9. Local government budgeting and borrowing: Norway

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9.1 INTRODUCTION

The organisation of the local public sector in Norway attempts to combine local democracy with an agency role in welfare services. Local governments are an important part of the welfare state and run about two-thirds of public service production.[1] Municipal and county governments are responsible for education from kindergartens to high schools, primary health care and hospitals, as well as care for the elderly, cultural services and infrastructure. Since equalisation of services in these areas is a central goal of the welfare state, service provision is subject to centralised financing and regulation. The local governments have been integrated into the welfare state by national laws defining social reforms combined with matching grants. The legal and financial framework established for the local public sector must be understood in this context.

The local governments also represent a tradition of local democracy and self-rule. They are an independent political structure with a local council elected by proportional representation as the highest authority. The mayor and the deputy mayor together with leaders and members of political committees are elected by and from the local council. Their authority is negatively defined – a local government can get involved in any activity not forbidden by law. In terms of service production, they enjoy most discretion in cultural services and infrastructure, but they also influence important "local" aspects of the welfare services, such as location of institutions (schools) and quality of service (like teacher intensity in schools).

The two key financial controls in the Norwegian system are a balanced budget rule and a procedure for loan approvals. The balanced budget rule implies that current revenues in local governments must finance current spending inclusive of debt servicing. Investments are to a large extent financed by loans, and there is an approval procedure for total loan financing.

The emphasis on loan financing of investment is assumed to stimulate inter-temporal efficiency. The central government controls are motivated by fiscal discipline, both between central and local governments and within local governments. Because of the moral hazard problems associated with centralised financing, controls are established to limit the use of deficits and debts as strategic instruments to obtain additional central grants. Given the centralised system of financing, discipline based on financial markets is not considered a viable option. Since Norway is not a member of the EU, adjustment to the Maastricht rules has not been an issue.

The controls also are seen as responses to decision problems at local level. Local voters may find it tempting to finance current spending by borrowing or sale of property. They can enjoy a high level of service provision in the short term, and by moving out of the community after a few years, they avoid the costs in terms of debt repayment or a public infrastructure that is run down. This has not been an important concern since mobility is low. More important, the welfare services represent redistribution and local politics must balance strong external interest groups and internal producer interests (professions). The centralised controls are a counterweight to the spending pressure resulting from redistributive welfare services.

According to Owens and Norregaard (1991), central governments in most OECD economies control the level of local government loan financing and in some countries even the purposes for which loans can be raised directly or through state banks. Compared with their overview, Norway looks like a less dirigiste regulation regime. The system is meant to encourage decentralised accountability and priority within a system of centralised financing with hard budget constraint. Ter-Minassian and Craig (1997) classify the Norwegian regime as "administrative control", as opposed to "market discipline", "co-operative control" or "rule-based control", and emphasise the approval procedure for total borrowing. The distinction between the four categories is not clear-cut in practice. As will become clear, we see the Norwegian design as a mixture of co-operation, rules and administrative control. The established rules and co-operation reduce the necessity to apply administrative intervention.

The chapter is organised as follows. Section 9.2 gives a brief overview of the financing of the local public sector. The regulations in place are presented in section 9.3. The system has produced deficits and debts as described in section 9.4. The working of the system at central government and local government levels is discussed in sections 9.5 and 9.6. The final section summarises some recent debates about changing the regulations.

9.2 THE FINANCING OF THE LOCAL PUBLIC SECTOR

Compared with most countries, the financing of local governments in Norway is very centralised. The centralisation implies limited local discretion in financing service provision. Local discretion is seen as a threat to the equality principles of the welfare state, both in terms of paying for services and receiving equal service supply. The main elements of the financing are:

- Grants represent about 40% of the revenues. Most of them are distributed as block grants based on objective criteria, but a variety of earmarked grants are in place to promote the detailed ambitions of national politicians. A residual grant amount is distributed annually based on a 'judgement' of the economic conditions in each locality.
- Most tax revenue is income tax and wealth tax shared with central government. Tax rules are determined in the national parliament and local tax rates are limited to a narrow band. All local governments apply the maximum rate (since 1979) and in this situation the tax revenue works as a block grant, except that local governments can influence the tax base over time.
- Property tax is not available to all local governments (in practice 200 of 435 municipalities have it), since it is restricted to urban areas and certain facilities (notably power stations). In addition, the property tax rate is limited to a narrow band. User fees are of rising importance. They are regulated by law and are limited to cover costs, but the share of costs covered and the cost levels do vary.
- The wage scale of local public employees is set in national bargaining with the trade unions. The Association of Local Governments (KS) negotiates on behalf of the local governments, but in close contact with the national government. Wage adjustments locally are limited to small amounts allocated for local bargaining and flexible use of the national pay scale. Teachers, who are employed by local governments, bargain directly with the national government over pay, workload and service regulations such as class size.

Total local government revenue amounts to around 17% of GDP, and Table 9.1 gives an overview of the major revenue sources. Local taxes account for 45% of total revenue, but behind this average figure we find considerable variation. The proportion of taxes in total revenue varies from 10 to 75% across the municipalities and from 25 to 60% across the counties. The local revenue sources, local taxes and user charges, amount to nearly 60% of total revenue. This figure is high compared with many other European countries, and may mislead an external observer into thinking that the Norwegian system of financing is rather decentralised. To get a proper understanding of the system, the central regulation of the local taxes stated above must be taken into account.

Table 9.1 Sources of income, municipalities and counties, %, 1998

Local taxes	44.8
Grants	39.7
User charges	11.7
Other	3.8
Total	100.0

Source: Advisory Commission on Local Public Finance.

In addition to financial controls, welfare services are regulated in detail by law. The regulations involve coverage (for example all children in primary school), standards (for example class size) and working conditions (for example children per employee in day care). Rights defined by law have grown more popular. Local governments must satisfy these rights, which are important in social support and health care.

Centralised financing is the result of the growing local government responsibility for national welfare services. Central government is seen as responsible for financing of the welfare services through grants and regulated income tax revenue sharing. The grant system includes tax equalisation and needs equalisation to promote equalisation of service standards. Local discretion to set user fees and property tax is marginal compared with the amounts channelled through grants and income tax. Local governments look to central government when they want to raise their revenue levels.

The financial conditions of the local public sector are decided by national parliament as part of the annual national budget. Prior to each fiscal year, central government announces a desired growth of total local government revenue, and of tax revenue and block grants separately. Parliament then sets maximum income tax rates and grants according to this overall revenue target. The distribution of block grants among local governments is also decided prior to the fiscal year. Based on these national decisions, local governments produce their own budgets.

The determinants of the growth of income tax revenues and grants during 1900–1990 are investigated by Borge and Rattsø (1997). They apply a standard demand model of local public services extended to include political structure. Local revenues are shown to be very income elastic; the elasticity with respect to the gross domestic product is 1.4. Given the size of the sector, the determination of the revenues is typically seen in relation to stabilisation policy. The analysis finds that macroeconomic booms have a negative impact on the growth of the local public sector. This is consistent with the view that central government uses the local public sector as a tool in a Keynesian-type stabilisation policy. National politics are also important. Both the ideology and strength of central government influence the growth of local revenues. Socialist oriented central governments tend to expand the sector, while strong governments, measured by coalition type, duration and fragmentation of parliament, are able to hold back on spending pressures.

9.3 THE REGULATORY FRAMEWORK OF THE LOCAL PUBLIC SECTOR

The Norwegian regulatory framework is based on a principle called "wealth preservation". The system has three main components. First, current expenditures cannot be financed by loans or sale of property. Second, loan financing is limited to investments and debt is preferably repaid in tandem with the economic depreciation. Third, central government can limit loan financing in local governments not obeying wealth preservation. The municipal debt crisis of the 1920s is often seen as the historical background for this "wealth preserving" principle.

At the local level, decision-making is organised around the annual budgets. These are regulated by the Local Government Act, and the main requirement is operational budget balance. In the budget, current revenue must cover current expenditures, interest payments and regular instalments of debt repayment. Loan financing of current spending is not allowed. The final budgets are controlled and approved by central government. Central government is represented by a regional commissioner in each county overlooking the local government finances. If a proper formulation of the budget implies an operational deficit, it will not be approved and is sent back to the local government for revision.

A balanced budget *ex ante* does not rule out an actual deficit when the account is settled. Income tax revenue during the year and expenditures linked to rules (like social support) may deviate from the budget. Actual deficits are allowed to be carried over, but as a main rule they must be "repaid" within 2 years.[2] In agreement with central government, the local council can extend the period to four years if faster repayment would have serious consequences for local service provision.

The balanced budget regulation is consistent with the "golden rule" that borrowing is limited to investment purposes. Benefit taxation promoting inter-temporal efficiency is encouraged since investments are allowed to be financed by loans. The rule may reduce inter-temporal flexibility, and service provision may be unstable when current spending is strongly linked to current revenues. However, local governments typically hold "rainy-day" funds to smooth out shifts in revenues, although this is not required. Compared with other countries, Norwegian local governments have wide discretion in investment policy, given the constraint that interest payments and debt instalment are included in the operational budget balance. Local governments know that larger loan-financed investment means future debt service covered by current revenues. It is probably more important that investments imply starting up of new service production that requires future spending for labour and materials.

In addition to annual budgets, local governments are required to work out a revolving long-term economic plan. This plan is part of another control system linked to loan financing: it must cover at least the next four years and provide a realistic forecast of revenues, expenditures and priorities in this period. The plan also includes a survey of debt, interest payments and instalments. If planned loan financing is inconsistent with the economic balance projected in the long-term economic plan, the local government must reduce its borrowing and investment activity. In addition to investment in fixed capital, loans may be raised for the conversion of older liabilities and for liquidity purposes. Liquidity loans must be discharged before the account for the fiscal year is settled. However, if there is an operational deficit, liquidity loans may be carried over and repaid over the same period as the deficit.

There are very few examples of local governments experiencing serious economic imbalances since World War II. When local governments are not able to fulfil their obligations, central government will take control of their finances. Local governments are not allowed to go bankrupt, and they will be bailed out by central government. Local governments do not speculate in this bail out, but they do use their "weak financial situation" as an argument for additional grants. The working of the system in this respect is evaluated by Rattsø (2000).

9.4 THE PERFORMANCE OF THE LOCAL PUBLIC SECTOR

The regulatory framework outlined above seems to work in terms of controlling debt accumulation and investment level. Table 9.2 displays the development of GDP, current local public revenue, investment and net debt during the years 1980–1998. In the 1980s revenues were strongly pro-cyclical. Revenue growth declined during the recession in the early 1980s and picked up again in the credit–led boom of the mid-1980s. After the drop in the oil price in 1986, the Norwegian economy went into a quite deep recession, which also hit the local public sector. In the 1990s the local public sector again was used in stabilisation policy, and revenues were more counter-cyclical. Revenue growth picked up in the early 1990s, while the recession continued, and was low in the boom years of 1995 and 1996. Primary education was extended to include 6-year-olds in 1997, bringing with it high revenue growth when the economy was still booming.

Table 9.2 *GDP growth, revenue growth, investment and debt in the Norwegian local public sector, 1980–1998*

Year	GDP growth [a]	Revenue growth [a]	Investment [b]	Net debt [c]
1980	5.0	4.6	17.7	43.5
1981	1.0	5.0	15.2	43.5
1982	0.2	2.6	13.2	41.8
1983	3.5	1.1	12.7	44.0
1984	5.9	4.3	11.4	42.3
1985	5.2	6.6	10.0	38.2
1986	3.6	1.8	12.0	35.4
1987	2.0	–0.1	13.5	40.2
1988	–0.1	2.8	13.6	46.0
1989	0.9	1.7	11.8	48.2
1990	2.0	3.3	9.8	45.4
1991	3.1	4.6	9.9	42.0
1992	3.3	4.9	9.2	42.5
1993	2.7	1.9	8.7	41.4
1994	5.5	3.4	8.7	37.3
1995	3.8	–1.5	9.5	35.9
1996	4.9	0.9	9.6	33.4
1997	4.3	4.1	12.1	29.8
1998	2.1	0.0	11.8	30.8
Average	**3.1**	**2.7**	**11.6**	**40.1**

Notes:
[a] Real growth (%).
[b] Gross investment as share of current revenue (%).
[c] Net debt as share of current revenue (%).

Sources: Statistics Norway and Advisory Commission on Local Public Finance.

The development of investment and debt shows the same pattern as revenues. Investment increased and debt was reduced during the boom in the mid-1980s. In 1986, the debt–revenue ratio was 35%. In the recession following the drop in the oil price in 1986, investment fell and debt increased sharply. The debt–revenue ratio was nearly 50% by the end of 1989, and with a real interest rate in double digits many observers feared that a debt crisis was emerging. However, a real crisis never appeared. The local governments were "saved" by a more expansionary fiscal policy and by lower interest rates. During most of the 1990s investment activity was low and the debt–revenue ratio gradually declined, to about 30%. Investment activity increased in 1997 and 1998, mainly driven by reforms initiated by central government within primary education and care for the elderly.

The financing of investments is documented in Table 9.3.[3] It appears that borrowing finances 45% of investments on average. There is substantial year-to-year variation. During the short period covered, the share of investments financed by borrowing varied from a low of 35% in 1996, to a high of over 53% in 1991. The operating surplus amounted to 35% of investments on average, varying from 17% in 1998 to 65% in 1994.

Table 9.3 Fixed capital investment, net borrowing and operating surplus, municipalities and counties, 1991–1998

Year	Investment (% of current rev.)	Net borrowing (% of investment)	Operating surplus (% of investment)
1991	9.3	53.4	25.6
1992	8.7	45.8	34.5
1993	7.6	49.8	33.2
1994	7.9	39.4	64.7
1995	8.5	45.8	38.0
1996	8.8	35.9	33.6
1997	11.2	43.2	40.6
1998	11.2	38.9	17.3
Average	**9.2**	**44.0**	**35.9**

Source: Advisory Commission on Local Public Finance.

The share of investments financed by borrowing varies substantially across the local units. In Table 9.4, we provide some information about the variation among the municipalities. In the period 1991–1998, the share of investments financed by borrowing was 44% on average, and one third of the municipalities had a borrowing rate between 40 and 60%. Nearly 20% of the municipalities financed a very small share (less than 20%) of their investments by borrowing. Although borrowing must be approved by the state, we observe quite high borrowing rates, even using an average over seven years. More than 10% of the municipalities had a borrowing rate above 70%. A high borrowing rate is not necessarily of concern if investment activity is low and/or revenues are high. However, the 18 municipalities with a borrowing rate above 80% did not have particularly low investment activity or high revenues. They only financed a large share of their investments by borrowing, and their borrowing-revenue ratio was twice the national average.

Table 9.4 Proportion of investments financed by borrowing, municipal averages[a], 1991–1998

Borrowing (% of inv.)	<20	20–40	40–60	60–80	80+
No. of municipalities (%)	18.2	24.7	32.2	20.7	4.2

Note: [a] Based on data for 429 municipalities. The capital Oslo, which is both a municipality and a county, and municipalities that are consolidated during the period under study, are excluded.

Source: Own calculations based on data from Statistics Norway.

The relationship between municipal revenue, operating surplus, investments and borrowing is investigated in Table 9.5.

Table 9.5 Correlation matrix for revenues, operating surplus, investments and borrowing; all variables are measured in per capita terms; municipalities[a], 1991–1998.

	Revenue	Operating surplus	Investments	Borrowing
Revenues[b]	1.00			
Operating surplus	0.49	1.00		
Investments	0.48	0.63	1.00	
Borrowing	–0.10	–0.24	0.11	1.00

Notes:
[a] Based on data for 429 municipalities. The capital Oslo, which is both a municipality and a county, and municipalities that are consolidated during the period under study, are excluded.
[b] Revenues include block grants and regulated income and wealth taxes.

Source: Own calculations based on data from Statistics Norway.

The correlation coefficients are based on average values over the years 1991–1998. First, there is a strong positive correlation between revenues and operating surplus, which is consistent with the more comprehensive econometric study by Borge (1996). Large revenues mean that more internal funds are available for fixed capital investment. Second, municipalities with revenue and surplus above average invest more than the average community, but they also borrow less. Consequently, good economic conditions are associated with a low borrowing-revenue ratio.

9.5 EXPERIENCE AT NATIONAL LEVEL

Central government's annual decision about income tax rates and grants balances a trade-off between revenue structure and revenue distribution. The decision is taken as part of the (*ex ante*) national budget process. The share of taxes in local government revenue varies substantially across the country (see section 9.2), and the mix of income tax revenues and block grants has important distributional consequences. An economic boom with high growth rate of local taxes will benefit local governments with a large share of taxes in total revenue. Local governments strongly dependent on grants will not take much part in the boom, particularly if grants are reduced in boom years. To avoid large differences in the revenue growth of local authorities, central government has aimed at an equal growth rate of taxes and block grants. In the 1990s, when the growth of the tax base exceeded the desired growth of total local government revenue, this was accomplished by reducing the maximum local income tax rates allowed. This policy was politically controversial, since it was seen as interventionist and reducing local autonomy.

Since Norwegian taxpayers pay their local taxes directly to the local government, central government cannot control the actual local tax revenues prior to the fiscal year. Local tax revenue is predicted on the basis of tax rates and tax rules together with a forecast for the development of the tax base. Predicted and actual growth of local tax revenue is displayed in Table 9.6, and there is a clear under-prediction bias. During the period 1986–1999, central government underestimated the growth rate each year except 1989 and 1999. This bias will also carry over to the local level since local governments usually apply the national government's predicted growth of total taxes in their own budgets. Central government will not accept budgets based on a higher growth rate.

The main reason for the systematic underestimation of the growth of local tax revenue is related to the annual construction of the national budget by central government. General wage growth is consistently underestimated in the national budget. Central government's prediction of nominal wage growth is seen as a guideline for wage bargaining and inflation expectations. It follows that predicted wage growth is biased downward. This bias has consequences for the prediction of tax revenue in general. It is an example of good intentions (keeping wage growth low) with unfortunate consequences (under-prediction of revenue).

Table 9.6 Growth in nominal tax revenue (income and wealth taxes) for the local public sector; actual and predicted; %, 1986–1999

Year	Predicted	Actual	Actual–Predicted
1986	6.6	12.7	6.1
1987	6.6	10.2	3.6
1988	6.4	8.7	2.3
1989	3.8	3.2	–0.6
1990	3.8	4.9	1.1
1991	3.5	4.2	0.7
1992	1.5	1.6	0.1
1993	3.7	4.6	0.9
1994	4.6	9.9	5.3
1995	–1.5	1.1	2.6
1996	1.3	6.4	5.1
1997	3.3	6.0	2.7
1998	0.8	4.5	3.2
1999	3.3	3.0	–0.3

Source: Advisory Commission on Local Public Finance.

During the fiscal year, central government gradually adjusts the estimated growth in local tax revenue. At this stage, the tax rates are already set. The government is caught in a "trap" with little room to manoeuvre. If central government wants to hold back a boom, the block grant must be reduced. Revenues for grant dependent local governments will be much affected, precisely those local governments that have little benefit from the tax boom. On the other hand, if central government wants to neutralise the distributional implications of the tax boom, it must increase the block grant in tandem with growth in local tax revenue and accept an even higher growth in total local government revenue. Usually it chooses a middle-of-the-road policy, which is to do nothing. Central government accepts that the growth of total local government revenue is higher than desired and that income distribution is shifted in favour of "tax rich" urban communities. The year of 1996 represents an exception from this "rule". Then central government decided to reduce the block grant when the growth of local taxes turned out to be higher than expected. This policy was very controversial, particularly because many grant dependent communities in the northern part of the country had a very low, or even negative, tax revenue growth.

9.6 EXPERIENCE AT LOCAL GOVERNMENT LEVEL

Local government budgets and borrowing must be approved by central government. Information about the exercise of these controls for municipalities is shown in Table 9.7. Regional commissioners in each county handle the controls. Most budgets and applications for borrowing are approved. The approval rate for budgets increased during the period 1994–1998, and was well above 90% in 1997 and 1998. The approval rate for borrowing has been stable and around 97% on average. The figures should not necessarily be interpreted as showing a lack of impact of the control instruments. First, the municipalities usually communicate informally with the regional commissioner before budget and borrowing applications are submitted. The staff of the commissioner supervise the local governments in their handling of finances, in particular the small municipalities. Budgets and borrowing applications are adjusted in this informal process. Second, the few budgets and borrowing applications that are rejected may be important for achieving financial balance in the municipalities under consideration.

Table 9.7 *Control of municipal budgets and borrowing, 1994–1998*

Year	Budgets		Borrowing	
	Approved	Disapproved	Approved	Disapproved
1994	374 (86%)	61 (14%)	1 413 (95%)	68 (5%)
1995	373 (86%)	62 (14%)	1 359 (97%)	48 (3%)
1996	389 (89%)	46 (11%)	1 237 (98%)	27 (2%)
1997	410 (94%)	24 (6%)	1 124 (96%)	42 (4%)
1998	406 (93%)	29 (7%)	1 188 (97%)	38 (3%)

Source: Ministry of Local Government.

The regional commissioners only control the municipal budgets *ex ante*. *Ex post*, when the account is settled, an operational deficit is not a rare event, as documented in Table 9.8. During the period 1980–1998, 15% of the municipalities managed to have an operating surplus every year. Nearly 40% of the municipalities had a deficit on more than three occasions, and as many as 15% had a deficit more than six years. On average, 18% of the municipalities had a deficit each year, but there was substantial variation from year to year. In 1985, only 5% of the municipalities ran a deficit, whereas more than 25% had a deficit in 1980 and 1987.

Table 9.8 *The number of years with an operational deficit; municipalities*[a]*, 1980–1998*

No. of years with a deficit	0	1–3	4–6	7–9	10–13
No. of municipalities	63	198	103	51	10
No. of municipalities (%)	14.8	46.6	24.2	12.0	2.4

Note: [a] Based on data for 425 municipalities. The capital Oslo, which is both a municipality and a county, and municipalities that are consolidated during the period under study, are excluded.

Source: Own calculations based on data from Statistics Norway.

Although many municipalities ran deficits in this period, we cannot conclude that the balanced budget rule has no impact on actual budgets. The budget deficits and the number of communities with a budget deficit could well have been larger without this rule. Since all Norwegian local governments face the same regulations, the impact of these regulations is hard to evaluate.

The international literature about the empirical effects of balanced budget rules is limited. Poterba (1995) and Inman (1997) survey the recent literature on US States. They form an interesting case because the shaping of the balanced budget rules varies widely across states. The study by Bohn and Inman (1996) is particularly interesting because it helps to identify exactly what attributes of the balanced budget rules are of importance for the actual deficit. The empirical analysis indicates that the most important aspect is whether the balanced budget requirement is imposed *ex ante* or *ex post*; that is, whether deficits are allowed to be carried over or not. Effective rules do not allow deficits to be carried over to the next fiscal year. Rules that require a balanced budget *ex ante* and allow deficits to be carried over seem to be ineffective. Although it is not obvious that these findings can be carried over to other institutional contexts, they do suggest that the balanced budget rule facing Norwegian local governments may have a minor impact. In a study of local government responses to shocks, along the lines of Poterba (1995), Rattsø (1999a) shows that investment level is the main shock-absorber in Norway. The rigidity of current spending and revenue is consistent with the US evidence that responses to shocks are constrained by regulations.

Penalties for violating the budget rules are emphasised by Inman (1997) in the context of EMU and the Maastricht Treaty. If violators must pay large penalties, the balanced budget rules are likely to be more effective, even if they are imposed *ex ante* and not *ex post*. In the case of local governments, a reduction in intergovernmental grants is a possible penalty. Is there any evidence of such a penalty for Norwegian local governments? The answer is a clear no. The balanced budget rule is not linked to any penalty. If grants are affected by past deficits, the change is in the opposite direction. This is confirmed by Fevolden and Sørensen (1983) in a study of a part of the block grant that is distributed annually based on a judgement of the economic condition in each locality. They find that high debt servicing costs (interest payments and instalments) are rewarded by more grants.

An analysis of aggregate local government investment throws some light on the inter-temporal decisions taken. Rattsø (1999b) studies whether the recent stagnation of investment reflects a sensible response to future revenue growth and demographic shift, or myopic spending responding to pressure groups. The analysis applies an inter-temporal optimisation model with rational expectations and concludes that unexpected changes in GDP and unemployment have been important determinants of investment. Although the last word has not been said, the study is a support for the forward looking model.

How do the municipalities manage to run deficits when the law requires balanced budgets? In general there are two possible explanations. First, revenue or expenditure shocks during the fiscal year may turn a balanced budget into a deficit. Second, submitted budgets may be balanced by deliberate overestimation of revenues and/or underestimation of expenditures.[4] It is hard to judge to what extent the observed deficits are the result of shocks and to what extent they are the result of creative budgeting. However, if they were the result of revenue shocks one would expect revenues to be more volatile in municipalities that run deficits frequently. This hypothesis is evaluated by Borge (1996). He differentiates between municipalities that did not have any deficits in the period 1981–90, and municipalities that had a deficit in at least one year. It appears that the volatility of revenues, measured by the standard deviation of the revenue growth rate, is almost identical in the two groups. Moreover, the two groups did not differ with respect to revenue level per capita or average growth rate. Revenue shocks seem to be of little importance for violation of the balanced budget rule and, although expenditure shocks are not analysed, it is not unreasonable to conclude that creative budgeting in the form of overestimated revenues and/or underestimated expenditures may play a significant role.

Borge (1996) also conducted an empirical analysis of municipal budget deficits. Both economic and political determinants seem to be of importance. The effect of a short-run or transitory revenue increase is to reduce the budget deficit. Moreover, the impact of a permanent revenue increase is less than that of a transitory revenue increase. According to the estimates, the response to a transitory grant reduction is to reduce current spending by 60% of the revenue loss and to increase the operating deficit by 40% of the loss. On the other hand, a transitory reduction in local taxes increases the operating deficit by 80% of the revenue loss. This difference is as expected because a change in local tax revenue is more of a surprise than a change in grants from central government. However, the difficulty of predicting the growth of the local tax base cannot explain why the long-run effects differ. According to the estimates, a permanent reduction in local tax revenue increases the deficit by nearly 40% of the revenue loss, compared with around 20% for a permanent reduction in grants.

Strength of political leadership is of importance for the budgetary outcome. Political strength is measured in several ways, and strong political leadership is characterised by majority control, little party fragmentation in the local council and small ideological differences within the ruling coalition. Whatever measure is applied, the message is that municipalities with a weak political leadership tend to have large budget deficits. Political strength has a substantial impact on budget responsibility at local level.

9.7 REFORM DEBATE

Central government control of the local public sector has been growing with the integration of local governments in the welfare state. The cumulative effect of this growing control to promote welfare services and secure equal provision across the country has led to frustrations concerning local democracy. Accordingly, there have been attempts at decentralisation since about 1980. A major reform of the grant system took place in 1986, and most conditional grants were replaced by block grants. The liberalisation of the credit market during the 1980s meant that control of local public investment through state banks was eliminated. The discussion about further reforms to improve the trade-off between equality and accountability is addressed by Borge and Rattsø (1998). Here we concentrate on the more narrow design of the regulatory framework.

Norway had a major reform of the Local Government Act in 1993 based on preparatory work of a commission and an active public debate. The reform basically addressed organisational issues, and local governments were given more freedom in organising their decision-making and service production. The framework of economic controls was not changed much. Operational budget flexibility was increased slightly, allowing the budget to be balanced by the use of rainy-day funds. Previously, surpluses from earlier years were earmarked for investment purposes. Furthermore, the period of "repayment" of an actual deficit was extended by accepting four years in special circumstances. Finally, a revolving long-term economic plan was made mandatory. The changes were meant to encourage local governments to focus more on the long-term consequences of their actions.

The commission that prepared the new Local Government Act proposed to abolish central government approval of local borrowing. The commission argued that approval is ineffective in terms of avoiding an economic crisis in individual local authorities, and that the economic competence at local level is substantially increased. Elimination of the approval procedure was seen as a way of increasing budget responsibility in local governments. A minority of the members of the commission wanted to keep the control on local borrowing. This minority argued that refusal of borrowing requests was the only effective instrument available to influence local governments with substantial fiscal imbalances. Moreover, since national government is held responsible for key welfare services such as education and health care, local governments may use borrowing strategically to extract more grants. Carlsen (1994) analyses this strategic aspect of local borrowing within a game-theoretical approach. The proposal to abolish central government approval of local government borrowing did not receive much support, and was strongly opposed by the Ministry of Finance and the regional commissioners. When the new Local Government Act was decided, parliament maintained the present system of control on local borrowing.

At the turn of the century the Ministry of Local Government proposed changing the central control of local budgeting and borrowing, taking a step towards increased reliance on market discipline. The previous system of administrative control described here will be maintained only for local governments that have violated the balanced budget rule in previous years. For the others, budgets and borrowing no longer need to be approved by central government. The main arguments for the proposal were that credit institutions get stronger incentives to check local finances before they levy a loan, and that resources spent on control and advice can be more effectively targeted towards local governments in financial imbalance. Some regional commissioners opposed the proposal, arguing that the current system of administrative control helped to achieve financial balance in the local public sector. It is also argued that local governments will face higher interest rates in the future, as credit institutions will consider loans to be more risky when they are not approved by central government.

Another debate has addressed the system of tax payments. The neighbouring countries, Sweden and Denmark, have chosen a system where local taxes are collected nationally and distributed to the local governments. The Danish and Swedish systems allow for more central control over local tax revenue prior to the fiscal year. A proposal by the Ministry of Finance to change to a more centralised system has been opposed vigorously by the local public sector and their Association of Local Governments. Such a reform most likely will reduce the growth of total revenue since central government will distribute local tax revenues prior to the fiscal year. The permanent underestimation of the revenue growth under the present system, as documented in Table 9.6, can be avoided. The alternative system is also seen as an important step towards more central control by effectively turning local taxes into a block grant. This point is also emphasised by Inman and Rubinfeld (1997, p. 47): "To avoid the moral hazard of having local governments view such transfers as 'blank checks' from the central government, the amount of such grants should be firmly tied to a publicly reviewed and locally decided tax rate." In Sweden and Denmark the centralised system of tax payment is combined with more local discretion to set tax rates.

9.8 CONCLUDING REMARKS

The financial situation of Norwegian local governments is and has been sound during the post-World War II period. No financial crises or mismanagement on any grand scale have been observed. The present system is seen as successful in this respect, and no major reforms of the regulatory framework are considered.

In a broader context, however, there is serious concern about the organising and financing of the welfare services run by the local public sector. Administrative federalism with strong vertical fiscal imbalance implies that the responsibility for the decentralised welfare services is not clearly set at the local level. Unclear accountability and spending pressure towards the centre may allow both allocative and cost inefficiencies. The vitality of the local democracy is the other side of this concern. Local politicians are hard pressed dividing a given pie among strong interest groups. The standardisation of the service provision and the rights defined by law has reduced the room to manoeuvre. The agency role of the local governments clearly contradicts the desire for local accountability and self-rule.

Reforms motivated by reorganisation of welfare services and stimulation of local democracy may influence the regulatory framework in the future.

NOTES

1. We use the concept "local government" to describe both levels of the local public sector, municipalities and counties.
2. The surpluses in the following two years must be large enough to cover the deficit.

3. The investment figures in Table 9.3 differ somewhat from the figures in Table 9.2. The reason is that Table 9.2 is based on the national accounts, whereas Table 9.3 is based on the local government accounts.
4. Inman (1983) discusses how US cities are able to violate the balanced budget law by clever book-keeping.

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10. Capital expenditures and financing in the communes in Switzerland

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10.1 INTRODUCTION

This chapter focuses on capital expenditure decisions and borrowing at the local level in Switzerland. With 2,903 communes at the end of 1998 and an average of 2,545 habitants per commune, one important issue in local government finance is the budgeting for and financing of capital expenditures. First, capital expenditures are uneven in nature and in small municipalities, which are the majority in Switzerland, a large investment in one year may preclude similar expenditures in subsequent years. But priority and coherence with long-term planning programmes are not self-evident in the decision-making process. Second, financing investment solely from the current revenues is impossible. Therefore the golden rule of a "balanced budget" must be revisited with the necessary distinction between current and capital budgets. Explicit rules are needed for long-term borrowing. Furthermore a distinction between replacement and new investment projects is necessary if the maximum term of the loan must correspond to the length of the life of the asset: the fiscal capacity available at any point in time cannot be assigned exclusively to new projects. Third, capital expenditure decisions are far from simple in practice, since it is difficult to identify and quantify the benefits and costs associated with them. Fourth, not only are the initial construction costs to be considered, but all future costs (that is, debt servicing, maintenance and operating costs) as well as non-market costs must be taken into account.

In most of the 26 Swiss cantons, these issues have been partly answered through constitutional processes linked to the budgeting process of the communes, and through the control by cantonal supervisory bodies over local capital budgets and subsequent borrowing by local governments. The following sections will try to explain how these institutions function. After a brief presentation (section 10.2) of the growth of the public sector between