup> Fiscal Inspection of the Canton of Valais (2006): Reorganization of the Municipality of Leukerbad.

PI 10	<p>Scoring Method M1:</p> <p>Elements of information available: i, iii, vi, vii.</p> <p>Elements not available: ii, iv, v.</p> <p>Four out of seven elements are available to the public. Rating: B.</p>	B
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(i) A complete set of information on the draft budget is posted on the website of the Canton at the time of its submission to parliament. The adopted budget is also immediately published on the cantonal website.<sup>35,36</sup>

(ii) In-year reports (extrapolations) are used for internal control purposes and are not destined for the public.<sup>37</sup>

(iii) The State Account is put online at the time of its submission to Parliament in the second half of March.<sup>38</sup> The State Account is a comprehensive, highly informative document comprising 448 pages.<sup>39</sup>

<sup>35</sup> The budget (online: [http://www.lu.ch/index/finanzen/fd\\_voranschlaege.htm](http://www.lu.ch/index/finanzen/fd_voranschlaege.htm)) is a comprehensive document of 290 pages. The first pages of the budget contain a summary outline of the budget for the Operating Statement and the Statement of Investments, both using an economic classification, and the Financing Statement as well as the development of the relevant financial figures with a brief explanation. In addition to the Cantonal Council's ruling on the budget itself and on the amount of the cantonal tax, the budget also contains a detailed, easy-to-read report section, as well as the service agreements of the service units with the performance budgets for their service groups, the budgets according to the administrative classification, the economic classification and the functional classification (in each case for the Operating Statement and the Statement of Investments). The Annex provides information on the workforce, apprentices and student interns, an inventory of construction investments and a glossary.

<sup>36</sup> Information: U. Hangartner, Staatskanzlei.

<sup>37</sup> Information from B. Elmiger, Department of Finance, in an e-mail sent on 18 December 2008

<sup>38</sup> Information: U. Hangartner, Staatskanzlei

<sup>39</sup> State Account online: [http://www.lu.ch/index/finanzen/fd\\_staatsrechnungen.htm](http://www.lu.ch/index/finanzen/fd_staatsrechnungen.htm). The first pages of the State Account contain a summary outline of the State Account for the Operating Statement and the Statement of Investments, both using an economic classification, and for the Financing Statement and the Balance Sheet as well as an overview of the development of the relevant financial figures with a brief explanation. The following section first contains the Executive Council's annual report. This consists of a brief comparison of the targets with the actual legislative programme, a detailed report on the objectives as per the Integrated Financial and Task Plan (IFTP) (with linkage to the legislative programme) and measures that have been planned in this and implemented in the meantime. The State Account also contains a report on the administrative relief for small and medium-sized companies. This is followed by the draft of the Cantonal Council's ruling on the approval of the State Account, the draft of the Cantonal Council's ruling on the closure of motions and postulates (which are listed individually, classified by department). Then comes the actual report on the State Account with a brief appreciation of the results and a graphic analysis of the development of the relevant financial figures, an evaluation of the result, the explanation for the envisaged utilization of the surplus income and an outlook of the future. The Cantonal Council's comments on the previous year's State Account and on the current IFTP are also reproduced. To conclude, the State Account is analysed and explained in further detail.

The next section presents the annual report of each individual service unit. The presentation is geared to the information requirements under the New Public Management.

The actual Administrative Account first gives a summary of the Financing Statement, then the Operating Statement and the Statement of Investments using the administrative classification, the economic classification and then the functional classification, with the first and the second level being shown. This is followed by the

(iv) The service units and departments are audited by the internal Audit function of the Canton of Lucerne. The Audit function's reporting is conducted in accordance with the Audit Act as follows: The inspection results are forwarded to the audited body, the Department of Finance, the relevant department or the State Chancellery or the court of jurisdiction. The Audit function reports at the end of the year (interim report) and the end of May (activity report) in turn to the Executive Council, the Planning and Finance Committee and the courts, if these are concerned. The report contains the audit activity and the key findings and assessments. The Audit function's work is audited at least every four years by an external audit firm chosen by the Cantonal Council. The internal Audit function's reports and the external audit firm's report are sent to the Executive Council and to the Cantonal Council's Planning and Finance Committee but are not made available to the public.

(v) Contracts awarded to external providers are not accessible to the public.<sup>40</sup>

(vi) The resources made available to service units can be derived from the budget or the State Account. Both of these documents are available online. See (i) and (iii).

(vii) The fees and charges are found in the document "Fees and Charges for the State Administration". This document is continually updated whenever changes become effective.<sup>41</sup> It can be found online under no. 680 in the Canton of Lucerne's Systematic Legal Collection.

Four of the seven types of information are available to the public. The rating is B.

### 3.3. Policy-based budgeting

#### *PI 11: Orderliness and participation in the annual budget process*

PI 11	<p>Scoring Method M2:</p> <p>(i) The budget calendar gives the departments five weeks to draw up their detailed budget after receipt of the budget circular. PEFA regards this deadline as reasonable, though not ideal. Rating: B.</p> <p>(ii) The budget circular is passed by the Executive Council and specified in quantitative terms for each department and for the State Chancellery and the courts with respect to the Operating Statement and the Statement of Investments. Rating A.</p> <p>(iii) The budget has been approved on time in each of the past three years. Rating: A.</p>	A
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Balance Sheet, which is supplemented by the list of guarantee commitments and contingent liabilities, the list of securities and the developed and undeveloped sites, the objects in the administrative assets and a list of debts.

The Annexes to the State Account comprise a cash flow statement, credit transfers (as pre-financing for planned investments), a checklist of special credits (special credits are extended by a decree or Cantonal Council ruling for unconditional expenses / capital expenditure in the case of any multi-year projects), an overview of the workforce (existing and planned positions) and information on the number of apprentices and student interns.

Finally, the content of closed motions and postulates is given. A glossary and a list of the service units/company codes are found at the end of the State Account.

<sup>40</sup> Information from B. Elmiger, Department of Finance, in an e-mail sent on 18 December 2008

<sup>41</sup> Information U. Hangartner, Staatskanzlei

Normally it is up to the Department of Finance to drive the budget formulation process and keep it on track. However, it is important for the entire government to steer this process with clear guidelines, firmly anchored in the state's overall strategy, and that the departments and their service units have sufficient time and opportunities to contribute their expertise to the budget formulation process and to be able to plan their area as autonomously as possible within the scope of the guidelines. Thus, ideally, the budget formulation process contains both top-down as well as bottom-up planning elements, and these are coordinated by the Head of Finance.

(i) The first dimension verifies the existence of a well-planned budget calendar and asks whether this calendar gives the departments involved and their service units sufficient time to contribute to the budget formulation process.

The Canton of Lucerne does have a budget calendar, which is planned rigidly and in detail. The departments and their service units are included in the budget formulation process in three cycles:

Cycle 1: Draft budget. The departments are requested on 21 January to draw up their draft budget. These draft budgets have to reach the Department of Finance by 7 March.  
Cycle 2: Detailed preparation of the new performance contracts and the performance budgets in the service units. On 15 April the budget circulars to the departments are approved by the Executive Council and then made known to the departments. On 21 May, the performance contracts/performance budgets have to be submitted by the implementing departments to the Department of Finance.  
Cycle 3: Two rounds of budget talks between the Department of Finance and the implementing departments. Start date: 2 June, end date: 13 June. An A rating means that there is a clear budget calendar and that the implementing departments and service units have at least six weeks to draw up their budget input in detail after receiving the budget circular. At least four weeks are required for a B rating. The deciding point is the amount of time given to the departments and their sub-units in Cycle 2. The budget calendar allows a total of 36 days, which corresponds to a good five weeks. PEFA regards this as reasonable but not ideal; it is too short for an A rating, so the rating is B.

(ii) In two preparatory phases, the departments as well as the State Chancellery and the courts receive quantitative circulars of the Executive Council on the budget input:

- a) Order to draw up the draft budget (21 January): IFTP-based quantitative guidelines for the Operating Statement and Statement of Investments.<sup>42</sup>
- b) Binding, NPM-compliant guidelines on the balance of the Operating Statement and the Statement of Investments with the Executive Council's ruling from 15 April.<sup>43</sup> Rating A.

(iii) Dimension (iii) asks about timely budget approval by the legislature. The 2008 budget was dealt with and passed by the Canton of Lucerne's Grand Council (now the Cantonal Council) on 5/6 November 2007. The 2007 budget was dealt with and passed by the Canton of Lucerne's Grand Council on 6/7 November 2006. The 2006 budget was dealt with and passed by the Canton of Lucerne's Grand Council on 7/8 November 2005<sup>44</sup>. As the budget was passed before the start of the new fiscal year in each of the past three years, the rating is A.

Given the individual dimension ratings of AAB, the overall rating using Method 2 is A.

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<sup>42</sup> Evidence: Template of draft budget to BKD from January 2008, e-mail from B. Elmiger, Department of Finance, from 18 December 2008

<sup>43</sup> Evidence: 2009 budget guidelines, RRB from 15 April 2008, e-mail from B. Elmiger, Department of Finance, from 18 December 2008

<sup>44</sup> Source: Minutes of the meetings of the Grand Council. <http://www.lu.ch/index/kantonsrat.htm>.

**PI 12: Multi-year perspective in fiscal planning, expenditure policy and budgeting**

PI 12	<p>Scoring Method M2:</p> <p>(i) The IFTP covers a five-year planning period. It is structured using a functional classification, but also shows the economic classification. However, the linkage between the budget and the IFTP is not clear, as the differences between the budgeted values and the preceding IFTP values are not commented upon. Rating C.</p> <p>(ii) The medium-term debt sustainability analysis is undertaken annually. The rating is A.</p> <p>(iii) The IFTP gives a detailed and consistent description of the financial consequences of the approved projects in the planning period. The linkage with the legislative programme (strategy) is implicit, but is supposed to become more explicit with the next legislative programme. Rating B.</p> <p>(iv) Investments should be selected with respect to forward expenditures in the IFTP within the scope of the planned developments in the performance budget. These forward expenditures are not transparent in the IFTP, however. The linkage with the strategy is as yet only implicitly made in the IFTP. Rating: B.</p>	B
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PI 12 evaluates the quality of the instruments and processes in medium-term financial and task planning.

(i) The IFTP 2008-2012 has a five-year planning horizon, with the first year 2008 also forming the budget year. The IFTP is primarily presented according to a functional classification but also shows the development by an economic classification. The first year (budget year) of the IFTP is practically the same as the budget. The IFTP and the budget are dealt with and passed by the Cantonal Council at the same meeting. Rating: A.

In order to assess the quality of the IFTP's financial prognosis and management, a comparison of the IFTP and the budget in the subsequent year is shown below, measured using the Operating Statement and on the basis of a functional classification. The table compares the IFTP values for the planned year 2008 as per IFTP 2007-2011, which was passed in autumn 2006, with the 2008 budget, passed in autumn 2007.

*Table 13: Accuracy of the IFTP budget predictions*

	2008 expenses as per IFTP 2007-2011	Expenses as per 2008 budget	Difference in %
Total	3,491.3	3,026.8	-13.3%
General Administration	361.6	389.1	+7.6%
Public Security	243.1	243.2	0.0%
Education	752.0	759.5	+1.0%
Culture and Recreation	47.2	49.3	4.5%
Health	694.1	261.6	-62.3%
Social Welfare	695.8	631.8	-9.2%

Transportation	125.1	148.4	+18.6%
Environment and Spatial Policy	37.6	38.1	+1.3%
Economy	253.0	250.0	-1.2%
Finance and Taxes	281.8	255.7	-9.3%

Sources: Kanton Luzern. Integrated Finance and Task Plan 2007-2011 and State Account 2008.

The comparison reveals some substantial discrepancies between the IFTP and the budget. It should be noted that the 2008 budget introduced enormous changes in the Canton of Lucerne, such as the reform of fiscal equalization and task allocation between the Confederation and the cantons, Financial Reform 08, and the independence of the hospitals<sup>45</sup> and of Lucerne Statistics. When the IFTP was being drawn up in autumn 2006, there were still some uncertainties in this respect. In general, however, the budget explains deviations *not* with respect to the IFTP planned values but only with respect to the previous year's budget. Thus, deviations from past trends are explained rather than deviations from the medium-term IFTP. PEFA gives this dimension just a C.

(ii) The IFTP shows the development of a range of key figures with reference to debt over the five-year planning period: the financing result, the internal financing ratio (i.e. the ratio between internal financing and net investment) and debt servicing as a percentage of the net domestic tax income. The evolution of the internal financing ratio is a particularly important item of financial key figures. An internal financing ratio of below 100% results in higher debt. If it is above 100%, then debt is reduced. The financial directive requires an internal financing ratio above 100%. Moreover, in the verbal part of the IFTP, the development of per-capita net debt is commented upon as a result of the forecast financing result or the internal financing ratio and compared with the financial directive's target for per-capita debt. – Dimension (ii) looks at whether debt sustainability is regularly analysed in the fiscal planning. An A rating means that this analysis is conducted annually. This is the case for the Canton of Lucerne's IFTP. There is no need to distinguish between domestic and foreign debt as the Canton of Lucerne does not have any foreign debt, according to the list of long-term debt in the 2007 State Account. Rating: A.

(iii) Dimension (iii) is devoted to the sector strategies, asking to what extent these exist and to what extent the strategic plans explicitly show the budget-linked consequences, both for operating expenses and capital expenditure, including the associated subsequent costs. The sector strategies in the Canton of Lucerne are laid down in the legislative programme. This is structured according to the main functions of the state. The IFTP is also structured according to these main functions. For each main function, the IFTP provides information in brief on:

- the basic contract with the tasks and the responsible service units and departments
- the general evolution per main function (first level of the functional classification) and sub-function (second level)
- the target development of output indicators and the indicator values in each sub-function over the planning period
- the planned changes with respect to the previous year's IFTP and reasons for the changes

<sup>45</sup> In 2008, only the state contribution is now given with respect to hospitals. In 2007, expenses in health came to CHF 683.9 million, with revenue of CHF 432.5 million, resulting in an expense surplus of CHF 251.4 million. The 2008 budget, however, predicts expenses of CHF 261.2 million and revenue of CHF 5.2 million. The budgeted expense surplus for 2008 thus amounts to CHF 256.4 million, which is similar to that for the 2007 budget.

- the approved projects per main function with the entire project costs per project over the entire planning period and the actual investment costs. These costs for the approved projects are included in the finance plan.
- projects that are planned but not yet approved. These are presented transparently in the same way as approved projects but are *not* included in the financial plan.
- the consequences of changes in the law.

This project-related information is then combined for each main function and its sub-functions and, in addition, the expenses and revenue for the Operating Statement and the corresponding capital expenditure and receipts in the Statement of Investments are shown, as are the impact on the state grants.

The explicit linkage of the projects with the strategy (legislative programme) remains outstanding. Here, the linkage is implicit only.<sup>46</sup> The IFTP states that the structure of the 2003-2007 legislative programmes did not yet permit such linkage.<sup>47</sup> However, the next legislative programme is to be structured in such a manner to ensure linkage of the planning processes. On account of this shortcoming still in existence today, dimension (iii) can only be given a B rating.

(iv) Dimension (iv) queries the strategic support of investment decisions and whether the forward expenditures are taken into account in investment decisions. In principle, the forward expenditures in investment decisions should have been included in the planned growth of the performance budgets of the service groups, in the service units' own interest.<sup>48</sup> However, the forward expenditures are not explicitly presented in the IFTP. The linkage of the investment projects with the strategy according to the legislative programme is as yet only implicit in the IFTP. It can be assumed that the majority of investment decisions are made in compliance with the strategy, but there is no proof that this applies for all investment decisions. Rating: B.

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<sup>46</sup> The Controlling services, Finances service unit, has confirmed this and also stated that, within the scope of the complete revision of the Public Finance Act, a systematic assessment of investments should be introduced with respect to their compliance with the strategy and financial consequences. Moreover, pay-backs should also be made, depending on the type of investment. These new future requirements will be laid down in a separate section of the Controlling and Accounting manual.

<sup>47</sup> IFTP 2008-2012, p. 24

<sup>48</sup> Information from the Department of Finance, Mr Elmiger

### 3.4. Predictability and control in budget execution

#### *PI 13: Transparency of taxpayer obligations and liabilities*

PI 13	<p>Scoring Method M2:</p> <p>(i) The legality of the tax obligation is a given and is firmly anchored in the Constitution. The tax base and the procedures are transparent. The tax office's discretionary powers are extensively defined. (B)</p> <p>(ii) The taxpayers have access to tax-relevant information via both the legislation and other, more specific decrees. However, there are currently no taxpayer education campaigns. (B)</p> <p>(iii) The appeals mechanism against decisions of the tax office is governed institutionally by a multi-level procedure. A fair assessment of appeals is ensured by the fact that appeals procedures are evaluated by the administrative courts at cantonal or national level. These courts are independent of the tax office and the government. (A)</p>	B+
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In Switzerland, the Confederation (central government) as well as the cantons and municipalities (sub-national level) have fiscal jurisdiction. However, the fiscal jurisdiction must be established in the Constitution of the corresponding body holding such jurisdiction. This means that every *tax* has to be approved in the Constitution.

There are taxes that are levied by all three levels (federal, cantonal and local). For instance, income tax and profits tax must be paid to the municipalities, cantons and the Confederation. However, other taxes are paid only to the Confederation, such as stamp duty, VAT or national road tax and others. There are others that are paid only to the canton and the municipality, such as wealth and capital tax, inheritance tax, property gains tax or dog licences.

*Table 14: Tax receipts 2005-2007*

Canton's tax receipts	2005		2006		2007	
	B	SA	B	SA	B	SA
Income tax and wealth tax	759	748	731	733	737	774
Profits tax and capital levy	118	125	114	154	123	142
Land tax	11	11	11	12	12	13
Capital earnings tax	11	14	11	15	15	18
Asset transfer taxes	22	24	22	28	24	31
Inheritance taxes	12	15	12	12	13	16
Property and expense taxes	94	82	85	84	85	86
<b>Total tax receipts</b>	<b>1,029</b>	<b>1,022</b>	<b>987</b>	<b>1,039</b>	<b>1,008</b>	<b>1,080</b>

Sources: 2007 State Account

The Canton of Lucerne has enshrined its authorization to levy taxes on cantonal and local taxes in § 77 lit. a of Lucerne's cantonal Constitution. With tax receipts of well over one billion Swiss francs in the period under review from 2005 to 2007, corresponding to around one-third

of the canton's total revenue, tax receipts hold the most important position in the canton's accounts. Within tax revenues, the income and wealth taxes of natural persons form the largest sub-item, accounting for some 75%.

(i) Clarity and comprehensiveness of tax liabilities

The Canton of Lucerne's authorization to levy taxes is laid down in its Constitution and specified in the Tax Act<sup>49</sup> and the Tax Ordinance<sup>50</sup> based on this. The discretionary powers in the tax assessment are largely limited by the Tax Act and the Tax Ordinance. Where certain elements remain at the tax office's discretion, these can be contested by taxpayers before the superintendence of the tax office, at the first instance, and subsequently by judicial means. (B)

(ii) Taxpayers have access to information on tax liabilities and administrative procedures.

The tax elements are dealt with comprehensively in the Tax Act. Likewise, the administrative procedures are extensively defined in the legislation. Tax-related information is available to taxpayers by way of various channels: the Tax Act and the implementing ordinances are available both online and in hardcopy form; by calling the tax office directly; tax-relevant decisions are published and made available to the public where these decisions are of general tax relevance and do not refer to specific cases under investigation. However, the tax office does not organize any specific information seminars for taxpayers.

With respect to access to information on tax liabilities and the associated procedures, the Lucerne practice meets all the requirements for an A rating. However, as no information seminars are offered, the rating is reduced to a B.

(iii) Existence and functioning of tax appeals mechanisms

The possibility of contesting decisions made by the tax office exists in all cases. The corresponding procedures are laid down in detail in the legislation (Tax Act and Judiciary Procedure Act).

Moreover, with the assessment decision on tax liability, the taxpayer is also informed of the deadline for lodging an appeal to the next higher instance. The first instance of appeal is generally the Tax Committee, an institution that is associated with the tax office but formally independent. Appeals against the rulings of the Tax Committee can be lodged with the administrative court, which is independent of the government. If the competent instance issues a decision in this respect, the decision will be published if of general interest. The tax office is instructed to judge all similar cases in the future in accordance with the court's ruling<sup>51</sup>. The procedure in the case of tax appeals is based largely on the general rules of administrative jurisdiction.<sup>52</sup> (A)

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<sup>49</sup> Tax Act of the Canton of Lucerne from 22 November 1999 (enacted by the Cantonal Council)

<sup>50</sup> Tax Ordinance of 12 December 2000 (enacted by the Executive Council)

<sup>51</sup> Example: Dumont practice on eligible building maintenance (Federal Supreme Court decision from 24 April 1997 as per Act, Federal Supreme Court collection no. 804, nStP 1997 p. 102 ff)

<sup>52</sup> Tax Act of the Canton of Lucerne from 22 November 1999; mainly § 124ff

**PI 14: Effectiveness of measures for taxpayer registration and tax assessment**

PI 14	<p>Scoring Method M2:</p> <p>(i) Taxpayers are registered in a database system. Through linkages with the register of population control (natural persons) and the commercial register (legal entities), all persons and firms registered in the canton are known to the tax office and thus may be assessed. (A)</p> <p>(ii) Failure to report tax-relevant information is a punishable offence. The rules in this respect are laid down in the Tax Act. However, given the self-assessment, taxpayers have the possibility of not declaring certain tax-relevant information. (B)</p> <p>(iii) The Canton of Lucerne does not have a comprehensive quality management system with clear criteria for risk assessment in taxes. (C)</p>	B
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**(i) Controls in the taxpayer registration system**

The tax declarations of legal entities and of self-employed persons (since 2006) are entered and processed centrally; those of natural persons are prepared in the municipalities and assessed by the cantonal tax office. At the request of a municipality and provided that the assessor has the appropriate professional qualifications, the canton may delegate its assessment powers for natural persons to the municipalities in question.

The main data-transfer processes between the tax register and the other tax-relevant systems are generally implemented. What is currently missing is a tax database at cantonal level, which was only designed and planned at the end of 2007.<sup>53</sup> The population control database comprises all natural persons. This application is linked to the tax register so that the tax register is also simultaneously updated when changes are made to the population control system. For legal entities, the commercial register is of most relevance for the tax register. The cantonal tax office can then receive further information to complete the register of legal entities from the Confederation or from municipalities (withholding tax). In this way, the tax office can ascertain that both natural persons and legal entities are known and assessed. Rating: A.

**(ii) Effectiveness of penalties for non-compliance with registration and declaration obligations**

Failure to report tax-relevant information is a punishable offence for all taxes levied by the canton. The rules on fiscal offences are laid down in the Tax Act<sup>54</sup>. The penalties generally amount to the same as the unpaid taxes. In the case of minor offences, the penalties may be reduced to one third, and in the case of serious offences, increased to up to three times the unpaid taxes.

Given the self-assessment, taxpayers have the possibility of not declaring certain tax-relevant information. Due to this self-assessment, the extent to which a tax declaration is incomplete and

<sup>53</sup> State Account 2007, p. 40

<sup>54</sup> Cf. Tax Act of the Canton of Lucerne from 22 November 1999 §§ 208 ff

does not contain all tax-relevant elements can only be estimated. Penalty and subsequent taxes amounted to some 0.3% of the overall tax receipts in the period under review. Rating: B.

(iii) Planning and monitoring of tax audit

The Canton of Lucerne uses a mixed procedure in its tax audit, i.e. on the one hand, there is a self-assessment by the taxpayers and, on the other hand, the tax office has the task of auditing the files submitted. The tax returns submitted are examined and assessed, partly directly and partly using plausibility checks. If the assessments are carried out at the level of the municipalities, the cantonal tax office conducts spot-checks on the quality of the tax assessments.<sup>55</sup> However, there are no quality checks of the tax assessments carried out by the cantonal office. Moreover, to date, there is no comprehensive quality management system at cantonal level to specify clear criteria in terms of the ICS, evaluation and risk management for the tax office. (C)

**PI 15: Effectiveness in collection of tax payments**

PI 15	<p>Scoring Method M1:</p> <p>(i) Tax collection is efficiently organized and effective, because overall tax arrears are less than 9 % of the tax receipts. But it is not possible to assess the average debt collection ratio of the past two years due to lack of data at cantonal level. (NS)</p> <p>(ii) Due to the fact that tax collection is carried out by the municipalities and the canton requests the compensation payments only twice a month, there is a delay until the tax revenues become available to the Treasury (C).</p> <p>(iii) The reconciliation of tax receipts with the tax bills issued is systematic and immediate. The settlement of taxes between the canton and the municipalities is done annually in January of the following year. (C)</p>	NS
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This indicator answers the question as to whether the tax arrears can be settled in time and the money thus made available to the Treasury.

(i) Success in the collection of tax arrears (ratio between outstanding taxes at the start of the year and taxes paid during the year)

Both cantonal and municipal taxes are assessed and collected by the municipalities, which collect the taxes and reconcile them with the tax debtors on a daily basis. The municipalities transfer the cantonal part of the taxes to the canton's accounts twice a month.<sup>56</sup> In addition, tax statements are drawn up on a monthly basis. The canton settles the tax revenues with the municipalities once a year (in January of the following year).<sup>57</sup> Because the taxes are collected by the municipalities, the Canton does not possess detailed information on tax arrears for the

<sup>55</sup> Information from the Tax Office of the City of Lucerne, 23 Dec. 2008

<sup>56</sup> Information from the Tax Office of the City of Lucerne, 23 Dec. 2008

<sup>57</sup> Information: Tax collection and municipality billing, Finances service unit, Department of Finance of the Canton of Lucerne, 26. Aug. 2009

two most recent fiscal years. The percentage of tax arrears at the beginning of the fiscal year, which was collected during that fiscal year, is unknown because no distinction is being made between new and old tax arrears. The debt collection rate can't be calculated.

The State Account shows the target tax figure in the Administrative Account. The tax collection can be calculated using the tax write-downs, also shown, and the tax credits listed in the Balance Sheet. Apart from the outstanding tax arrears, the tax credits at the start of the year also contain tax debts that are not yet due. Furthermore, part of the tax arrears listed in the Balance Sheet of the Canton Lucerne at the beginning of the year is settled between Canton and municipalities in the first part of January of the following year.<sup>58</sup> Taking this adjustment into account, the amount of tax arrears diminishes by more than two third.

Table 15: Tax collection (in CHF million)

	2005	2006	2007
(1) Tax collected <sup>59</sup>	1,005	1,018	1,058
(2) Tax arrears at the start of the year <sup>60</sup>	309	323	336
(3) Adjusted tax arrears at the start of the year <sup>61</sup>	90	90	82
(4) Tax write-downs / subsidies	9	11	9
(5) Total taxes owed	1,022	1,040	1,080

Source: State Account of the Canton of Lucerne / Department of Finance

The total amount of tax debts and tax arrears is less than 9% of the annual tax receipts. However, taxpayers' willingness to pay is high overall, and the collection of tax debts is very effective, with the result that annual tax write-downs amount to only around 1% of the tax assessed. Nevertheless, the required information to calculate the debt collection rate is missing, as explained before, and therefore dimension (i) cannot be scored.

(ii) Efficient transfer of tax collections to the Treasury

The cantonal and municipal taxes are paid into the municipalities' accounts and are immediately available to the municipalities' treasury for the performance of their financial duties. The municipalities transfer the cantonal part to the canton's accounts twice a month.<sup>62</sup> There is thus a maximum delay of two weeks between the time that the money is paid in and the canton's Treasury account is credited. (C)

(iii) Frequency of reconciliation between tax assessments, tax collections, tax arrears and tax receipts

Both municipal and cantonal taxes are collected by the municipalities and are reconciled daily by these with the tax debtors. In addition, tax statements are drawn up monthly so that the corresponding system evaluations are available within the following month.<sup>63</sup> Meanwhile, the

<sup>58</sup> According to information received from Tax collection and municipality billing, Finances service unit, Department of Finance of the Canton of Lucerne,

<sup>59</sup> Tax owed minus the difference between tax arrears at the end of the year and tax arrears at the end of the previous year less tax write-downs / subsidies

<sup>60</sup> State Account of the Canton of Lucerne 2005 - 2007

<sup>61</sup> Information: Tax collection and municipality billing, Finances service unit, Department of Finance of the Canton of Lucerne 26 Aug. 2009

<sup>62</sup> Information from the Tax Office of the City of Lucerne, 23 Dec. 2008

<sup>63</sup> Information from the Tax Office of the City of Lucerne, 23 Dec. 2008

canton settles the tax revenues with the municipalities annually (in January of the following year).<sup>64</sup> (C)

***PI 16: Predictability in the availability of funds for commitment of expenditures***

PI 16	<p>Scoring Method M1:</p> <p>(i) A cash flow forecast is prepared for the fiscal year and updated daily on the basis of cash inflows and outflows. (A)</p> <p>(ii) The ministries, departments and agencies are free to plan and commit expenditure in accordance with the budgeted appropriations. (A)</p> <p>(iii) There are no significant in-year adjustments to budget allocations and any adjustments are done in a transparent and predictable way. (A)</p>	A
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(i) Extent to which cash flows are forecast and monitored.

The Finances service unit is responsible for ensuring solvency and optimizing the financing costs of the Canton of Lucerne.<sup>65</sup> Multi-year and in-year controlling instruments are available to this end.

A multi-year perspective of the cash flow exists in the quarterly reports on the Asset & Liability Management activities<sup>66</sup> in the form of a five-year liquidity forecast. This liquidity forecast compares the maturity dates of bonds with the cash balances in accordance with the budget and the IFTP and thus calculates the additional resources or refinancing needed.

Liquidity planning with a rolling horizon is used at the in-year level, updated daily. The short-term cash items take account of impending financial commitments and estimated cash receipts. The Treasurer asks service units with large payment transactions to provide information on upcoming payments volumes, thus ensuring that sufficient cash is available in time.<sup>67</sup> Rating: A.

(ii) Reliability and horizon of information on the availability of budgeted resources

The MDAs (ministries, departments and agencies) are not subject to any payment restrictions with respect to the budgeted resources. The entire approved budget is at their disposal from 1 January. The MDAs are under no obligation to inform the Treasury of any major payments in advance. For the larger entities, however, the Treasurer conducts regular surveys on payments. Apart from such surveys, the Treasury creates the flexibility it needs by setting various payment deadlines. Rating: A.

(iii) Frequency and transparency of adjustments to budget allocations, which are decided above the levels of management of MDAs.

<sup>64</sup> Information: Tax collection and municipality billing, Finances service unit, Department of Finance of the Canton of Lucerne

<sup>65</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 3.1 + Insight into the structure of an ALM report

<sup>66</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 4.6

<sup>67</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 6

The Public Finance Act governs further and supplementary credits, i.e. in-year budgetary adjustments. If the special credits<sup>68</sup> or budget credits<sup>69</sup> are not sufficient, an application for a supplementary credit or further credit must be submitted to the Cantonal Council in good time, except in four specific cases.<sup>70</sup> These exceptions include additional expenses due to inflation and tied (earmarked) expenses and expenditure.<sup>71</sup> For expenses and capital expenditure forming an exception, the corresponding exoneration should be sought in the financial reporting.<sup>72</sup>

The adjustments to budget allocations are laid down by law and – apart from the above exceptions – must be approved by the Cantonal Council. The adjustments are made in a transparent and predictable process. In accordance with the legislation, decisions on adjustments to budget credits and special credits are made individually and not grouped together on a particular date. There are thus budget adjustments several times a year. However, in 2006 there were 18 further credits amounting to CHF 8.4 million and in 2007 a total of 17 further credits for a total of CHF 8 million, corresponding to some 0.2% of the overall budget, which can be said to be insignificant. Rating: A.

All three dimensions have the highest rating. The Finances service unit has a multi-year liquidity planning system and also ensures solvency with its rolling liquidity planning system, updated daily, which it uses to optimize financing costs. The MDAs are not subject to any cash restriction and are free to plan and commit expenditure in accordance with the budgeted appropriations. With respect to the law, several in-year adjustments to budget allocations are possible; however, this must be viewed in perspective, given the fact that there are no overall deadlines for budget adjustments and there was a relatively low level of budgetary adjustments in 2006 and 2007.

#### PI 17: Recording and management of cash balances, debt and guarantees

PI 17	<p>Scoring Method M2:</p> <p>(i) Domestic and foreign debt records are reliable, complete and updated regularly. Reports are produced quarterly. (A)</p> <p>(ii) Only the largest cash balances in terms of amount are calculated daily, all others at least monthly. Each cash transaction is entered in SAP and consolidation is automatic. (B)</p> <p>(iii) The contracting of loans and issuance of guarantees are made against transparent criteria, and are also approved by the responsible government entity (Executive Council or Parliament). (A)</p>	A
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#### (i) Quality of debt data recording and reporting

<sup>68</sup> In accordance with § 21 (2) Public Finance Act, special credits are unconditional expenses exceeding the amount of CHF 3 million or which are less than CHF 3 million and not in the budget or approved as further credit.

<sup>69</sup> According to § 11 Public Finance Act, the budget credits comprise the performance budgets per service group, state contributions and investments.

<sup>70</sup> § 12 and § 22 Public Finance Act

<sup>71</sup> § 13 (1) and § 23 (1) Public Finance Act

<sup>72</sup> § 13 (3) and § 23 (2) Public Finance Act

Debt is recorded and managed centrally: The Executive Council decides on the contracting of medium- and long-term loans with a term of more than one year<sup>73</sup> and the Department of Finance is responsible for managing short-term loans with terms of up to 12 months within the framework of a limit defined by the Executive Council.<sup>74</sup>

This central management of debt is conducted within Asset & Liability Management (ALM) of the Finances service unit, using an ALM software tool. Correspondingly, the data is of high quality and is updated daily. The ALM of the Finances service unit draws up a quarterly report on the ALM transactions<sup>75</sup> for the Risk Committee (Financial Director, Head of the Finances service unit, Head of the Audit function and independent external experts) and, based on this report, an annual report is submitted to the Executive Council.<sup>76</sup> The ALM quarterly report comprises a financial status with a comprehensive list of financial assets and debt. In addition, the fixed interest rates, the interest charge and the risk positions of the portfolio are also shown, among other things. Rating: A.

(ii) Extent of consolidation of cash balances

Lucerne's cantonal administration has a central cash management system and thus a cash pool.

The larger cash balances are calculated daily, the others at least monthly. Each cash balance is entered in SAP, so that the cash balance of the Canton of Lucerne is automatically consolidated. However, the consolidated cash balance is not always up-to-date as certain cash balances are only entered monthly. Rating: B.

(iii) Systems for contracting loans and issuance of guarantees

The contracting of loans and the issuance of guarantees are laid down in the law.

The Executive Council decides on the contracting of medium and long-term loans with a term of more than one year and the Department of Finance is responsible for managing short-term loans with terms of up to 12 months. The Executive Council approves the planned short-term contracting of loans by the Finances service unit by way of an overall ceiling that must not be exceeded.<sup>77</sup>

The ALM Directive sets out the permitted forms of contracting loans. At the forefront in short-term debt are fixed advances by banks, insurance companies, pension funds, etc. and, for medium and long-term loans, government bonds (straight, options, convertible) as well as private placements, promissory notes and direct loans.<sup>78</sup> The ALM quarterly report includes specific monitoring of the portfolio risk positions.

The guarantee commitments and contingent liabilities are posted yearly in the annual report. The 2006 State Account shows total guarantee commitments and contingent liabilities of some CHF 380 million. The state's guarantee commitments are approved by the Executive Council;

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<sup>73</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, items 1.1 and 8

<sup>74</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, items 1.1.2 and 2.1

<sup>75</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 4.6

<sup>76</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 2.4

<sup>77</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, items 1.1, 2.1 and 8

<sup>78</sup> Asset & Liability Management – Directives of the Department of Finance of the Canton of Lucerne, item 9

those which exceed the sum of CHF 1 million require the approval of the Cantonal Council. Further guarantees – e.g. the state guarantee of the privatized Cantonal Bank of Lucerne – require a separate legal basis, which must be approved by Parliament or by public vote.

Debt is managed centrally in Asset & Liability Management, which draws up a comprehensive quarterly report based on high-quality data from an ALM tool (A). Only the larger cash balances are entered daily, the rest are calculated at least monthly (B). The contracting of loans and the issuance of guarantees are laid down by law. Rating: A.

Using Scoring Method M2, the result for PI-17 is a rating of A.

**PI 18: Effectiveness of payroll controls**

PI 18	<p>Scoring Method M1:</p> <ul style="list-style-type: none"> <li>(i) The personnel database and payroll are integrated in an ERP system and reconciliation is thus system-internal and automatic. (A)</li> <li>(ii) The personnel data and the associated payroll are updated at least monthly. (A)</li> <li>(iii) Authority to change records and payroll is restricted but there is no systematic audit. (B)</li> <li>(iv) A payroll audit covering all wage offices of the cantonal administration has been conducted at least once in the past three years. (C)</li> </ul>	C+
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(i) Degree of integration and reconciliation between personnel records and payroll data

The Canton of Lucerne uses an Enterprise Resource Planning tool from SAP, which integrates the Human Resource Management (HRM) and accounting software tool. Between these two software solutions is a system-internal interface that automates the booking and reconciliation of entries.

The reconciliation process for personnel records is as follows: The individual service units ask the HR service unit to modify the personnel records. The HR service unit imports these modifications into SAP and sends the updated data (SAP printout) back to the service unit in question. This ensures that the modifications are imported correctly into SAP (including work quota, employment duration, etc.). In addition, the service units have access at all times to SAP-HR, to check their employees' monthly payments. Reconciliation of payroll data is at least monthly.

Rating A.

(ii) Timeliness of changes to personnel records and payroll

The changes to personnel records are made as described under i), updated at least monthly for the payroll. Once the personnel records have been changed, reconciliation with the payroll is automatic in the ERP system. Rating: A.

(iii) Internal controls of changes to personnel records and the payroll

The process for changing personnel records and the payroll is documented and must be complied with.<sup>79</sup>

The process for changing personnel records has already been mentioned under i). Internal control exists in that the order for changing the personnel records is made decentrally and the entry is then made centrally in the HR service unit. Its correct input must subsequently be confirmed by the decentralized service unit. Although the decentralized service units have access to SAP-HR, the authorization for changing personnel records is limited to a restricted number of people in HR.

The payroll is conducted in accordance with a checklist. The payroll is managed in SAP, which automatically generates checklists and error lists. This also verifies amounts paid up to a certain limit. Monthly salaries exceeding CHF 12,500 are checked by the Audit function.

Apart from the control mechanisms described above, there is currently no internal control system for salary payments, but there are plans to create one. Nonetheless, the authorizations and the bases for making changes to the payroll and personnel records are clearly defined. Rating: B.

(iv) Existence of payroll audits to identify control weaknesses and/or ghost workers

With respect to payroll audits, the Audit Act does not include any express instruction for the Audit function. The Audit function checks the salary system as part of its general tasks<sup>80</sup> and thus not annually and completely within the meaning of PI-18. In 2007 an audit was conducted on the payroll offices, wherein the Auditor checked the internal control systems in the payroll offices in addition to checking the insurance premiums and social security contributions. This found that most of the payroll offices have work instructions for individual processes but that there is no self-contained internal control system. This audit did not check whether the employees on the payrolls were actually employed in the Canton of Lucerne, so the existence of ghost workers cannot be fully ruled out.

The checks carried out by the Audit function ensure a control mechanism in the salary system but not to the extent of an established audit of the payroll. Rating: C.

The first two Indicators get the highest score, mainly as a result of the ERP solution from SAP and the defined work processes. A comprehensive internal control system is only in construction and there is no established payroll audit. For this reason, Indicator iii) gets a B score and the last indicator a C. Based on the Scoring Method M1, the overall rating is a C+.

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<sup>79</sup> Payroll checklist

<sup>80</sup> § 12 Audit Act

**PI 19: Competition, value for money and controls in procurement**

PI 19	Scoring Method M2: (i) There is no data to prove that the law has been observed in the awarding of public contracts. (D) (ii) Justification for use of less competitive procurement methods is enshrined in the law. However, there is no proof that these rules are adhered to. (C) (iii) There is a procurement complaints mechanism with an independent body, which is rarely used. (A)	C+
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(i) Evidence on the observance of the Public Procurement Act (percentage of the number of contracts awarded in accordance with the law)

The Canton of Lucerne has a law on public procurements. According to this law and the corresponding ordinances, procurements of over CHF 250,000 (or CHF 500,000 for contracts in the primary construction sector) must be awarded in an open and selective procedure, i.e. the contract must be published in an official publication.<sup>81</sup> Below this threshold, less competitive procurement methods (invitation to tender) should be used.<sup>82</sup> Only for an amount below CHF 100,000 for supplies, CHF 150,000 for services and contracts in the secondary construction sector, or CHF 300,000 for contracts in the primary construction sector may contracts be awarded without open competition (private procedure).<sup>83</sup>

There is no central office that systematically verifies the observance of the public procurement system and, therefore, there is no data to prove the extent to which the Public Procurement Act has been observed. Within the scope of its work to verify the correct, lawful and economical execution of the budget<sup>84</sup>, the Audit function also carries out random checks on observance of the Public Procurement Act.<sup>85</sup> Rating: D.

(ii) Extent of justification for use of less competitive procurement methods

The Public Procurement Act contains instructions on less competitive methods, or private methods. Apart from the threshold, below which contracts may be awarded freely or using a less competitive method, the law provide for 10 cases in which the private method may be used.<sup>86</sup> These include unforeseeable events, technical and artistic specificities or if there are no suitable options in an open, selective or tendering procedure.<sup>87</sup>

<sup>81</sup> § 7 Public Procurement Act in association with § 5 Ordinance to the Public Procurement Act

<sup>82</sup> § 5 Ordinance to the Public Procurement Act

<sup>83</sup> § 6 (1) Ordinance to the Public Procurement Act

<sup>84</sup> § 12 Audit Act

<sup>85</sup> This estimate is confirmed by the legal service of the Department of Finance.

<sup>86</sup> § 5 f. Ordinance to the Public Procurement Act

<sup>87</sup> § 6 (2) Ordinance to the Public Procurement Act

Justification for use of less competitive procurement methods is clearly enshrined in the law. However, there is no organizational unit that systematically verifies compliance with the public procurement system and, therefore, it is not possible to say whether the less competitive procurement methods are only used when this is actually provided for by law. Rating: C.

(iii) Existence and operation of a procurement complaints mechanism

There is a possibility of filing a complaint with the Administrative Court and subsequently with the Federal Supreme Court.<sup>88</sup> Incorrect or incomplete statements of the fact relevant in law or violations of the law, including excesses or misuse of discretion, may be brought to the attention of the Administrative Court.<sup>89</sup> For the purposes of accelerating the process, the law authorizes the Administrative Court to rule in a single-judge formation. Between October 2006 and September 2007, six complaints were filed with the Administrative Court, of which three were resolved by being withdrawn. The proceedings took an average of three months each. The Administrative Court is responsible for the publication of its rulings. However, the Administrative Court publishes only the most important rulings and not all of them. None of the cases were published in the period between 2006 and 2007. Rating A.

On account of the lack of evidence of observance of the public procurement system, a rating of D is given. Justification for use of less competitive procurement methods is clearly enshrined in the law, but there is no data to prove the extent to which the Public Procurement Act has been observed (C). There is a procurement complaints mechanism with an independent body in the form of the Constitutional or Federal Supreme Court (A). Overall, using the Scoring Method M2, the rating is C+.

**PI 20: Effectiveness of internal controls for non-salary expenditure**

PI 20	Scoring Method M1: (i) The service units are obliged to conduct controls on the use of special credits, from which the current budget status can be seen at any time. (A) (ii) An internal control system in Accounts Payable allows for an effective control of expenditures. (A) (iii) The internal control system must be used for all non-salary expenditure transactions. (A)	A
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(i) Effectiveness of credit controls

Under § 24 (1) of the Public Finance Act, the individual service units must conduct controls on the utilization of special and further credits, from which the level of liabilities received and still required as well as payments made can be seen. The Canton of Lucerne has two types of credits, budget credits and special credits. Special credits are needed if they exceed a sum of CHF 3 million or if they are less than CHF 3 million and were not approved as a budget

<sup>88</sup> § 28 (1) Public Procurement Act

<sup>89</sup> § 30 Public Procurement Act

credit.<sup>90</sup> Budget credits are the approved performance budgets per service group, the state contributions and the investments in accordance with the budget and are forfeited if not used by the end of the year.<sup>91</sup>

In addition to the controls conducted by the service units, the Notes to the annual report include a special credit control, from which expenditures made to date can be seen. The statement on the utilization of special credits must be presented to the Cantonal Council for approval within three years of the opening of the work. No statement need be presented if the amount of the credit was set definitively and conclusively upon approval.<sup>92</sup> Any cost excesses must be justified to Parliament. In addition, there is a control within the scope of the ICS in Accounts Payable, described under ii).

There is a credit-control system designed to prevent budget excesses. Whenever any excesses occur, the ongoing credit-control system flags this in time, allowing for appropriate intervention to be taken. Secondly, excesses have to be justified to Parliament. The credit-control system was effective for the years 2006 and 2007, as all nine and ten investments made respectively were within budget. Rating: A.

(ii) Comprehensiveness, relevance and understanding of other internal control rules/procedures

With the internal control system in Accounts Payable, the Canton of Lucerne has a uniform, systematic and risk-limiting set of rules for the correct processing of all non-salary expenditures. The internal control system seeks to systematically avoid the possible risks of misappropriation and miscalculation. The principles of the ICS require complete and correct validation of incoming invoices, observance of the segregation of duties (dual control) and the principle of “no booking without a receipt”. The financial controller must first validate that the expenditure may be made and that it lies within the scope of the budget. The audit is then conducted by another person and, finally, the SAP system ensures that the account has to be entered and initiated by two separate persons.<sup>93</sup> Rating: A.

(iii) Degree of compliance with rules for processing and recording transactions

Every payment transaction must be conducted in accordance with the internal control system in Accounts Payable. There are no rules on exceptions, whereby, for instance, the internal control system could be circumvented for emergency expenditures. This ensures that the principles of the internal control system are applied for all transactions. The Audit function is assigned the task of verifying the internal control system in the individual service areas.<sup>94</sup> The audit report 2007 points out two minor mistakes in the internal control of two service areas. Both service areas have several internal controls but no overall concept of an internal control system. These minor mistakes prove that the internal control system is altogether established and well-performing Rating: A.

The Canton of Lucerne has a comprehensive credit-control system and uses an internal control system in Accounts Payable, which does not allow exceptions for any non-salary expenditures. The Canton of Lucerne thus has an effective control system for non-salary expenditures, which receives the highest score in all three dimensions of PI 20. Overall rating: A.

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<sup>90</sup> § 21 (2) Public Finance Act

<sup>91</sup> § 11 Public Finance Act

<sup>92</sup> § 24 (2) Public Finance Act

<sup>93</sup> Instructions on the Internal Control System (ICS), sub-section Accounts Payable, and the Ordinance on the authorization to dispose of loans and credit decision

<sup>94</sup> Under § 12 (1) b Audit Act

**PI 21 Effectiveness of internal audit**

PI 21	Scoring Method: M1  (i) The Audit function acts as an internal auditor that checks and assesses the state activities with professional standards, focused on systemic issues. (A)  (ii) The reports of the Internal Audit are distributed in writing to the audited entities as well as the government or the court management. (A)  (iii) The deficiencies found by the Internal Audit must be resolved within a period of three months or, in the case of serious deficiencies, a report must be given on how the deficiencies can be resolved. (A)	A
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The Canton of Lucerne makes a difference between Controlling and Internal audit. While Controlling focuses mainly on issues concerning financial and operational information, efficiency and effectiveness, internal audit emphasises on subjects like financial supervision or evaluation of the internal control systems.

**Controlling** is a subject of the Finance and Controlling unit in the Secretariat of each Department. The controlling units support the head of each service unit in his work. The controlling unit also compiles quarterly reports to the head of service units and to the Executive.<sup>95</sup>

**Internal audit** is one of the subjects of the Audit function. The Audit function is the canton's highest specialized body concerning financial supervision and it acts in both ways, as the internal and as the external auditor. It supports Parliament in exercising superintendence over the cantonal administration and over operations in the administration of justice. It also supports the Executive and the highest courts in performing their supervisory activities and the ministries and departments in resolving shortcomings. The Audit function is an autonomous and technically independent institution answerable only to the Constitution and the law for its auditing activities. The Audit function coordinates there auditing activities concerning external audits with the Parliament and internal audit activities with the Executive and the agencies.

Unlike other countries, which make an organizational difference between internal and external audits, the Swiss Federation and the Swiss Cantons came to the conclusion that for the Swiss political system, external and internal auditing should be concentrated in one organizational unit. Based on this monistic approach, the following explanations refer to the role of the Audit function.

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<sup>95</sup> Information: H.P. Heini; Head of Finance and Controlling; Department of Education and Culture

(i) Coverage and quality of the internal audit function

All entities that receive, administrate or spend state finances are subject to financial control by the Audit function. Apart from the administrative units of the cantonal administration, these also include the bodies for the administration of justice, organizations and persons outside of the cantonal administration to whom the Canton delegates a public task as well as organizations and persons who receive state contributions. Where laws or statutes provide for a separate auditor for such entities, the Audit function merely provides an appreciation of the findings of the audit reports.

The Audit function is headed by a highly skilled expert in the field. Within the scope of cantonal financial supervision, it ensures the systematic internal and external auditing of the entire budget management. This means that it assesses the state budget according to recognized audit principles, verifying the correct, lawful, economical and effective execution of the budget.

The Audit function conducts the following checks:

- a. verification of the State Account and its underlying separate accounts of the individual administrative units and courts
- b. evaluation of the internal control systems (ICS),
- c. systemic tests, project tests, object tests and methodology tests for efficiency analysis and impact appraisals and in controlling
- d. verifications on behalf of the Confederation
- e. verifications as an auditor with organizations and persons where there is a public interest therein.

It performs its activities in accordance with the Audit Act<sup>96</sup> and according to technically recognized principles. The Audit function is also ISO 9001:2000-certified, which means that it bases its activities on the corresponding guidelines of this quality management system. The focus in its auditing tasks is on systemic tests, which are conducted using a risk-oriented approach.<sup>97</sup> Rating: A.

(ii) Frequency and distribution of reports

The Audit function provides the audited entity, the Department of Finance and the competent department or the State Chancellery or the highest competent court with the results of its audit in writing. Where the Audit function finds that immediate action appears necessary, the notification is made straight away. For special mandates, the situation is reported to the commissioning entity and the competent department or the State Chancellery or the highest competent court.

Once a year, in May, the Audit function provides the Audit Committees of the Cantonal Council, the Executive Committee and, insofar as their supervisory tasks are concerned, the highest court with an activity report outlining the scope and the focus of its auditing as well as key findings and evaluations. At the start of the year, it submits an interim report on its audit activities. Reports are also submitted in the case of significant incidences. As a rule, the Audit function only reports on completed procedures. In addition, the Executive Council and the responsible Committees of the Cantonal Council for auditing periodically invite the head of the Audit function to discussions. Rating: A.

(iii) Extent of management response to internal audit findings

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<sup>96</sup> Audit Act of 8 March 2004 of the Canton of Lucerne

<sup>97</sup> Information: B. Häfliger, Head of Audit function.

If immaterial weaknesses are found, specifically errors in terms of formality, the Audit function requires the audited entity to provide a written report on the resolution of the situation by a specific deadline, which must be within at least three months. If material weaknesses are found, the Audit function sets the audited entity a maximum period of three months to report in writing through the official channels and furnish information on the measures taken.

If the deficiency found is not resolved by the audited entity and if no measures are taken to remove it, the Executive Council, or the highest court concerned, must rule on the measures to be taken at the request of the Audit function. Rating: A.

The overall rating is A.

### 3.5. Accounting, recording and reporting

#### *PI 22: Timeliness and regularity of accounts reconciliation*

PI 22	Scoring Method M2: (i) All bank accounts are reconciled at least weekly. (A) (ii) Advances are reconciled monthly. (A)	A
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#### (i) Regularity of bank reconciliations

With the exception of three service units, only the Treasury manages bank accounts. The statements of centrally managed bank accounts are reconciled daily with the accounting system and the non-centrally managed bank accounts – only a small portion in terms of amounts – at least weekly. Rating: A.

#### (ii) Regularity of reconciliation and clearance of suspense accounts and advances

Suspense accounts and advances are cleared and reconciled monthly.

The bank account statements are reconciled at least weekly with the accounting system, and suspense accounts and advances are cleared monthly.

Rating: A.

Both indicators get the highest score (A).

#### *PI 23: Availability of information on resources received by service delivery units*

PI 23	Scoring Method M1: (i) Cost accounting provides information on the cost structure in the healthcare sector. (B)	B
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#### (i) Collection and processing of information to demonstrate the resources that were actually received by the front-line service delivery units

Under § 36 (1) of the Public Finance Act, each service unit is obliged to run a cost accounting system. Cost accounting can be used to evaluate detailed information on the cost structure at a cantonal level and thus produce information on the relationship between overheads and other costs. Unlike the healthcare sector, the elementary schools do not fall within the canton's remit and, therefore, § 36 (1) of the Public Finance Act does not apply to the elementary school system. The municipalities, which bear the costs of the elementary schools, are not required to introduce cost accounting until 2009.

At present, only the healthcare sector has detailed information on the cost structure through the cost accounting introduced. However, cost accounting is not used to find out about the availability of resources with the service delivery units.<sup>98</sup> Rating: B.

**PI 24: Quality and timeliness of in-year budget reports**

PI 24	Scoring Method M1: (i) There are two in-year reports at two different levels, although these do not include any verification of credit lines. (C) (ii) Intra-departmental reports are prepared quarterly, inter-departmental reports after the second and third quarters. Both reports are issued on time. (A) (iii) The data is of high quality. (A)	C+
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(i) Scope of reports in terms of coverage and compatibility with budget estimates

Each service unit prepares a quarterly report for the department management, and the department management summarises the service units' reports into a departmental report. The departmental report shows a profit-centre account using an economic classification and an overview of the performance budget per service group. The profit-centre account and the performance budget compare the actual figures with the budgeted figures. In the Projects & Tasks sub-section, the service units assess the status of projects and/or tasks. Only the biggest projects are shown, including their financial status, but there is no comprehensive project list as a form of verification of credit lines. The data on the status of credits does exist (see PI-20) but is not used for reporting purposes.

In addition, after the second and third quarter, the Finances service unit prepares – on the basis of the departmental report – a report for the Executive Council, containing information on overall administration. The in-year reports contain an extrapolation of the Operating Statement and the Statement of Investments, sub-divided according to the individual departments. Apart from the extrapolation, qualitative statements are made on the personnel, financial key figures and main projects. As in the department controlling, there is no overview of the status of credit lines.

The reports do not cover the verification of credit lines. The absence of such a central control results in a score of C for the budget extrapolation.

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<sup>98</sup> Indicator 23 is used as, according to the Guidelines, there is often a problem of service delivery units not receiving the budgeted funds. As shown in PI-16 (iii), the individual service delivery units can already dispose of the entire budgeted funds at the start of the year, so it is not possible for them not to receive the budgeted funds.

## (ii) Timeliness of the issue of reports

The department reports are prepared quarterly and the in-year reports for the Executive Council after the second and third quarters. The Executive Council issues the in-year report six weeks after the end of the second quarter and four weeks after the third quarter; internally, the department report is submitted to the head of the department three to four weeks after the end of the quarter. Rating: A.

## (iii) Quality of information

There are no material concerns regarding data accuracy. First, all departments are obliged to prepare a quarterly report, so the budget comparisons are therefore complete. Secondly, the evaluations are carried out in SAP-CO, which guarantees a high level of data accuracy. Rating: A.

There are two in-year reports at two different levels, although these do not include any verification of credit lines and are therefore rated C. The reports are issued on time (A) and the quality of the information is high (A). The M1 Scoring Method results in a score of C+ for the quality and timeliness of in-year budget reports.

**PI 25: Quality and timeliness of annual financial statements**

PI 25	Scoring Method M1: (i) The Canton of Lucerne does not prepare consolidated annual financial statements (D) (ii) The annual financial statements are submitted to Parliament in June. (A) (iii) The Canton of Lucerne does not use IPSAS but the corresponding national standard, HAM1. (C)	D+
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## (i) Completeness of the financial statements

The Canton of Lucerne currently uses the Harmonized Accounting Model 1 (HAM1) in its annual financial statements; the only area in which it deviates substantially from HAM1 is in the immediate depreciation in road construction. There is no consolidation in this accounting model. The entities controlled by the Canton of Lucerne – mainly in the form of public companies – prepare their own financial statements, which are not consolidated in the annual accounts of the Canton of Lucerne.

Given the absence of consolidation, the annual financial statements do not provide a complete picture of the financial situation and are therefore rated D.

## (ii) Timeliness of submission of the financial statements

The audited annual report is submitted to the Executive Council at the start of April and to Parliament in June, i.e. within PEFA's deadline of six months after the end of the fiscal year. Rating A.

## (iii) Accounting standards used

HAM1 is not an indirect implementation of IPSAS<sup>99</sup>; moreover, it is not an accounting standard but an accounting model.<sup>100</sup> Published in 1981, HAM1 seeks to manage accounts under the following principles: annual basis, comprehensiveness, clarity, accuracy, gross reporting, budgeted reporting as well as a qualitative, quantitative and temporal binding.<sup>101</sup> From these principles, the main strength of HAM1 is the application of the accrual basis.

It is often said that the harmonization offered by HAM1 is more formal than material, leaving the cantons or municipalities substantial scope in their application of HAM1. Furthermore, the Chart of Accounts is characteristic as the central element of this accounting model and, correspondingly, the balance sheet and evaluation guidelines are often regulated using the Chart of Accounts. Rating: C.

Given the absence of consolidation, the annual financial statements do not provide a complete picture of the financial situation and are therefore rated D. The financial report is submitted to Parliament on time (A). The Canton of Lucerne does not use IPSAS but the corresponding national standard, HAM1 (C). The M1 scoring method gives an overall rating of D+.

### 3.6. External scrutiny and audit

#### *PI 26: Scope, nature and follow-up of external audit*

PI 26	<p>Scoring Method M1:</p> <p>(i) The Canton of Lucerne's State Account is audited by the Audit function according to professional standards. The audit focuses primarily on systemic issues. The entities to be audited are selected with respect to risk; there is no 100% audit of all entities. (B)</p> <p>(ii) The Audit function's report on the State Account is submitted to the parliamentary committees prior to commencement of the audits. (A)</p> <p>(iii) The legislation requires that the auditors' objections be resolved within three months or that corresponding measures for their resolution be introduced. (A)</p>	B+
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The external audit is conducted by both the parliamentary committees and the Audit function. As Parliament has unlimited budgetary sovereignty, it also has the authority to approve the State Account. The canton's highest specialized body with respect to professional auditing is the Audit function. This is an autonomous and technically independent institution answerable only to the Constitution and the law for its auditing activities. It supports Parliament in

<sup>99</sup> IPSAS = International Public Sector Accounting Standards. See: Handbook of International Public Sector Announcements

<sup>100</sup> There is a clear formal and material difference between accounting under HAM and IPSAS. Formally, IPSAS accounts contain important additional components (cash flow statement, notes, etc. with information on other aspects not of relevance to the balance sheet and income statement, such as contingent liabilities). Materially, IPSAS includes an evaluation of the individual items and business cases in accordance with recognized and uniform rules.

<sup>101</sup> HAM2 (2008), p. 11.

exercising superintendence over the cantonal administration and also the Executive and the highest courts in fulfilling their supervisory tasks. As a “monistic” financial supervisory system, the function thus assumes the role of both an internal and external auditor. Moreover, the Audit function largely fulfils the requirements of INTOSAI’s 1997 Lima Declaration<sup>102</sup>.

(i) Scope/nature of external audit performed

The external audit is conducted by both the parliamentary committees and the Audit function. The Audit and Scrutiny Committee oversees the canton’s budget, while the Planning and Finance Committee observes its development within the scope of fiscal planning. The Planning and Finance Committee uses detailed documentation and information from the administration to verify the budgets and the applications for further credit, the Integrated Financial and Task Plan (IFTP) and the State Account, including the special accounts. The Cantonal Council’s committees responsible for auditing the accounts can, within the scope of such an audit, include the head and the staff of the Audit function in the discussions and consult with them on the accounts, view the Audit’s function’s audit reports, the service unit’s reports on the resolution of objections and the evidence of bookings and also have the Audit function conduct additional investigations.

This Audit function assesses the state budget according to recognized audit principles, verifying the correct, lawful, economical and effective execution of the budget. Auditing of the State Account and of the individual administrative entities’ separate accounts forms one of the main tasks of the Audit function. The inspection in this respect arises from the audit programme set annually by the Audit function. The entities to be audited are selected with respect to risk; a 100% audit of all entities is carried out within a three-year cycle. The audit reports are prepared for the Executive and can be inspected by the competent parliamentary committees. However, the audit report is not made available to the public.<sup>103</sup> Rating: B.

(ii) Timeliness of submission of audit reports to Parliament

The State Account is audited on time for the committees’ discussions of the auditing parliamentary delegation, which is responsible for verifying the State Account. However, as the committees’ discussions are held at the start of May, the reports have to be available by the end of April. The committee can include the Audit function in its discussions and consult it for submitting the accounts and also view the Audit function’s audit report on the State Account. Rating: A.

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<sup>102</sup> Cf. Message of the Executive Council to the Cantonal Council on the drafting of a law on auditing (B11 of 10 June 2003)

<sup>103</sup> Information basis: Audit Act and interview with B. Haefliger, Head of the Audit function. The possibility of publishing the reports was debated within the framework of the discussions on the Audit Act but clearly rejected in the vote on the issue.

## (iii) Evidence of follow-up on audit recommendations

If the audit reports contain comments on immaterial weaknesses, specifically errors in terms of formality, the audited entity is required to provide the Audit function with a written report on the resolution of the situation by a specific deadline, which must be within at least three months. If the audit finds material weaknesses, the Audit function sets the audited entity a maximum period of three months to report in writing through the official channels and furnish information on the measures taken.

If no measures are taken by the service unit or the department to resolve the deficiencies found, or if, in the case of material deficiencies, no report is submitted, and if the shortcomings are not resolved through appropriate measures, the Audit function is required to submit measures to the Executive Council or the highest competent court to be ordered for resolution of the deficiencies found.

Deficiencies found are generally resolved within the given deadline. In exceptional cases, which must be justified, the deadline for resolving deficiencies may be extended. Rating: A.

The overall rating according to the M1 method is B+.

**PI 27: Legislative scrutiny of the annual budget law**

PI 27	<p>Scoring Method M1:</p> <p>(i) The extent of the budget scrutiny is based on the information made available. The legislature's review covers the budget and the medium-term Integrated Financial and Task Plan within the advisory parliamentary committees and also in the overall Parliament. (A)</p> <p>(ii) Parliament's budget review is well-established and is respected by the Executive. (A)</p> <p>(iii) As a rule, the Executive has two months to review the budget proposal. (A)</p> <p>(iv) Clear rules exist for approval powers for in-year supplementary and further credits. (A)</p>	A
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This indicator describes the work of Parliament within the scope of the government's budget proposal.

## (i) Scope of the legislature's scrutiny

One of Parliament's main tasks is handling the state budget and the Integrated Financial and Task Plan (IFTP). Parliament has unlimited budget sovereignty. In accordance with the Budget Act, the Executive is obliged to provide the Cantonal Council with the state budget yearly, including the budget of the Supreme and Administrative Court. The budget must be prepared using the principles of completeness, clarity, truth, accuracy, specification and budgeting reporting. It is then divided into sub-budgets according to the administration's organizational structure. Together with the budget, the Executive also submits to Parliament the medium-term plan (IFTP) and a general fiscal-policy evaluation on the basis of the most important financial key figures concerning the state budget and on the basis of the fiscal-policy model. Both the budget and the IFTP contain sufficient information for Parliament to get a good overview of the planned projects.

The government's review of the budget proposal is carried out in two stages. Detailed hearings on the administrative unit's individual sub-budgets are first held in specialized committees. The findings are then compiled and prepared in the Planning and Finance Committee for the budgetary review in Parliament. Rating: A.

(ii) Extent to which Parliament's procedures are well-established and respected

Responding to the state budget proposal is an important task for Parliament, stemming from its unlimited budget sovereignty. The role of the advisory committees and, in particular, the Planning and Finance Committee is recognized and is taken into account by the Executive in accordance with the master schedule. Through its absolute budget sovereignty, Parliament can actually exercise influence on the extent of tasks taken on by the canton, by reducing or increasing the budget. Rating: A.

(iii) Adequacy of time for Parliament to respond to the Executive Council's budget proposal

The Executive Council presents Parliament with the budget proposal alongside the Integrated Financial and Task Plan after the summer break, at the start of September. As a rule, Parliament and its specific committees then have two months to respond to the state budget proposal. Parliament responds to the state budget in the first half of November. If the timeframe is insufficient, Parliament generally can respond to the budget proposal at a later stage. Rating: A.

(iv) Rules for in-year amendments to the budget by the Executive

If the approved credit lines or a special credit turns out to be too low, Departments can apply for a further or supplementary credit for special credits to Parliament, subject to the following conditions. Further credits are not necessary for Parliament if these are envisaged for inflation-led additional expenditure/expenses or for earmarked expenditure and expenses. In addition, no approval from Parliament is needed for amounts below one-thousandth of the unit's income in state taxes. Overall, such supplementary credits for additional budget items should not exceed one percent of an entity's revenue from state taxes. Credit applications from the government are thus excluded from approval by Parliament if the expenditure is at least offset by the receipts that can be generated in the same fiscal year for the same purpose. Rating: A.

**PI 28: Legislative scrutiny of external audit reports**

PI 28	<p>Scoring Method M1:</p> <p>(i) The legislature's scrutiny of the audit report on the State Account drawn up by the Planning and Financial Committee is usually completed within three months. (A)</p> <p>(ii) The key findings from the audit reports are systematically discussed and recorded with the departments and service units in hearings. (A)</p> <p>(iii) Measures approved by Parliament are binding for the government. (A)</p>	A
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Timeliness of examination of audit reports

The key player in responding to the State Account and in preparing an audit report for Parliament is the Planning and Financial Committee. This is examined by the competent

specialized committee of Parliament within two months after publication of the State Account. The specialized committees' audit reports are supplemented by a statement by the Department of Finance and forwarded to the Planning and Finance Committee, which conducts an overall evaluation for Parliament within three months of the State Account being presented. Rating: A.

(ii) Extent of hearings on key findings

As the executive body of the Planning and Financial Committee, the Audit function conducts in-depth discussions with the departments and the heads of the service units of the entities to be audited. The audit areas are determined on the basis of risk and revised with respect to the extent of risk annually or at least once every four years. The Department of Finance and, if need be, the areas concerned may respond to the key findings in the audit reports. Rating A.

(iii) Issuance of recommended actions and implementation by the Executive

Measures recommended by Parliament are passed by the latter in the form of motions or postulates and thereby made binding for the Executive. "Binding" means that the Executive gets an order and has to report back on the execution of the order to Parliament. The Parliament then decides, whether the measures taken are sufficient or not and whether there is a need to report again to Parliament on the follow up. Rating: A.

The overall rating is A.

### 3.7. Fiscal relations with higher level government

#### *HLG-1 Predictability of transfers from the Confederation*

HLG-1	<p>Scoring Method M1:</p> <p>(i) In all three years under review, the actual transfers from the Confederation are higher than the budgeted figures, for both earmarked and non-earmarked transfers. A.</p> <p>(ii) An analysis of the deviation between actual and planned Confederation transfers, according to a functional classification, is not possible on account of the data being too extensive and disperse. No rating.</p> <p>(iii) For the non-earmarked Confederation transfers, there is no timetable agreed on in advance. There is thus no way of evaluating the timeliness of payments. D.</p>	D+
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HLG-1 assesses the predictability of transfers from the higher-level government, i.e. the Confederation, to the canton. The canton's access to shared receipts is also included in the evaluation.

(i) Annual overall deviation between the actual and predicted Confederation transfers

Indicator (i) covers all earmarked and non-earmarked inflows of federal funds, including shared receipts when these are not collected and retained by the canton itself. This determines the extent – from an overall point of view – to which the actual transfers deviate from the predicted transfers.

The *non-earmarked* inflows of federal funds are classified by the HAM under account group 44, Unconditional grants. Account group 44 comprises solely the account 440 “Shares in federal receipts” with the following transactions:

- Share in direct federal taxation
- Share in withholding tax
- HVF (performance-related heavy vehicle fee)
- Share in the profit of the Swiss National Bank
- Others

However, the direct federal taxation is collected by the cantons themselves<sup>104</sup> and, after deduction of the cantonal share, transferred to the Confederation within a defined period after receipt by the canton<sup>105</sup>. It is therefore<sup>106</sup> subsequently excluded from account 440.

Table 16: Deviation from the expected Confederation transfers

		2005	2006	2007
<b>Budget</b>	Non-earmarked transfers (in CHF million)			
	Federal receipts	334.1	341.5	361.2
	- Share in direct federal taxation	183.5	206.4	222.7
	= Non-earmarked federal grants	150.6	135.1	138.5
	Earmarked transfers (in CHF million)	243.5	245.7	255.8
	Total (in CHF million)	394.1	380.8	394.3
<b>Account</b>	Non-earmarked transfers (in CHF million)			
	Federal receipts	355.5	360.1	376.4
	- Share in direct federal taxation	198.0	211.5	224.3
	= Non-earmarked federal grants	157.5	148.6	152.1
	Earmarked transfers (in CHF million)	250.3	247.0	271.8
	Total (in CHF million)	407.8	395.6	423.9
<b>Deviation</b>	Total as a percentage of account	3.5%	3.9%	7.5%

Source: Kanton Luzern. State Account 2006 and 2007.

Under the HAM, earmarked grants fall under account group 46 “Third-party contributions for own account” and, within that, under account 460 “Own contributions from the Confederation”. Ongoing operating grants of an earmarked nature from the Confederation and its institutions reporting to it directly or indirectly are booked. These include many quite large and small federal grants, such as fire compensation, premium reductions, disability insurance contributions for special-needs schools, subsidiaries for vocational schools.

<sup>104</sup> Federal Act on direct federal taxation, Art. 160

<sup>105</sup> Federal Act on direct federal taxation, Art. 196

<sup>106</sup> PEFA Guidelines

The transfers from the Confederation were higher than the budgeted expectations in each year of the period under review. Criterion (i) gets an A rating.

(ii) The second dimension assesses, for the *earmarked* federal transfers to the canton, the extent of the deviation between the budgeted and actual transactions for all three years under review, broken down by main function according to a functional classification. This assessment is not possible for technical reasons in the case of the Canton of Lucerne. It is generally acknowledged that the transfer system between the Confederation and the canton was far too confusing in the past<sup>107</sup>. In 2007 alone, over 400 bookings in this respect were made<sup>108</sup>. A rating is not possible for dimension (ii).

(iii) The non-earmarked transfers do not follow a timetable agreed upon between the Confederation and the canton, as would ideally be expected by PEFA. Transfers from the Confederation are made via a separate current account at the Department of Finance. Claims from the canton on the Confederation are settled twice a month with open counter-claims from the Confederation on the canton and the balances then transferred. The claims of the canton are largely made on a decentralized basis by the departments, sometimes based on project billing.<sup>109</sup> This procedure does not include any central monitoring of the timeliness of the transfers made. Liquidity management is partly based on empirical values but also regularly obtains information from the departments on upcoming incoming and outgoing payments.<sup>110</sup>

Nonetheless, the estimates within the Department of Finance assume that the Confederation settles its debts as soon as possible.<sup>111</sup> As the Confederation and the canton have not agreed on a timetable for the transfers, dimension (iii) must be given a D rating.

The M1 Scoring Method<sup>112</sup> results in an overall rating of D+.

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<sup>107</sup> The project “Reform of fiscal equalization and task allocation between the Confederation and the cantons” under the new fiscal equalization system referred to this specific fact quite substantially. Fact Sheet No. 1 of the new fiscal equalization system, published by the Federal Finance Administration in September 2004, states: “The current task allocation between the Confederation and the cantons and also the transfer system have grown historically – since the foundation of the Swiss federal state in 1848 – and are not based on a carefully designed scheme. It is hardly surprising, therefore, to find that deficiencies – some quite substantial – have crept into the organization of the federal state and the fiscal relations between the various levels of government over the years.” The same document goes on to mention the “complicated nature of the financial flows in the federal state” as a serious problem. On 1 January 2008, however, the reformed system for fiscal equalization and task allocation was introduced, which seeks to remedy the situation in this respect. The new fiscal equalization system reform will certainly help to mitigate the problem but will not remove it completely. - Cf. also Section 2.1 in this report.

<sup>108</sup> Information from the Controlling service, Finances service unit, Department of Finance of the Canton of Lucerne.

<sup>109</sup> Information from the Finances service unit, Tax collection and municipality billing, as well as the Finances service unit, Asset und Liability Management

<sup>110</sup> Information from the Finances service unit, Asset und Liability Management

<sup>111</sup> Estimates: Finances service unit: Controlling services, also Asset und Liability Management.

<sup>112</sup> Further clarifications from the PEFA Secretariat in September 2008 in the case of dimensions that cannot be clarified. Online: [www.pefa.org/pfm\\_performance\\_file/Clarifications-September 2008-Final\\_1223497962.pdf](http://www.pefa.org/pfm_performance_file/Clarifications-September 2008-Final_1223497962.pdf)

## 4. Cantonal reform projects

### 4.1. Reform projects

The Canton of Lucerne's ongoing projects in the area of financial management are both strategic and operational in nature.

#### 4.1.1 Reform projects from a strategic viewpoint

The Canton of Lucerne faces steep competition from its neighbouring cantons with respect to taxes. The main objective of the canton's fiscal policy is thus to be able to lower the tax rates and tariffs in such a manner that the tax burden in the Canton of Lucerne gradually approaches the Swiss average. This is a particularly difficult objective as, meanwhile, the policy of neighbouring cantons is to lower taxes even more. The Canton of Lucerne aims to reach its goal by consistently reviewing its offering, optimizing its service provision and carrying out structural adjustments. Lower taxes and, at the same time, an improvement in the transport infrastructure should make the canton a more attractive place to live and to set up business, and thereby encourage new taxpayers to move there and increase the level of economic value creation.<sup>113</sup>

#### 4.1.2 Reform projects from an operational viewpoint

There are two reform projects underway in the Canton of Lucerne at an operational level: the law on the management of finances and services (complete revision of the Public Finance Act) and the development and operation of a central tax solution (LU-Tax).

- The consultation process on the proposed law on the management of finances and services (known as FLG)<sup>114</sup> was opened on 20 May 2009 by the Department of Finance of the Canton of Lucerne. In principle, the law is scheduled to come into effect on 1 January 2011. The main content of the new law is as follows:
  - Expanded scope of governance: Budget *and management* of finances and services.
  - More flexibility with the debt cap: The budgeted expense surplus must not exceed a maximum of 5% (previously 4%) of a unit of state taxes; investments for the year must be at least 80% covered by operational activities; balancing of the Operating Statement over a period of seven years. The inflow of funds from operational activities must at least cover the outflow of funds for investments in the medium term.
  - Positioning of the legislative programme in an explicit long-term strategy (10-year horizon). Drafting of service plans based on this in the form of planning reports per task area (second level of the functional classification). These service plans are used for political (parliamentary) control and are assigned impact targets and updated every four years. The service plan is used as a basis for the Task and Financial Plan (TFP), which is updated yearly. This is used to derive the operational performance contracts for service groups and services, which are used for operational management.

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<sup>113</sup> Legislative programme 2007-2011, p. 29

<sup>114</sup> Consultation message on the proposed law on the management of finances and services

- Approval of the budget and the Task and Financial Plan in one document.
- Supplementary credits are generally required once a certain minimum level has been exceeded. Minor cost excesses must be offset by the performance budget. The Executive Council can approve overdrafts of credit lines in certain cases: urgent projects, expenditures prescribed by the Confederation or by court order, transitory contributions, depreciation/value adjustments. Overdrafts are permitted if the compensation within the approved budget would be disproportionate. The Cantonal Council must be informed of these in the annual report.
- Annual reporting by means of a comprehensive report, which also provides information on strategy implementation.
- Presentation of the assets, financial and earnings situation on the basis of a “true and fair” view, in accordance with IPSAS and HAM2. The balance sheet will be restated for this purpose.
- In principle, consolidation of all entities on which the Canton has substantial influence and to which it pays substantial operating grants: The Executive Council decides on which entities are to be consolidated in this respect. The Annex to the message also lists the following entities: Lucerne Cantonal Hospital, Lucerne Psychiatric Hospital, University of Lucerne, LUSTAT. Full consolidation will be carried out, based on the equity method. The following are among those entities for which consolidation is not planned: Agricultural Credit Fund, Lucerne Pension Fund, various compensation funds, Building Insurance, Cantonal Bank of Lucerne.
- The project “Procurement, development and operation of a central taxation solution” (LU-Tax) was first discussed in the Cantonal Council in April 2009. This aims primarily to speed up the tax assessment and billing process but also to simplify cooperation between municipalities and the canton, enhance data quality and enquiry possibilities, increase transparency of data flows and data storage, and lower the costs for the municipalities and the canton. The main innovations planned are as follows:
  - Tax assessment via a central, uniform IT system for the canton and all municipalities
  - Clear task allocation in tax assessment between the canton and the municipalities: Responsibilities of the canton and municipalities divided according to the type of taxpayers
  - Centralization of the tax register with online access for the canton and municipalities
  - Centralized document input: Information is scanned in centrally and made available online to the canton and municipalities.
  - Decentralised collection of cantonal and municipal taxes as well as direct federal taxes.

With the planned reforms, the Canton of Lucerne will address some of the issues raised by the PEFA study:

- PI-9: The overview of the fiscal risks will be improved through consolidation. However, the risks of the non-consolidated entities, particularly the Cantonal Bank of Lucerne and the Lucerne Pension Fund, also have to be carefully monitored.
- PI-15: Tax collection: The LU-Tax project intends to speed up the tax assessment and billing process. The extent to which this will also solve the problem of tax arrears and improve the timeliness of the municipalities' transfers of cantonal taxes remains to be seen.
- PI-25: The consolidation and the presentation of the assets, financial and earnings situation on the basis of a "true and fair" view, in accordance with IPSAS and HAM2, will further improve the quality of the financial reports considerably.

In addition, other important reform measures are also planned for cantonal financial management. In particular, the strategic linkage between the Task and Financial Plan (TFP) and the budget will be enhanced (PI-12). With this reform measure, controlling the cantonal service performance will also be easier and more impact-oriented. Finally, measures are also planned for internal controls of payroll spending.<sup>115</sup>

#### **4.2. Evaluation of the will to reform**

The Canton of Lucerne has displayed in recent years a strong will to reform and an impressive ability to do. The most outstanding examples of this are the development and implementation of Lucerne '99, or the Municipalities Reform 2000+, as well as the Finance Reform 08, and also the comprehensive introduction of New Public Management.<sup>116</sup> The Canton of Lucerne continues to face harsh tax competition from its neighbouring cantons. The canton is therefore fully aware of the need to optimize its processes continually. It will only be able to maintain its current fiscal positioning, with above-average taxes among its neighbouring cantons, for as long as the parties and taxpayers are sufficiently confident that scarce resources are being allocated efficiently and utilized economically. Such fiscal competition among the cantons also creates greater discipline and fosters innovation. The introduction of HAM2 is thus a requirement to which all cantons are subject. Based on the thorough discussion of the PEFA study within the administration and the positive initial feedback to the present study from the competent administrative areas, there is clearly a positive approach to reform, particularly within the Department of Finance. With the proposed new law on the management of finances and services and also the LU-Tax project, the Canton of Lucerne has once again demonstrated its will to reform. With the message on the new law on the management of finances and services, the Department of Finance has shown its intention to go beyond the minimum implementation of HAM2. On the question of consolidation, the reform proposed by the Department of Finance assertively exploits the options available for modern international standards in public financial management so as to enhance budget transparency.

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<sup>115</sup> Information from the Head of the Finances service unit at the final meeting on the PEFA study, end-May 2009.

<sup>116</sup> See above, Section 2.2.2 System of government and reform strategies

## Annex

### Annex 1: Summary Table of Findings

Indicator	Brief explanation and data sources	Score
1 Aggregate expenditure out-turn compared to original approved budget	Only minimum deviation of expenses from the budget (max. 1.3%). Source: State Account.	A
2 Composition of expenditure out-turn compared to original approved budget	Spending by main function largely corresponds to the budget. Some functions with low levels of spending did, however, show substantial deviations, e.g. Culture and Recreation. Source: State Account.	A
3 Aggregate revenue out-turn compared to original approved budget	Actual receipts exceeded budgeted receipts in all of the years under review, despite a tax reduction in 2006. The economy was booming, however, in the period under review. Source: State Account	A
4 Stock and monitoring of expenditure payment arrears	The payment arrears are minimal. SAP does not monitor accounts payable of e.g. hospitals, courts, the road traffic office. Source: SAP evaluation, Head of Accounting.	B+
5 Classification of the budget	In addition to the administrative classification and the economic classification, the budget also shows a functional classification, although this is presented in only one level for the Statement of Investments. Source: State budget.	B
6 Comprehensiveness of information included in budget documentation	The budget information is transparent. However, details on the macroeconomic assumptions have to be taken from the IFTP or the State Account. Source: State budget, IFTP, State Account.	A
7 Extent of unreported government operations	The level of extra-budgetary expenditure is insignificant. Source: State Account.	A
8 Transparency of inter-governmental fiscal relations	Most of the state contributions to the municipalities are formula based. The financial information on these state contributions is usually somewhat late. The information on municipalities' finances is up-to-date but only shows the actual values and not the budgeted values. Information: State Account, Department Secretariat of the Department of Finance, Municipalities Office, Statistics Office.	B
9 Oversight of aggregate fiscal risk from other public sector entities	The canton is not liable for the municipalities' commitments. The fiscal risks of autonomous government agencies and public enterprises are observed but not consolidated. Information on risk consolidation: Department of Finance.	C+
10 Public access to key fiscal information	Four out of seven elements of the fiscal information are available for public access. Not available: In-year financial reports, audit report, outsourcing contracts. Information: Department of Finance.	B
11 Orderliness and participation in the annual budget process	The budget process is arranged in an orderly manner and the budget circulars are policy-based. The departments do have time for budget input within the framework of the budget circulars. This time is quite limited, however. Information. Budget calendar.	A
12 Multi-year perspective in fiscal planning, expenditure policy and budgeting	The multi-year perspective is conveyed via the IFTP. The linkage to the IFTP budget requires some improvement. What is missing from the IFTP is an explicit presentation of the forward expenditures of investment decisions. Information. Controlling services, Finances service unit.	B
13 Transparency of taxpayer obligations and liabilities	Transparency largely exists in taxpayers' tax liability. Appeals may be filed against decisions. Transparency could be further	B+

	improved with information campaigns for taxpayers. Information: Tax Act and Tax Ordinance.	
14 Effectiveness of measures for taxpayer registration and tax assessment	The taxpayers are entered in a tax register, which is compared with the population control register and the commercial register. Tax evasion cannot be fully ruled out on account of the principle of self-assessment, but it is punished. The tax system lacks a comprehensive quality management system. Information: Tax Act, information from the Tax Office of the City of Lucerne.	B
15 Effectiveness in collection of tax payments	The reconciliation between tax bills and tax receipts functions well. The taxes between the canton and the municipalities are reconciled only once a year, in January of the following year. But it is not possible to assess the average debt collection ratio for lack of data at cantonal level. Information: State Account, the Tax Office of the Canton of Lucerne, Tax collection and municipality billing.	NS
16 Predictability in the availability of funds for commitment of expenditures	The cash flow forecast is updated daily; the departments, service units and public entities can spend freely within the budget. In-year budget adjustments are rare and are made in an orderly manner. Information: Directives from the Department of Finance, Public Finance Act.	A
17 Recording and management of cash balances, debt and guarantees	The contracting of loans and issuance of guarantees is centralized, debt is recorded reliably and documented quarterly in a report. Only the larger cash balances are calculated daily, the others at least monthly. Information: Directives from the Department of Finance.	A
18 Effectiveness of payroll controls	Personnel data and salary payments are coupled in an ERP system and the personnel data is updated at least once a month. There is, however, no official auditing of how the authorizations for updating personnel data are managed. Payroll data of all payroll offices have been audited at least once in the past three years. Information: Checklist for salary processing and Audit Act.	C+
19 Competition, value for money and controls in procurement	The procurement system is clearly regulated and a complaints mechanism exists. However, there is no specific monitoring instance to check that the law is observed.	B
20 Effectiveness of internal controls for non-salary expenditure	Internal controls for non-salary expenditure are well established. Information: Public Finance Act and Directive for the Internal Control System.	A
21 Effectiveness of internal audit	The internal audit operates professionally. Specific routines are in place for resolving the deficiencies found. Information: Audit Act, Head of the Audit function.	A
22 Timeliness and regularity of accounts reconciliation	Bank accounts are reconciled weekly, advances monthly. Information: Department of Finance.	A
23 Availability of information on resources received by service delivery units	Information on the availability of resources for service delivery units is recorded directly via cost and performance accounting. Information. Public Finance Act.	B
24 Quality and timeliness of in-year budget reports	Two types of in-year budget comparison reports are drawn up: inter-departmental (quarterly) and intra-departmental (after the second and third quarters). However, there is no in-year verification of credit lines. Information: Templates, provided by the Department of Finance.	C+
25 Quality and timeliness of annual financial statements	The financial reports are prepared on time, but without full consolidation and not in compliance with IPSAS.	D+
26 Scope, nature and follow-up of external audit	The audit performed by the Audit function is on time. The priority is on systemic test issues. The routines for resolving deficiencies found are good. The entities to be audited are selected with respect to risk; however, there is no 100% audit of	B+

	all entities. Information: Audit Act; Head of the Audit function.	
27 Legislative scrutiny of the annual budget law	The parliamentary scrutiny of the budget and the IFTP is carried out in a purposeful and orderly manner and in good time. The legislature can also assert its influence on in-year budget adjustments. Information: Audit Act, budget calendar.	A
28 Legislative scrutiny of external audit reports	The audit findings are reviewed by the Planning and Finance Committee of Parliament. Any parliamentary resolutions that refer to findings from the audit are binding for the government. Information: Cantonal Council Act; Rules of Procedure for the Cantonal Council; Head of the Audit function.	A
HLG-1 Predictability of transfers from the Confederation	The transfers actually made are higher than those predicted. However, it is not technically possible to analyse the deviation along the functional classification on account of the data being too disperse. Also, there is no timetable for the transfers so as to verify the timeliness of the incoming payments. Sources: Controlling services, Tax collection, Asset und Liability Management.	D+

## Annex 2: The results in brief

The following is a rapid-read overview of the results presented above.

### *Credibility of the budget (PI-1 to PI-4)*

The indicators under “Credibility of the budget” seek to determine how well the budget formulation corresponds with the budget implementation in terms of expenses and revenue, i.e. how well the budget can forecast and control the actual development of the state activities for the planned year. They look at the accuracy of forecast expenditures overall and also broken down by main function according to a functional classification, as well as the accuracy of the forecast receipts. To round off the picture, this section also looks at how well the canton adheres to and/or monitors payment deadlines. The canton should not claim to adhere to its spending budget by simply not paying bills on time.

The analysis finds that the cantonal budget has a high degree of credibility. With respect to the forecast accuracy for the total expenditure (or expenses; PI-1), for the functional composition of expenditures (or expenses; PI-2), and for the total receipts (or return; PI-3), the Canton of Lucerne’s PFM gets the highest score of A. Of note is that the forecast accuracy on the return side was not reduced by the lower tax rate. It is also worth noting that the actual return exceeded the budgeted return substantially in all three years under review, while the variance was only minor on the expenses side. This may be viewed as an indication of conservative budgeting and of discipline in terms of expenses, but the returns also show the signs of the booming economy during the period under review.

PI-4 evaluates the stock and monitoring of expenditure payment arrears. As for the stock of payment arrears, the cantonal PFM can be awarded an A. What’s more, the timeliness of payments improved year-on-year during the period under review, with the number of outstanding payments falling in each successive year. In the monitoring of expenditure payment arrears, there is a noticeable difference between the state core area (Parliament, government, cantonal administration, courts), where outstanding payments are recorded throughout in SAP and due-date analyses are conducted at regular intervals, and the extended circle of cantonal institutions, such as hospitals, where outstanding invoices are not entered in SAP and thereby escape the routine monitoring of payment dates. The availability of data for monitoring the stock of expenditure payment arrears gets a score of B. The overall rating is B.

### *Comprehensiveness and transparency (PI-5 to PI-10)*

The section “Comprehensiveness and transparency” looks at the budget formulation to determine:

- how appropriately the budget is classified,
- whether the initial situation and the macroeconomic planning assumptions are presented transparently in the budget,
- whether there are any unreported cantonal activities,
- how transparent the fiscal relations with the municipalities are,
- whether there is an overview of cantonal risks at the municipalities’ end or with public institutions and companies, and
- how complete the financial data is available to the public.

In the budget classification (PI-5), the canton uses the Harmonized Accounting Model (HAM) that is standard for Swiss cantons and municipalities. However, the cantonal budget also observes the requirements of NPM. In agreement with the HAM, there is an institutional classification, an economic classification and a functional classification. The functional classification is largely compatible with the COFOG standard, though it is not identical. In the Operating Statement, the functional classification is presented in two levels, but only in one level for the Statement of Investments. For these last two reasons, the rating assigned is B.

The available budget information (PI-6) is presented in a transparent way. The requirements of PEFA are largely met. The macroeconomic assumptions are presented in the Integrated Financial and Task Plan (IFTP), the medium-term fiscal-policy planning document, but they are not repeated in the budget. The information on debt and assets at the start of the current year appears in the State Account passed in the spring but is not repeated in the budget and the IFTP. Nonetheless, the PEFA rating is an A.

The extent of unreported government operations (PI-7) is very low. Off-budget funds activities are recorded in the Notes to the State Account. Their volume is practically negligible. There are no donor-financed activities. The rating is A.

The fiscal relations with the municipalities (PI-8) are relatively transparent. The vast majority of state contributions follow clear, though sometimes complex, rules, resulting in a rating of A for the first dimension of this indicator. However, the municipalities rely on prompt financial information from the canton about these state contributions, and this information is sometimes available only just in time, arriving after some of the municipalities – particularly the larger ones – have already advanced well into their budget process. This dimension is given a B. The PEFA standards expect the canton to have a good overview of the municipalities' finances, particularly with respect to the allocation of resources. As the municipalities' financial statistics record and process only the actual values, the rating for this dimension is a C. The overall rating is B.

The canton's observation of risks among public institutions and companies but also with the municipalities (PI-9) is fulfilled in part. The risk of autonomous government agencies and public enterprises is recorded annually but not consolidated. PEFA regards this as problematic (rating: C). As, in principle, the canton is not liable for the municipalities, the rating for the second dimension is A. The overall rating is C+.

The fiscal information for public access (PI-10) does not meet all of PEFA's requirements. Only the following four out of seven expected elements are present: Budget, State Account, resources per service unit, fees regulation. Not present are in-year financial reports, audit report, outsourcing contracts. The rating is B.

#### *Policy-based budgeting (PI-11 and PI-12)*

The section on "Policy-based budgeting" seeks to find out the extent to which the budget is formulated along orderly lines with clear policy-based guidelines from the overall Executive Council, in a framework that allows the administration to participate adequately. This section also looks at how well the medium-term Integrated Financial and Task Planning interconnects with the strategy, on the one hand, and with the budget on the other.

The question of *orderliness and participation in the annual budget process* (PI-11) gets a positive response. The budget calendar is planned in great detail and has to be implemented without delay. The *administration participates* in the budget formulation in various cycles. For the detailed preparation of the new performance contracts and the performance budgets, the departments and the service units have about five weeks, a reasonable period of time in PEFA's estimation. The above two dimensions – binding *budget ceilings* from the Executive Council

for the departments, the State Chancellery and courts – as well as *prompt approval* of the budget are given a score of A. The overall rating for PI-11 is A.

The *multi-year perspective of the Financial and Task Planning and the budget formulation* (PI-12) evaluates four dimensions. The first dimension gets only a C rating. Although the IFTP has a *five-year planning horizon* and fulfils the required *classification criteria* with respect to the functional classification and the economic classification, the budget makes *too little reference to the planned values in the IFTP* for the year in question. Justification is given for deviations with respect to the previous year's budget but not with respect to the corresponding IFTP planned value. The IFTP may thus be insufficiently used as a controlling instrument. Secondly, the IFTP shows the *development of the leading financial key figures with respect to the state debt* beyond the entire planning horizon. Rating A. In the third and fourth dimension, however, the rating is B. This is because the IFTP *corresponds only implicitly with the strategy, i.e. the legislative programme*, for the time being and because the *forward expenditures of investments* are not transparent in the IFTP. The overall rating is B.

#### *Predictability and control in budget execution (PI-13 to PI-21)*

In the section “Predictability and control in budget execution”, PEFA evaluates various aspects of the tax system, the availability of funds and issues of liquidity management and the extension of guarantee, controls for payroll and non-salary expenditure, the competitive nature of the procurement system and the effectiveness of the internal audit. These indicators refer to the commitment of expenditures.

Within the tax system, three sub-sections are observed: transparency in the tax liability, the effectiveness of measures for taxpayer registration and tax assessment, and the effectiveness of tax collection.

Concerning the *transparency of the tax liability* (PI-13), it can be noted that the tax liability is clearly set out in the law. Nonetheless, the tax office still has certain, albeit limited, *discretionary powers*. PEFA regards this as a slight loss of transparency. The dimension in question is given a B. In general, the result is highly positive for the simple *access of taxpayers to tax-relevant information* via the Internet, hardcopy documents and by calling the tax office. PEFA expects the tax office to offer its own information campaigns, which is not the case. This brings the second dimension down to a B. The *appeals mechanism* for taxpayers is guaranteed, however, producing an A rating. The overall score is B+.

The *effectiveness of measures for taxpayer registration and tax assessment* (PI-14) first examines the risk of gaps in the *tax register*. The canton fulfils all the requirements here for an A rating. The second dimension asks whether the assessment procedure can ensure a *complete estimate* of the taxed objects (income, assets, etc.). The process is based on a self-assessment, with penalty taxes mitigating the risk of tax evasion and tax fraud. There is no guarantee that the tax assessment does not omit certain facts; the volume of taxes lost in this manner is thought to be lower, however, resulting in a B score. There is *quality control* only for those tax assessments conducted by the municipalities but not for those carried out by the canton: at the cantonal level there is no comprehensive quality management system that could provide clear criteria in terms of ICS, evaluation and risk management. This dimension is given a C. The overall rating is B.

On the question of the *effectiveness of the tax collection process* (PI-15), it is positive to note that the control of accounts payable (reconciliation of tax bills sent with taxes received) is systematic and immediate. Due to the fact that there is no age profile for tax arrears, the tax collection ratio for tax arrears of the last two fiscal years cannot be calculated. A disadvantage is the *delay in time between the inflow of taxes by the municipalities and the transfer* of the

corresponding funds to the canton. Because one dimension cannot be rated for lack of data, there is no score for PI-15.

As to the *predictability in the availability of funds for commitment of expenditures* (PI-16), all three dimensions have a score of A. The Finances service unit operates a *multi-year liquidity planning system*; it ensures solvency with its rolling liquidity *in-year planning system*, updated daily, and thus optimizes financing costs. The MDAs (ministries, departments and agencies) are not subject to any *cash restriction* and are free to plan and commit expenditure in accordance with the budgeted appropriations. In terms of legislation, several *in-year budget adjustments* are possible. However, this freedom does not undermine the budget discipline in reality, as shown by the very few budget adjustments made in 2006 and 2007. The overall rating is A.

Concerning the *recording and management of cash balances, debt and guarantees* (PI-17), it can be seen that *debt management* is carried out centrally in the Asset & Liability Management ALM, which prepares a comprehensive quarterly report. This is based on very high-quality data from the ALM tool (Rating A). Only the larger *cash balances* are entered daily, the rest are calculated at least monthly (Rating B). The *contracting of loans and the issuance of guarantees* are laid down by law and approved centrally (Rating: A). The overall rating is A.

The *internal payroll controls* (PI-18) function very well in many areas. Nonetheless, certain security loopholes cannot be ruled out. With the SAP-ERP tool, salary payments are *linked to the personnel data* (Rating: A). The processing of *altering personnel data* is well secured (Rating: A). The *authorizations* for altering personnel data are strictly limited but are not subjected to an audit. The ICS in the area of salary payments is under construction (Rating: B). The Audit function verifies the salary system within the framework of its general tasks. There is no *payroll controls* within the meaning of PI-18, as the audit is not carried out annually and does not cover all aspects of the personnel system. This means that the existence of “ghost workers”, etc. cannot be ruled out (Rating: C). The overall rating is C+.

The law clearly sets out the *competitive procurement system* (PI-19), including the degree of flexibility permitted. However, there is no evidence of which parts of the law have been observed or not, as there is no central body to monitor *observance of the procurement system* (Rating: D). There is also no evidence of the extent to which less competitive procurement methods comply with the legal requirements (Rating C). There is, however, a two-stage *complaints mechanism* (Rating: A). The overall rating is C+.

The *effectiveness of the internal controls for non-salary expenditure* (PI-20) gets the maximum score of A in all dimensions. In particular, the control of accounts payable does not permit the non-salary expenditure to deviate from the audit requirements for completeness and accuracy of validation and segregation of tasks. The control of special credits also monitors multi-year credits. Overall rating: A.

The *effectiveness of the internal audit* (PI-21) is positive in all dimensions. The Audit function has a two-fold position in that it supports both the Executive and the courts in their supervisory tasks and also Parliament in its superintendence. The Audit function operates autonomously and answers only to the Constitution and the laws. Its audit work covers the cantonal administration and the courts as well as institutions or persons outside of the cantonal administration that fulfil public tasks and/or receive state contributions. The supervisory body operates according to professional standards, with the *priority on systemic tests*. The *reports of the Audit function* are sent to the audited entity itself, the Department of Finance and the competent department, or to the State Chancellery or the competent court. There are clear, *specific deadlines for resolving any deficiencies found*. Overall rating: A.

*Accounting, recording and reporting (PI-22 to PI-25)*

These four indicators refer to the reporting system and are looking for regular and punctual account reconciliations between the bank and the accounting system (for evidence of the validity of the accounting), information on the availability of resources received by service delivery units (e.g. to ascertain their ability to operate), the quality and timeliness of in-year budget comparisons (so as to identify any problems as early as possible) and the quality and timeliness of financial reports (with respect to consolidation, truthful evaluation and relevance).

The indicator on the *timeliness and regularity of accounts reconciliation* (PI-22) meets all the criteria for an A rating. In principle, the Treasury reconciles the bank statement daily with the accounting system. For suspense accounts and advances, reconciliation is monthly.

*Information on the availability of resources received by service delivery units* (PI-23) can be derived implicitly from the cost and performance accounting. However, the information from the cost and performance accounting is not used to find out about the availability of resources received by service delivery units. The rating is B.

On the *quality and timeliness of in-year budget reports* (PI-24), it can be seen that the budget comparisons are based on *reliable information* and carried out at *appropriate intervals*. Both of these dimensions get an A score. However, as *credit lines* (i.e. payment authorizations extending beyond the budgeted year) are included only partially in the budget comparison, costs in association with long-term projects cannot be completely recorded in the in-year controls (Rating: C). The overall rating is C+.

PEFA regards the *quality and timeline of annual financial statements* (PI-25) as insufficient for two reasons: given the *absence of consolidation*, the annual accounts do not give an overview (Rating: D) and the accounting standards used are *not IPSAS-compliant*, which, particularly in evaluating assets, has an impact on transparency and international comparability (Rating: C). However, an A rating is given for timeliness. The overall rating is D+.

*External scrutiny and audit (PI-26 to PI-28)*

These three indicators highlight the practice of external auditing and the handling of audit findings as well as that of the annual budget and the external audit reports by Parliament. This asks the question of how the “Principal” can assert its authority over the “Agent”.

In terms of the *scope, nature and follow-up of the external audit* (PI-26), it is positive to see that the Audit function’s audit report is available before the parliamentary committees begin their controls (Rating: A). It is also positive to see that any deficiencies found must be resolved by the audit bodies or the corresponding corrective measures be introduced within a defined period of time (Rating: A). The Audit function conducts its testing randomly, though its choice is also based on risk (Rating: B). The overall rating is B+.

The routine for *handling the annual budget by the Executive* (PI-27) can be regarded as good in all aspects: extent, procedure and timing of the review, as well as the approval practice for supplementary credits. Overall rating: A.

The *legislative scrutiny of external audit reports* meets all the requirements set. The audit report prepared by the Planning and Finance Committee is dealt with within an appropriate period of time; the key findings and test results are systematically discussed and recorded with the departments and service units; the measures approved by Parliament are binding for the government.

### **Annex 3: Information sources**

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***Interviews, oral and written information***

BAK Basel Economics

Economy and Labour service unit, Unemployment fund of the Canton of Lucerne

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Department of Finance, Canton of Lucerne, Tax collection and municipality billing

Audit function, Canton of Lucerne, Management

Canton of Lucerne (Feb. 2009): Written feedback on the first draft of the report “Analysis of the cantonal financial management using the PEFA framework”

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Asset & Liability Management – Directive of the Department of Finance of the Canton of Lucerne

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Participation and Contribution controlling plan, Outline (Executive Council decision)

Budget proposal of the Executive Council, Executive Council decision, Template

Salary processing, checklist

Controlling master plan 2008

Planning and budgeting, flow chart

Planned budget proposal of the Executive Council, Template

Review of the IFTP process 2008-2012 and presentation of suggestions for improvement

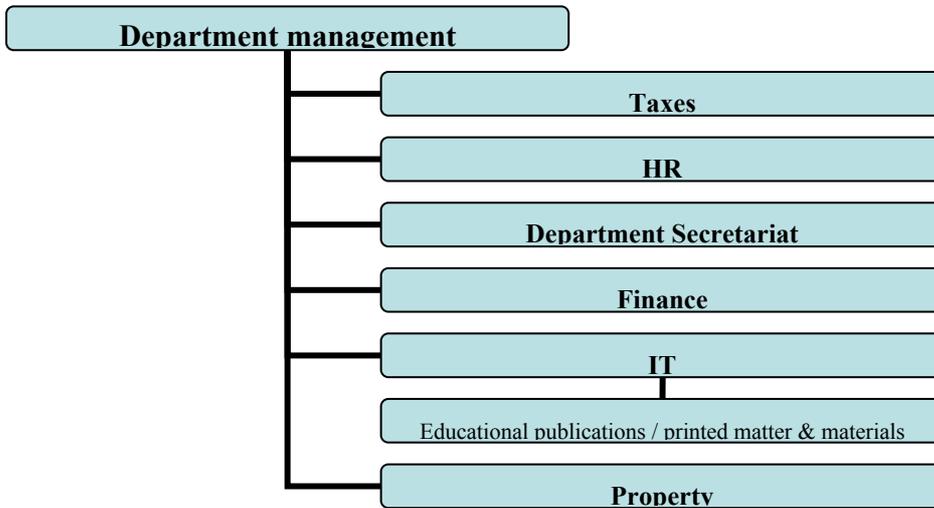
Review of the State Account 2007 and presentation of suggestions for improvement

Minutes of the meetings of the Grand Council (Cantonal Council)

Directive on the Internal Control System (ICS), Accounts Payable Accounting sub-section

### Annex 4: Organizational charts

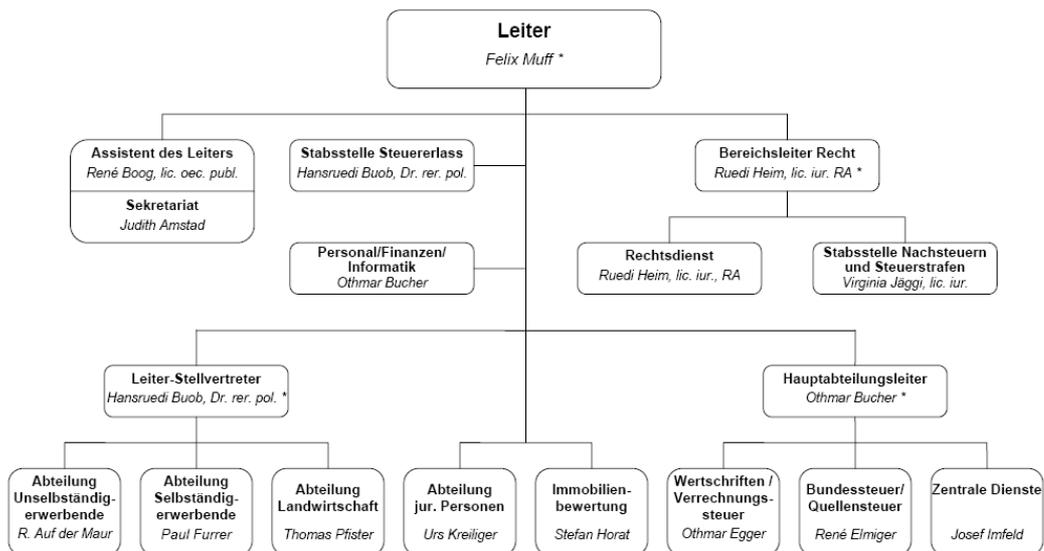
#### Department of Finance



- Autonomous entities**  
 - Lucerne Pension Fund  
 - LUSTAT Lucerne Statistics

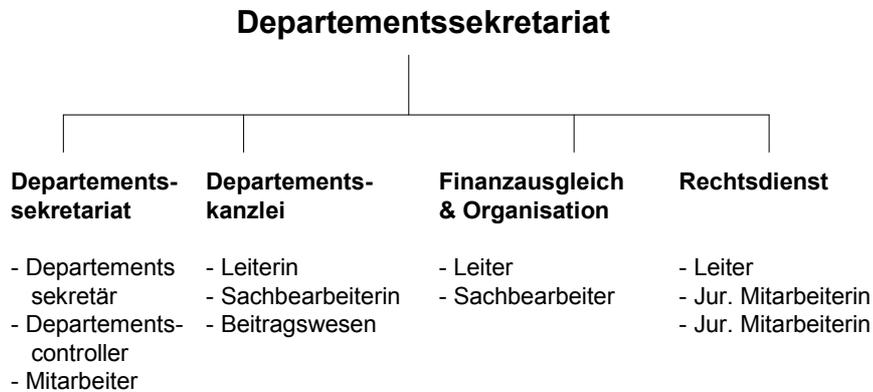
#### Tax service unit

Organigramm  
**Dienststelle Steuern des Kantons Luzern**  
 1. April 2008

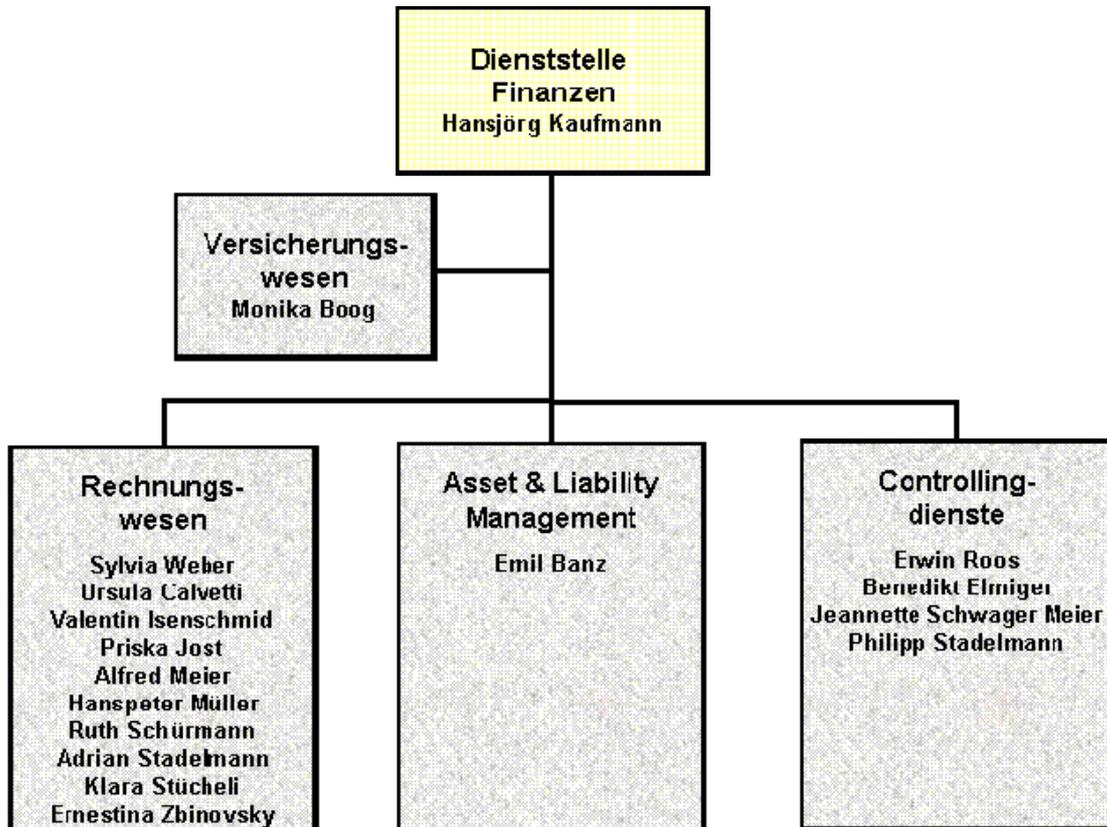


\* = Mitglied der Geschäftsleitung

## Department Secretariat service unit



## Finances service unit



Bau-, Umwelt- und Wirtschaftsdepartement Vorsteher: Max Pfister, Regierungsrat	Bildungs- und Kulturdepartement Vorsteher: Dr. Anton Schwingruber, Regierungsrat	Finanzdepartement Vorsteher: Marcel Schwerzmann, Regierungsrat	Gesundheits- und Sozialdepartement Vorsteher: Dr. Markus Dürr, Regierungsrat	Justiz- und Sicherheitsdepartement Vorsteherin: Yvonne Schärli, Regierungsrätin
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Entwicklungsservice</li> <li>SAP-Systeme und ServiceDesk</li> <li>Lehrmittelverlag &amp; Beschaffungsmanagement</li> </ul>	<p><b>Staatskanzlei</b></p> <p>Vorsteher: Dr. Markus Hodel, Staatschreiber administrativ zugeordnet: Finanzkontrolle, kantonaler Datenschutzbeauftragter</p> <p><b>Departementssekretariat</b></p> <ul style="list-style-type: none"> <li>Zentrale Dienste</li> <li>Rechtsdienst</li> <li>Finanzen und Controlling</li> <li>Organisation und Informatik</li> <li>Gesundheit</li> <li>Soziales und Arbeit</li> </ul> <p><b>Dienststelle Spitäler</b></p> <p><b>Kantonsärztliche Dienste</b></p> <ul style="list-style-type: none"> <li>Zentrale Dienste</li> <li>Ärzte und Medizinalpersonen</li> <li>Infektionskrankheiten</li> <li>Sucht</li> <li>Prävention und Gesundheitsförderung</li> <li>Ausserkantonale Hospitalisationen</li> <li>Betäubungsmittel</li> <li>Kantonszahnarzt</li> </ul> <p><b>Kantonsapotheker</b></p> <ul style="list-style-type: none"> <li>Heilmittelbereich/Betäubungsmittel/Medizinprodukte</li> <li>Kantonale Ethikkommission</li> <li>Fachstelle Chemikalien/Gefahrengutbeauftragte</li> <li>Koordinierter Sanitätsdienst</li> </ul> <p><b>Dienststelle Lebensmittelkontrolle und Verbraucherschutz</b></p> <ul style="list-style-type: none"> <li>Inspektionen/Probeerhebung</li> <li>Abteilung Analytik/Qualitätssicherung</li> <li>Abteilung Wasser</li> <li>Abteilung Biologie</li> </ul> <p><b>Veterinärdienst</b></p> <ul style="list-style-type: none"> <li>Zentrale Dienste</li> <li>Tiergesundheit</li> <li>Lebensmittelsicherheit</li> <li>Tierschutz</li> <li>Veterinärpolizei</li> </ul> <p><b>Dienststelle Soziales und Gesellschaft</b></p> <ul style="list-style-type: none"> <li>Zentrale Dienste und Finanzen</li> <li>Sozialhilfe, Asyl- und Flüchtlingswesen</li> <li>Gesellschaftsfragen</li> <li>Opferhilfe und Kinderschutz</li> <li>Soziale Einrichtungen</li> </ul> <p><b>Dienststelle Wirtschaft und Arbeit</b></p> <ul style="list-style-type: none"> <li>Stabstellen Support und Recht</li> <li>Abteilung Arbeitsmarkt</li> <li>Arbeitslosenkasse</li> <li>Industrie- und Gewerbeaufsicht</li> </ul>	<p><b>Departementssekretariat</b></p> <ul style="list-style-type: none"> <li>Stabsdienste</li> <li>Rechtsdienst</li> <li>Controlling, Finanzen und Informatik</li> </ul> <p><b>Kantonspolizei</b></p> <ul style="list-style-type: none"> <li>Gastgewerbe und Gewerbe Polizei</li> <li>Passbüro</li> </ul> <p><b>Amt für Migration</b></p> <p><b>Strassenverkehrsamt</b></p> <ul style="list-style-type: none"> <li>Gemeindeanliegen</li> </ul> <p><b>Amt für Gemeinden</b></p> <p><b>Regierungsstatthalter Luzern, Hochdorf, Sursee, Willisau, Entlebuch</b></p> <ul style="list-style-type: none"> <li>Selbständige Dienste</li> <li><b>Schlichtungsbehörde für Miete und Pacht</b></li> <li><b>Handelsregisteramt</b></li> <li><b>Staatsarchiv</b></li> </ul> <p><b>Dienststelle Militär, Zivilschutz + Justizvollzug</b></p> <ul style="list-style-type: none"> <li>Militär und Zivilschutz</li> <li>Vollzugs- und Bewährungsdienste</li> <li>Haft- und Untersuchungsgefängnis Grotshof</li> <li>Strafanstalt Wauwilermoos</li> </ul>
<p><b>Selbständige Anstalten:</b></p> <ul style="list-style-type: none"> <li>Landwirtschaftliche Kreditkasse des Kantons Luzern</li> <li>Luzerner Bäuerliche Bürgschaftsstiftung</li> </ul>	<p><b>Selbständige Anstalten</b></p> <ul style="list-style-type: none"> <li>Luzerner Pensionskasse</li> <li>LUSTAT Statistik Luzern</li> </ul>	<p><b>Selbständige Anstalten</b></p> <ul style="list-style-type: none"> <li>Luzerner Pensionskasse</li> <li>LUSTAT Statistik Luzern</li> </ul>	<p><b>Selbständige Anstalten</b></p> <ul style="list-style-type: none"> <li>luzerner Kantonsspital</li> <li>luzerner Psychiatrie</li> <li>Ausgleichskasse Luzern</li> <li>Familienausgleichskasse des Kantons Luzern</li> <li>luzerner Familienausgleichskasse für Selbständigerwerbende</li> <li>IV-Stelle Luzern</li> </ul>	<p><b>Selbständige Anstalten</b></p> <ul style="list-style-type: none"> <li>Gebäudeversicherung des Kantons Luzern</li> <li>Stiftung Jugenddorf St.Georg, Bad Knutwil</li> </ul>

## **Annex 5: Comparison between IPSAS and HAM2<sup>117</sup>**

According to the assessment made by the Cantonal Financial Directors (Ministers of Finance of the sub-national governments), there are various arguments against the wholesale adoption of IPSAS in Switzerland. For instance, IPSAS does not address some important issues such as credit law and steering aspects (financial plan/budget, etc.). Moreover, IPSAS contains a large number of disclosure requirements, some of which are particularly demanding. These requirements would be too costly for a country with a decentralized state structure such as Switzerland. What's more, the principle of a "true and fair view", originating in the private sector, is highly disputed in the manner formulated by IPSAS.

Therefore, based on a critical examination of the principles and standards of IPSAS, the Cantonal Financial Directors and the expert team of the study group for cantonal financial issues (FkF) concluded that, given the drawbacks of IPSAS, it does not make sense to fully adopt the IPSAS standards in Switzerland. IPSAS was thus used for guidance purposes only in drawing up HAM2. The following is a brief overview of the main differences between IPSAS and HAM2.

### **a) Principle of a true and fair view**

The principle of a true and fair view is formulated as follows in HAM2 under Article 50 of the sample law: "The accounting and reporting should present the financial budget in such a manner that it corresponds to the actual assets, financial and earnings situation".

Although this formulation is similar to that of IPSAS, it is somewhat more flexible. A target status is given. Meanwhile, IPSAS says the reporting should "give an image corresponding to the actual situation". The article in question is thus as close as possible to the fundamental ideas of IPSAS without ruling out deviations from IPSAS.

### **b) Accounting policies**

Basically HAM2 and IPSAS use the same accounting and reporting policies. Only the principle of comprehensibility was supplemented in HAM2. The greatest material difference is in the concept of prudence, which exists in both IPSAS and HAM2. In HAM2, however, it is more extensively presented. HAM2 also permits the formation of hidden reserves within the scope of the prudence concept, while IPSAS merely calls for prudence in estimates, but does not permit any further value adjustments.

### **c) Statement of changes in net assets/equity**

With IPSAS, the statement of changes in net assets/equity is a separate part of the financial statements. In HAM2, it forms part of the Notes. Equity is thus not calculated in the same manner.

According to IPSAS, the statement of changes in net assets/equity should contain the following aspects:

- The net surplus or deficit for the period
- Each item of receipt and expenditure that is recognized directly in net assets/equity, and the total of these items
- The cumulative effect of changes in accounting standards and the correction of fundamental errors.

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<sup>117</sup>Source: Handbook of the Harmonized Accounting Model for the cantons and municipalities HAM2; Conference of Cantonal Financial Directors, Vol. 10. 2008

The receipts and expenditure that may be recognized directly in net assets/equity under IPSAS include contributions from owners and distributions to owners. These contain transfers between two entities within an economic entity. Moreover, the actuarial gains and losses from pension funds can be recognized directly in net assets/equity. Furthermore, other IPSAS standards require revaluation surpluses and deficits and certain foreign exchange differences to be recognized directly as changes in net assets/equity along with capital transactions with and distributions to the entity's owners.

Basically, HAM2 meets the requirements set out by IPSAS. However, one major difference is that fluctuations caused by the periodic revaluation of financial assets, which is done to prevent volatility or influence the valuations on the spending and debt cap, exist in the revaluation reserve; this is not IPSAS-compliant. The account "Withdrawals from equity" (489) is thus used for the non-IPSAS-compliant dissolution of equity.

#### **d) Valuation**

IPSAS does not require a breakdown into financial assets and administrative assets. Investment property may be valued at cost (acquisition costs) or according to the fair value, with preference given to the latter. However, the method chosen by an entity must be applied to all of its investment property. Fixed assets are preferably valued at cost though they may also be carried under the revaluation model and depreciated. There are special rules for financial instruments and for leasing.

According to HAM2, the subsequent valuations of financial investments are carried out on the basis of the fair value on the balance-sheet day, with a revaluation conducted on a regular basis (every three to five years). In IPSAS, however, when the fair value is chosen, a revaluation is conducted annually. For smaller public authorities, this would require too much effort without any apparent added value. The administrative assets are valued solely at cost, which corresponds to the main variant in IPSAS but excludes the alternative.

#### **e) Depreciation**

As a compromise between the IPSAS solution and the traditional fiscal-policy depreciation according to the prudence concept, as further interpreted in HAM2, it should be possible to depreciate administrative assets using the straight-line or declining-balance method. Ordinary and additional depreciation should be shown separately, however. Additional depreciation as a means of fiscal policy is permitted under HAM2, but not in IPSAS. It has to be posted as extraordinary expenses and thus has no impact on the operating result.

#### **f) Provisions and contingent liabilities**

Concerning provisions, HAM2 has adopted the restrictive rules of IPSAS, so basically there is no difference here. However, HAM2 implements this rule by setting limits.

#### **g) Tax revenues**

Both HAM2 and IPSAS require tax revenues to be recognized under the accrual basis. With IPSAS, however, this has to be done on the basis of the taxable event, whereas HAM2 regards this principle as optional only.

#### **h) Consolidated perspective**

The definition of organizations within the scope of consolidation 3 is similar to that outlined in IPSAS standards 6, 7 and 8. In HAM2, however, disclosure is only required for the breakdown of holdings and guarantees, whereas IPSAS requires – depending on the degree of control – full consolidation, a valuation according to the equity method, or proportionate consolidation. Consolidation is also permissible under HAM2, however, with a freer choice between full consolidation and the equity method than is possible under IPSAS.