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Reforming a centralized system of local public finance: Norway

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Countries have arranged their local public sector in different ways. Norway has had a centralized system with strong central government controls and is now attempting to build in more local discretion and accountability. Most countries seem to converge towards a mixed model of local accountability and central controls. The Norwegian case offers insight into the complex trade-offs involved. Compared to the conventional arguments of the local public finance literature, we emphasize the redistributive aspects of local service production and the associated decision-making problems of aggregating preferences in heterogeneous communities with strong interest groups.

1 Introduction

When the Norwegian government now contemplates a reform of local public finance, there is no particular event or crisis that motivates the reform. But frustrations have built up over time both at the central and the local political level. The desires for local democracy and accountability clash with national political goals of distribution and macroeconomic control. Politicians look for reforms where both the local and the national concerns can be better taken care of – a new mix of local discretion and central controls.

It seems to us that there is an international trend towards more centralized financing of local governments. Norway has been among the most centralized, with very little local discretion to tax in practice. Neighbouring Denmark and Sweden are more decentralized, but their governments have recently attempted to control the local government tax setting through limits and agreements. Poterba and Reuben (1995, p. 385) report that 'all but four (US) states limit the taxing authority of counties, cities, or municipalities within their jurisdictions'. The recent history of local public finance in the UK is a series of *ad hoc* attempts at 'rate capping' and other means of controlling local public spending and taxation (Glennerster, 1992). It is not clear that the Norwegian system of centralized financing with limited local discretion is very different from more decentralized systems of financing with central controls. The countries are probably struggling with the same challenges in local public financing, and we think that the Norwegian debate can be of interest for an international audience.

Reforms are typically a long-run process. We enter the stage in 1995, when a government commission was set up to evaluate the present financing of the local public sector and to propose reforms.[1] The commission was a collection of experts, dominated by economists and no members were politically appointed. The immediate concern of the government was the grant system, the distributional consequences of the system and the balancing between matching grants and block grants. The commission also was asked to address the broader aspects of local government financing, in particular the composition of the local tax base, the local tax autonomy and the grant-tax mix. This article is a presentation of the thinking and the proposals of the commission, but also a broader evaluation of reform. Dafflon (1997) writes a similar discussion of reform in Switzerland.

In federal and unitary states alike, a choice must be made regarding the division of labour and the decision-making system of central and local governments. Concerns at the national level, primarily related to distribution and stabilization, must be balanced against the desire for local democracy and accountability. Overall the system must ensure economically efficient resource use. Compared to the mainstream literature on local public finance, we emphasize two aspects. First, local public goods are only a small part of the local government portfolio, and welfare services produced under national regulation and with strong distributional characteristics consume most of the local budgets. In the Norwegian welfare state, the public sector is responsible for primary and secondary education, health care, child care and care for the elderly, and local governments run all these services.[2] Second, the design of the local public sector cannot be discussed under the assumption that decision making in local governments is a simple aggregation of preferences represented by the median voter. The reforms are partly motivated by concerns regarding the influence of interest groups, bureaucratization and unhelpful political competition for voters. The conflicts of interest are exacerbated by the heavy role of redistributive services.

We start out to find some guidelines from the international literature and then go on to describe the centralized Norwegian system and to give an evaluation of possible reforms.

2 Where do we want to go?

Local governments are set up to fulfil broad goals for the society at large. In federal states, the autonomy of sub-national levels of governments is written into the constitution. In unitary states like Norway, the central government has the upper hand in designing the structure, the decision making and the tasks of local governments. The broad goals guiding the design are similar across most nation states.

The economic rational for local governments is the decentralization theorem of Oates (1972). Decentralization gains can be obtained when local preferences for local public goods can be balanced against costs. The welfare gain results from desired variation compared to standardized solutions prescribed by the central government. The key word is variation - local governments must be able to choose their own service levels. Local discretion to tax is consequently an essential assumption of the decentralization theorem. The advantages of decentralization must be evaluated against possible costs related to economies of scale and geographical spillovers, and alternative policies to deal with these.

Decentralization allows for competition in service production. Tiebout (1956) has

shown how competition between local governments can replicate the competition of the market. The mobility of people and firms helps assure efficient use of resources. Under favourable conditions, local governments generate both cost and allocative efficiency. By extension, decentralization also can contribute to intertemporal efficiency - when preferences over time vary between localities. And the competition between local governments can give incentives for innovations in service production and service quality. With redistributive tax financing, however, competition to attract wealthy taxpayers and businesses can be unproductive.

Economic efficiency is only reached if the decision-making system does the 'right' balancing of the trade-offs involved. This is no problem with the perfect sorting in the best of Tiebout's worlds. But realistically we have heterogeneous preferences within each community, and the problem of preference aggregation must be addressed. The decisive median voter under majority rule does not guarantee economic efficiency, as shown by Bergstrom (1979). In the multidimensional world of the many-purpose local governments in most countries, the median voter theorem is of limited help anyway. Inman (1987) shows that there is no simple solution to this aggregation problem. In the real world, the structure of the legislature and the party system help to reduce the expected instability in multidimensional decision making. But no strong mechanisms ensuring Pareto optimal outcomes of the decision making can be identified. We observe a complex process involving bureaucrats and interest groups in addition to party competition and with separate problems of information and incentives as regards the implementation of the decisions. The argument for decentralization in this context is the mobilization of voter control.

With competition and voter control, local autonomy and accountability are usually seen as promoting economic efficiency. However, when the local public sector is responsible for the provision of welfare services, additional problems of decision making and distribution emerge. The literature does not offer clear criteria for the handling of such 'merit goods' (Musgrave, 1959) or 'redistributive services' (Foster et al., 1980). As discussed by Jørgen Lotz in Chapter 2, decentralization is more of an administrative issue and local governments act as agents of the central government. Local governments run the services to avoid overburdened, national bureaucracy and to adjust to local conditions. The central government regulates and co-finances the provision to have a fairly uniform service level across the country. The local decision problems involved result from the common pool problem of redistributive politics addressed by Weingast et al. (1981). Welfare services are provided free of charge to specific age groups (care for the elderly) and geographic areas (schools) and financed by general taxation and grants. Common pool problems typically are expected to give sub-optimal outcomes. Even competition between local governments can work badly with redistributive services, since new incentives are created to attract 'cheap' taxpayers and discourage the entry of 'costly' immigrants. Added to this, local autonomy in taxation can give large differences in service standards between regions, tax rates and user fees that conflict with distributional objectives, and variation in economic activity over time with destabilizing implications.

Central government policies to deal with distribution under decentralization create a strategic game between the local and the national levels. Local governments can take advantage of the central government concern for uniform service levels. The central government decisions of control are distorted by the national counterpart to the local common pool problem, in the US called 'pork-barrel politics'. Since the national political representation is based on geography, the central government financial controls of local governments are determined in a battle over distribution. The financial and regulatory framework that local governments must live with is itself the result of redistributive politics. To some extent 'distorted' decisions about resource use at the local level must be evaluated against 'distorted' central decisions of control.

We conclude that simple guidelines only emerge from this discussion, and the literature it is based on, when we take a narrow view of local public finance. When local governments produce local public goods for a homogenous population, decentralization is the obvious model of finance. Local governments are close to a voluntary club solving a collective local problem. When the local public sector is responsible for welfare services under central government regulation and with strong redistributive implications in heterogeneous communities, both the criteria for evaluation and the decision-making problems change dramatically. The distributional aspects are seen as an essential part of the service provision. There is an inescapable trade-off between local priority and national distribution goals, and both local and central concerns are legitimate. In addition, local conflicts of interests and national interest groups associated with the welfare services complicate the design of the decision-making system. The complications associated with redistributive services and aggregation of preferences explain why countries experiment with different forms of local autonomy and central control. An empirical evaluation of the trade-offs and the decision-making problems is necessary to design a system of local public finance that works well.

3 Financing and regulating local governments in Norway

The financing of Norwegian local governments has gradually been more centralized since the extreme decentralization in the nineteenth century. Local governments initially represented different forms of socialization of services (schools and health care) that were offered by private charity organizations and churches. Few national regulations of local government activities and finance existed. The municipalities could choose tax rates and tax bases, and grants from the central government were of little importance. The first big step in the centralization process was income tax regulation and grants introduced to cope with the economic crisis of the 1930s and the huge differences between municipalities related to this. The second important centralizing element was the building of the welfare state and the local public responsibility for the main welfare services under central government regulation. The welfare services meant detailed regulations to control quality and equality and numerous conditional grants to promote the desires of the centre. Gradually the national government took over most of the responsibility of financing the local governments, and the local tax autonomy was reduced.

Several attempts at decentralization have been made during the last two decades. A block grant system was introduced in 1986. The Local Government Act has been revised to give local governments more freedom to organize their decision making and production. The liberalization of the credit market during the 1980s meant that the control of local public investment through public banks was eliminated.

Today's regime of financing has the following main ingredients:

- Grants represent about 40 per cent of the revenues. Most of the grants are distributed as block grants based on objective criteria, but a variety of matching grants are in place to promote the detailed ambitions of national politicians. A residual grant amount is distributed annually based on 'judgement' of the economic conditions in each locality.
- Most tax revenue is income tax and wealth tax shared with the 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. It is a puzzle, as discussed in section 8, why all local governments have chosen not to use their income tax discretion.
- The property tax is not available to all local governments (in practice 200 of 435 municipalities have property tax), 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 Local Government Act requires that operational budgets balance inclusive of interest payments and regular instalments of debt. Investment activity is decided locally, but loan financing must be formally approved by the central government. The loan constraint is seldom binding; the important constraint is the inclusion of interest payments in the current balanced budget. Actual deficits are allowed to be carried over, but must be paid within two years.
- The wage scale of the local public employees is set in national bargaining with the trade unions. The Association of Municipalities (Kommunenes Sentralforbund, 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. The teachers, who are employed by local governments, bargain directly with the national government over pay, workload, and service regulation like class size.
- The 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. Although the regulations are detailed, the service level varies a lot – as discussed in section 4.

Table 3.1 provides an overview of the present sources of revenue in Norway. Local

Table 3.1. Sources of income: percentage of total revenue (1995)

Local tax	45.3
Grants	40.1
User charges	11.8
Other	2.8
Total	100.0

taxes account for 45 per cent of total revenue. This average figure, however, masks considerable variation, for the share of taxes in total revenue varies from 11 per cent to 75 per cent across the municipalities and from 25 per cent to 63 per cent across the counties. At first glance, the figures seem to be at odds with our claim that the Norwegian system is centralized compared to most other industrial countries. Local taxes and user charges amount to nearly 60 per cent of total revenue, and the share of grants is quite low compared to many European countries. To get a proper understanding of the system, the central regulation of local taxes must be taken into account.

The main local tax is the personal income tax (see Table 3.2). It amounts to nearly 80 per cent of municipal taxes and 90 per cent of county taxes. The municipalities generate revenue from many tax bases. In addition to the personal income tax, they have a personal wealth tax, a corporate income tax, a corporate wealth tax[3] and a property tax. The counties rely on personal and corporate income tax only. The income and wealth taxes, which amount to nearly 95 per cent of municipal taxes and 100 per cent of county taxes, are shared with the national government.

Prior to each fiscal year the national government announces a desired growth of total local government revenue, and of tax revenue and block grants separately. Since the share of taxes in local government revenue varies substantially between local units, and given the present tax equalization scheme, the balancing between taxes and block grants has important distributional consequences. An economic boom with high growth rate of local taxes will benefit local governments with a high share of taxes in total revenue. Local governments strongly dependent on grants will not take much part in the boom, in particular if grants are reduced in boom years. To avoid large differences in the revenue growth of local authorities, the national government has aimed at an equal growth rate of taxes and block grants. In the 1990s, when the growth of the local tax base has exceeded the desired growth of total local government revenue, this has been accomplished by reducing the maximum local income tax rates allowed.[4] This policy has been politically controversial, since it is seen as interventionist and reducing local autonomy.

Table 3.2. The composition of the local tax base: percentage of tax revenue (1994)

	Municipalities	Counties
Personal income tax	78.7	89.5
Personal wealth tax	7.1	
Corporate income tax	7.3	10.5
Corporate wealth tax	1.3	
Property tax	5.6	
Total	100.0	100.0

Revenues from electric power production and 'overcompensation' in the expenditure needs equalization imply that small municipalities in the periphery have better services than the rest. They have smaller classes, more spending per class, higher share of children in kindergartens, more services to the elderly and so on. Tax equalization grants and expenditure needs grants to the benefit of the periphery imply that the 'poor' end up as 'rich' and vice versa. Property taxes and user fees have little impact on revenue levels, but Borge (1995) shows that user fees are an important part of the local political battle.

This system is presumably best described as centralized with limited local discretion. The centralization applies not only to tax regulation and grant financing, but also to wage setting and standardization of service provision.

4 What is the demand for reform?

The centralized Norwegian system is characterized by a lot of frustration at both the local and the central level, among both politicians and bureaucrats. The national politicians get all the blame for the problems of the local public sector – and there are many. The system invites crisis description of each and all the services in each and all local governments – as a way of avoiding local responsibility for service levels and of obtaining more funds from the central government. The media play a major role identifying 'problems' in schools, hospitals, child care centres and so on around the country. When local politicians are confronted with the problems, they immediately pass them on to the central government, which sets the financial constraints.

On the other hand, the system also allows the central politicians to avoid being directly responsible for the major welfare services decentralized to the local public sector. When a more general 'crisis' description pops up in the media, dealing with the elderly, the children or the health situation, the likely response from national politicians is to shift the responsibility back to the local level. They argue that local authorities should get more value for their money and give higher priority to the service concerned. And ministers can gain positive publicity by bringing a small amount out to a small community to solve a problem raised in the tabloid press.

In this game the local governments often have an informational advantage. They can argue that the unsatisfactory service provision is a result of specific local conditions beyond its control, and it may be difficult for the national government to check whether these claims are correct or not. In order to reduce the political pressure from the local level, which often is reinforced by whatever opposition in the parliament, it may be tempting for the central government to provide supplementary grants. Carlsen (1995) documents how a game about the financing of a regional hospital evolved.

In some sense this system of unclear responsibilities is favourable from the politicians' point of view; both politicians at the local and the central level can avoid responsibility for public services. In the long run, however, it creates the impression of 'fuzzy institutions' (Taylor, 1998) and thereby threatens the legitimacy of the system. And it is hardly economically productive. We think that the local authorities in particular should be more worried about the long-term consequences of their strategic behaviour to extract more grants. When an organization always presents itself in crisis and is negotiating about more funds, both the internal discipline and the external legitimacy can be damaged. The consequences of the strategy may well be more central control over services and financing.

Strong demands for reform in local government finance are expressed in the public debate, but there is no universal agreement on where to go. Should the system of financing be even more centralized than it is today, or should the movement towards centralization be reversed?

Protagonists for further centralization can be found in the Ministry of Finance. From their point of view, the present system of financing is a source of macroeconomic instability. Because the local tax base is strongly pro-cyclical, local public spending tends to increase in booms and fall in recessions. The instability reflects the way taxes are paid to local authorities, the composition of the tax base and the share of taxes in local government revenue. The taxpayers pay their local taxes directly to the local government. Consequently, the national government cannot control the total amount of local taxes prior to the fiscal year. The neighbouring countries of Denmark and Sweden have chosen systems with better macroeconomic control of the flow of local taxes. All taxes are paid to the central government, and local taxes are paid (in advance) to the local governments in the same way as block grants. Given the way taxes are paid to Norwegian local governments, macroeconomic instability can be reduced by increasing the reliance on grants and/or defining a local tax base that is more stable over the business cycle.

Demand for centralization also is expressed from 'sectoral' interests at the national level - ministries, politicians and other interests linked to welfare services such as education and health care. They typically emphasize the problems of inequality. Although the services are regulated in detail by the central government, their supply varies with local financial conditions. It is seen as unacceptable that children should have different quality and quantity of schooling across the country or that the health care treatment should depend on the financial situation and priorities of each local government. The 'welfare sector' wants more earmarking of grants and more central regulation of the services to fulfil the equality goals of the welfare state.

On the other side, the Association of Municipalities often argues for a more decentralized system of financing. It is claimed that local self-rule is severely restricted by the increased reliance on grants and reduced tax autonomy. They consider the move from matching grants to block grants as the starting point for further reduction of central control. The next steps should be to reduce the reliance on grants and to increase local tax autonomy. More decentralized financing will increase local accountability and reduce the problems of unclear responsibilities. And maybe most important of all, accountability and responsibility are necessary to strengthen local democracy and local self-rule.

The two proposals, 'more centralization' and 'more decentralization', offer simple answers to difficult questions. Since fundamental trade-offs are involved, both proposals have their pros and cons. More centralization may give more equal service provision and macroeconomic stability, but at the likely cost of less responsibility and efficiency at the local level. More decentralization may increase local accountability and efficiency at the expense of larger differences in service standards and macroeconomic instability.

The government expert commission established to evaluate and recommend reforms to the local public sector were given no political guidelines as regards the choice between centralization and decentralization. The main goals of the grant system have been set in official documents. According to the Norwegian tradition, the commission was expected not only to discuss alternative solutions, but also to give specific recommendations. The commission started out with general criteria for a 'good' system of financing - economic efficiency, equal distribution, macroeconomic stability and local democracy. Below we develop these criteria and the four main issues raised:

- What tax financing?
- What grant system?
- What mix of grants and taxes?
- What local tax autonomy?

The main motivation of the commission was to reduce the trade-off between economic efficiency and distribution. This can be influenced most directly by the selection of tax base and formulation of the grant system. The broader issues of reform related to the organization of the welfare services are discussed in section 9.

5 Reform I: what tax financing of the local public sector?

As noted by Oates (1990), nearly all major forms of taxation are applied in local governments somewhere in the world. This is true even though there are fairly specific guidelines for tax assignment based on economic theory. The diversity shows that historical and political factors in each country dominate the determination of tax assignment compared to economic principles. The economic principles in this area owe much to Musgrave (1983). McLure (1996) and Oates (1996) give updated overviews, while Bahl and Linn (1992) discuss the issue with respect to actual implementation. Inman and Rubinfeld (1996) work out guidelines in a political-economy context, and Quigley and Rubinfeld (1986) discuss the trade-offs of budget reform.

Four main criteria come out of this literature and served as the criteria used by the commission:

- the principles of residence and benefit taxation
- low mobility
- even distribution
- stability over the business cycle.

Local revenue raising creates a link between service use and tax payment, and lays the foundation for good spending and taxation decisions. When those who vote for higher spending also pay the taxes, the benefits of higher spending must be traded off against the costs of increased taxation. The residence principle, which implies that local taxes should be restricted to local residents and paid by as many residents as possible, is a good rule of thumb when local authorities provide local public goods that benefit all residents. When local authorities provide private services, the residence principle is no guarantee for efficiency. In this case local taxes should be restricted to the beneficiaries of the services, but with possible problematic distributional consequences.

The mobility of the tax base is given much attention in the literature. Oates (1996) clarifies the conditions for efficiency-enhancing competition among jurisdictions, notably the use of benefit taxation. When these conditions do not hold, a mobile tax base will encourage tax competition and may lead to low taxes and underprovision of local public services, as shown by Wilson (1986) and by Zodrow and Mieszkowski (1986). Political economy considerations have led to a more positive view on tax competition even without benefit taxation as suggested by Brennan and Buchanan (1980). In an early contribution, Courant et al. (1979) argue that a mobile tax defends the voters against exploitation by local bureaucrats and public employees. More generally tax competition is discussed as a disciplining device for political decisions by among others Edwards and Keen (1996). The commission recognizes the positive aspects of tax competition, but concluded that mobile taxes should be avoided. Mobility of tax bases will encourage policies and subsidies to attract local government revenue sources, and with distortionary effects. The decision-making system should be improved by other means.

The most obvious argument for an even distribution of the tax base is equity, since an uneven distribution of the tax base is a source of differences in service standards between local governments. Central governments can compensate for differences by a tax equalization system, but an ambitious tax equalization programme breaks the link between the local tax base and local government revenue. An even distribution of the tax base can also be defended on efficiency grounds, since it reduces the incentives for fiscally induced migration.

The local public sector is typically considered as destabilizing in a macroeconomic context. When local tax revenues are pro-cyclical, balanced budget rules imply that local public spending tends to increase in booms and fall in recessions. A tax base that is stable over the business cycle can serve as an automatic stabilizer.

When local taxes satisfy the above criteria, the trade-offs between equalization and stabilization on the one hand, and accountability and efficiency on the other, can be reduced. When the tax base is relatively evenly distributed and stable over the business cycle, substantial tax financing of the local public sector is possible to promote accountability and efficiency.

In an international perspective, the property tax is the most common local tax. The property tax performs well according to the chosen criteria. The property tax is paid by homeowners and firms located in the community, and is clearly linked to the municipality as long as the tax burden is not exported to individuals or firms outside.

It will work as a benefit tax if the consumption of local public services is proportional to house values or the quality of local public services is capitalized into house values. Although the property tax base is not perfectly immobile, the property tax is probably the tax with the least mobile tax base. Finally, the property tax base is relatively stable over the business cycle. New construction is relatively small compared to the existing base, and the tax assessment is typically not affected by short-term fluctuations in market prices. The distributional aspects of the property tax obviously depend on the specific tax design.

At the other end of the spectrum, a local corporate income tax does not meet the criteria for good local taxes, certainly in Norway. First, the corporate income tax is very unevenly distributed between local authorities. The max–min ratio is 20:1 across the municipalities and 8:1 across the counties. Second, the corporate income tax is strongly pro-cyclical. In a recent experience, the boom from 1994 to 1995, the aggregate corporate income tax base grew by 21 per cent, more than three times the 6 per cent growth of the personal income tax base. The corporate income tax also is hard to predict because firms to some extent can decide when to pay their taxes. At the local level the corporate income tax is even more unstable and more difficult to predict, mainly because industry is less diversified at the local level. Another source of instability and unpredictability at the local level is the coordination of tax assessment of companies with activity in several municipalities. A local firm that runs a surplus may not generate any tax revenue for the municipality if it is included in a company or concern that runs a deficit in other municipalities. Third, the mobile corporate income tax base encourages tax competition. Municipalities and counties do not compete by lowering taxes, but rather by offering subsidized sites and buildings, and advice and services from the local development agency.

The proposed reform implies a property tax that becomes an exclusive tax of the municipalities, that it covers all property, and therefore that all municipalities should be able to use it. The present property tax does not generate much revenue, only about 5.6 per cent of municipal taxes and 0.3 per cent of GDP. These figures are low compared to many other countries, partly because Norway has a relatively high wealth tax. An alternative could be to replace the wealth tax with an extended property tax covering all property, in which case the property tax could amount to about 3 per cent of GDP. The existing local corporate income tax has been proposed to be abolished, and corporate taxation consequently will be a national issue only. Since the property tax does not generate much revenue, other taxes are needed to obtain significant local financing. As explained by Lars Söderström in Chapter 1, personal income tax is and has been the most important local tax in the Scandinavian countries, due to its substantial revenue raising capacity. It is also paid by local residents and is quite evenly distributed. With respect to distribution, the max–min ratio is 3:1 across the municipalities and 2:1 across the counties. The main argument against the personal income tax as a local tax is its instability over the business cycle. In addition, the income tax is shared with the central government.

6 Reform II: grant design

The important role of grants has been motivated by equalization and by the desire to influence local government service production. The wish to redistribute income between local units has been taken care of by tax equalization and needs equalization schemes designed as block grants. Denmark led the way in this direction in Scandinavia. The present system is fairly consistent with the summary of US designs by Ladd and Yinger (1994). In addition, the service production has been controlled by an array of matching grants. The matching grants typically have been introduced to promote new services or expand services with central government priority.

Two political concerns have motivated a re-evaluation. First, politically unacceptable differences in service levels between municipalities and counties had developed despite, or rather because of, the equalization schemes. It is an interesting political economy story of reform. The needs formula was originally designed to reproduce the distribution made by the old matching grants. When it was introduced in 1986, the central government wanted a new block grant system, and it was afraid that a change in the distribution could mobilize strong opposition that could threaten the whole reform. Now a reconsideration of the formula seemed necessary for the legitimacy of the system and to reduce differences in standards. Second, new matching grants have steadily been introduced since 1986, thereby undermining the block grant system. These matching grants worsened the distributional problems since the richest communities can best take advantage of the matching grants. A new evaluation of the basis of matching grants was considered necessary. Another concern, not much emphasized among politicians, has been the unclear financial responsibilities following the present complicated system and the games for central government funds associated with it.

The commission proposes to base the grant system on block grants. When the purpose is equalization or general revenue support, block grants are more efficient than matching grants. Earmarking should only be considered when the national government wants targeted influence on local priorities. The potential advantages of earmarking must be traded off against the costs in terms of a more uneven distribution across local authorities, less predictability and stability, less local discretion, and a more complicated grant system that requires more use of administative resources. The recommendation implies the elimination of more than 40 per cent of existing matching grants to be consolidated into the block grant.

The design of block grants is controversial. A central issue is the link between tax and needs equalization discussed by Ladd and Yinger (1994) and the incentive problems involved, laid out by Oakland (1994). Tax and needs equalization now are made separately with no coordination. There is consequently no distributional objective for the total of the two; needs equalization is carried out independent of tax equalization. When cost factors, such as the settlement pattern, are compensated as part of the needs equalization grant, the incentive to reduce costs is limited. Tax and total equalization and the trade-off between equity and efficiency clearly are political issues where economic principles are of little help. Interestingly, the active public debate on the grant proposal did not address these choices. As regards the incentive problems, equity goals are seen as much more important than vague concerns about inefficiencies. Politicians are only concerned with the equity aspect – to compensate the periphery for unfavourable cost conditions.

Because of the ongoing debate about consolidation of municipalities, the handling of population size is of particular importance. The parliament has decided not to consolidate municipalities unless all municipalities involved agree. But full compensation for the disadvantage of economies of scale gives no local incentives for consolidation. When they consolidate into bigger units to take advantage of economies of scale, the municipalities involved will not enjoy the cost saving since the needs equalization grant is reduced accordingly. On the other hand, if they are not compensated, small municipalities will have lower service levels than the rest. The compromise solution to allow municipalities, which consolidate, to keep their size compensation for five years, assuming that they are able to take advantage of the consolidation during this period.

As discussed by Lars Söderström in Chapter 1, the formulation of the tax equalization scheme is important for incentives and distribution under income taxation. As he reports, more than half the municipalities and 17 out of 19 counties have received guaranteed minimum tax revenue. Any expansion of the tax base in a minimum revenue community is counterbalanced by a reduction of tax equalization grants. A further proposal was to reduce the 100 per cent compensation for revenues below the stated minimum, so that local governments can keep some of any improvement of the tax base. The parliament decided to reduce the compensation rate to 90 per cent and at the same time to raise the reference level to avoid grant reductions in local authorities with a low tax base.[5]

Most of the empirical work of the commission involved a fresh look at the needs equalization formula. As discussed above, the existing formula was designed to reproduce the distribution of the old matching grants. It was not based on proper analyses of cost disparities between local authorities. The commission established relative weights for different age groups by a decomposition of local public spending by age. Other factors than the age composition affecting expenditure need were analysed by regression analysis and included population size, various measures of population density, mortality rate, the share of elderly living alone, divorce rate, the share of single parent households and the unemployment rate. The importance and weight of these variables were determined by multivariate regression analyses using spending per client in individual services as dependent variables, controlling for local government revenue and the age composition of the population. Variables that came out significant at the 10 per cent level were included in the needs equalization formula.

Needless to say, the methodology of determining the details of expenditure needs formulas is controversial. Ladd (1994) offers an overview of the issues. The approach of the commission is similar to that of Bradbury et al. (1984), Ratcliffe et al. (1990) and Ladd and Yinger (1991). Given the choice of regression analysis, many statistical problems related to measurement, multi-collinearity and identification remain. The evaluation of the robustness of the results necessarily must be tentative.

The proposed change in the needs equalization formula is politically controversial because it differs substantially from the existing formula. Population size and population density are given lower weights, whereas social factors like mortality rate, divorce rate, the share of single parent households and the unemployment rate are given higher weights. The revision implies a substantial redistribution of grants from small rural communities to larger urban ones. Service levels definitely are equalized by this revision. But regional policy and rural–urban distribution are at the heart of Norwegian politics, and it was argued that the revision would depopulate large parts of northern Norway and other rural areas. On the other hand, it was quite widely accepted that the existing formula gave room for higher service standards in rural areas compared to other parts of the country. Most politicians were reluctant to increase service standards in urban communities by substantial redistribution of grants from rural communities.

The political compromise, worked out by the social-democratic government, accepted the commission's needs equalization formula. But to avoid substantial grant reductions in individual communities, several actions were taken. First, the new formula is introduced gradually over a period of five years. Second, municipalities with population size below 3000 and tax base below 110 per cent of the national average receive a new 'regional' grant. Third, more money is distributed by judgement of the economic condition in each locality. The political solution delays redistribution and thereby delays a transition towards more equal service levels. The debate leaves an open question whether grants to the local public sector are an efficient instrument of regional policy.

7 Reform III: revenue composition

As discussed in section 1, the share of taxes in local government revenue has steadily decreased throughout the twentieth century. This development is not particular to Norway; it is a common trend for almost all western countries. Is this reduced financial independence of local government a problem for local democracy and local self-rule? In the UK, the report of the Layfield Committee, published in 1976, addressed this issue in terms of accountability and confusion of responsibility.[6] Were local authorities accountable to the local communities to whom they provided services, or were they accountable to the central government? Layfield argued that local authorities should be more accountable to the local communities, and the main proposal was to introduce a local income tax in order to reduce the proportion of expenditures financed by grants.

A narrow economic view suggests that the average tax share is of little importance; it is rather the incentives at the margin that matter. Incentives to develop the local tax base or to carry out efficient tax collection depend on the marginal effect on local government revenue. If the local authorities receive a larger share of the personal income tax, the marginal effect will increase. But given the tax equalization system, the impact will be quite small for most of them. If one only cares about the marginal effects, the logical thing to do is to reduce the share of taxes in local government revenue combined with a less ambitious tax equalization system. This would not affect the marginal effect of changes in the local tax base, but it would provide increased macroeconomic stability without disturbing the distribution. At least in Norway, such a proposal would get little support, implying that the share of taxes in local government revenue seems to be of political importance. More generally, Jackman (1988, p. 7) notes that this type of proposal '. . . has been attacked by political scientists on the ground that distinguishing the total from marginal expenditures is confusing in a political context, and thus may undermine the political preconditions for democratic accountability'.

The commission accepts the proposition that the share of taxes in local government revenue is of political importance, and has proposed to increase the tax share. Taking the tax system and the proposed local tax base as given, a higher tax share can only be achieved by giving the local authorities a larger share of the personal income tax. If all revenue from the proportional part of the personal income tax is assigned to local authorities, the tax share can increase from 45 per cent to 55 per cent. How far one wants to go will to a great extent depend on the distributional consequences of reducing the block grant, which in turn depends on the design of the grant system.

A technical change of the grant system was proposed to make it easier to increase the tax share without adverse distributional consequences. Needs equalization is done as a pure redistribution among local authorities. Transfers to authorities with above average spending needs are financed by contributions from authorities with below average spending needs. The money related to the previous needs equalization grant (75 per cent of the total block grant) is now distributed on a per capita basis. Consequently, the per capita block grant reduction following from increased tax share will be the same for all municipalities and all counties. The degree of equalization can to a large extent be made independent of the size of the block grant. Denmark and Sweden have similar systems where both tax equalization and needs equalization are carried out by pure redistribution.

A technical aspect of the channelling of tax revenue has been of importance for the evaluation of alternative tax solutions. At present, tax payments are made directly to the municipalities. Cyclical changes in tax revenues immediately affect them, and the tax equalization is distributed with a two-year lag. This system explains the desire to keep tax and grant shares constant in the short run, as explained in section 4. An alternative system, whereby the taxes are collected nationally and distributed to the local governments, as applied in Sweden and Denmark, allows more central control of cyclical effects and distribution and reduces the negative effects of higher tax share and more local tax autonomy. Interestingly, the local public sector has opposed an alternative system quite vigorously, seeing it as an important step towards more central control.

8 Reform IV: local tax autonomy

In a centralized system of financing in a unitary state, the tax system is the responsibility of the central government. Even for taxes generating revenue for the local public sector, the definition of the tax base and the tax rate structure are set nationally. The local discretion is limited to the tax rate and possibly tax assessments. The main economic argument for local discretion to set tax rates is related to the decentralization theorem of Oates (1972). When the local tax rate can adjust to varying spending preferences, a decentralization gain can be achieved compared to a situation with a uniform tax rate decided at the national level. Local tax autonomy may also be of importance for accountability and local democracy. The voter incentive to control the resource use of the local government may increase when a tax decision is involved. Many see this as a way of stimulating democratic participation and cost control.

The commission presents these arguments for local tax autonomy, but also emphasies possible problems with local tax discretion. The arguments for local tax discretion build on the assumption that local decisions reflect citizens' preferences. This ideal description of democracy has been challenged in the public choice literature. Brennan and Buchanan (1980) assume that bureaucrats and public employees that systematically exploit the citizens dominate the political decision-making process. If this is a more reasonable description of the local decision-making process, a tax limit may be desirable to make it more difficult to exploit the voters. This issue has been discussed intensively in the US, in particular in relation to the property tax limitation amendment Proposition 13 approved in California in 1978. The most recent evidence supplied by Reuben (1997) indicates that tax and expenditure limits have been effective in holding down spending. Poterba and Reuben (1995) document that local government employees have experienced slower wage growth in states with property tax limits than in states without such limits. The motivation for the various attempts at containing local public spending in the UK looks more ideological. The more informal UK evidence on the effects of such attempts, summarized by Glennerster (1992, ch. 5), shows that local government behaviour certainly has responded to central controls, but not necessarily leading to reduced spending. Anyway, when the public sector exhibits a bias to excessive spending, there may be a case for central control of local taxation. This is made even more relevant by the redistributive taxation and service provision in Norway.

The commission recommends more local tax autonomy under centrally determined limitations. The proposal implies a broad property tax for all municipalities with local discretion to set the rate within a band. The property tax is well suited for local discretion. First, it is an exclusive municipal tax and is easily identified by the taxpayers. The high visibility of the tax makes it more difficult for bureaucrats and public employees to exploit the voters, consistent with the empirical evidence of Pommerehne and Schneider (1978). Second, the low mobility of the tax base makes unproductive tax competition less likely. To have a strong link between tax payment and service provision, tax equalization grants related to the property tax are not recommended.

The personal income tax is seen as a weaker candidate for local tax discretion. The personal income tax is less visible than the property tax because it is shared among three levels of government and because withholding of salary pays it. Moreover, as discussed in section 3, the share of the income tax received by local authorities is an important tool for the national government to achieve an equal growth rate of taxes and block grants. Local tax discretion makes such balancing more difficult and may have adverse distributional consequences. National distributional goals can be taken care of by tax equalizing grants. But there are incentive problems related to such grants with local tax discretion. If the grants are based on the locally chosen tax rate, they will tend to subsidize tax increases. If the grants are based on a normative tax rate, 'poor' municipalities may benefit from worsening their tax base.

In the neighbouring countries of Denmark and Sweden, the local governments have discretion to set the personal income tax rates, and they do vary. The experience from these countries indicates that local tax autonomy makes it difficult for the national government to carry out its desired fiscal policy. The national government

loses control over the aggregate income tax level and aggregate public spending. In both countries actions have been taken to provide some national influence over the local income tax rates. Denmark has a long history of negotiations between the central government and the associations of local authorities. The development of local income tax rates is an important theme in these negotiations, and the agreement usually limits the growth of local tax rates. In Sweden similar negotiations are conducted for the fiscal years 1997 and 1998. During the recession in the early 1990s, Swedish local authorities were not allowed to increase their tax rates.

We noticed in section 2 that it is puzzling that the existing local discretion in the personal income tax rate is neither exploited by the municipalities nor by the counties. All use the maximum income tax rate allowed. Most observers think that the local governments are worried about being punished by reduced grants if they reduce their tax rate. Even if the present grant system is based primarily on objective criteria, a large amount is distributed based on judgement. And more amounts are distributed by *ad hoc* policy 'packages' to promote specific services. If local governments show that they are sufficiently rich to enable them to reduce their tax rate, they cannot expect to be rewarded in the battle for these marginal funds. From the perspective of the welfare state, different income tax rates will be seen as a distributional problem by allowing the 'rich' to pay lower taxes and at the same time have good services. The standard of welfare services is not desired to vary dependent on local priorities.

The lack of income tax rate variation together with the limited role of the property tax implies that the present system is, in fact, quite centralized. The local public sector acts as if the central government is responsible for the financing of welfare services, and local authorities act strategically to influence the size of centrally determined revenue sources. Given the national concerns for equality in education, health care and care for the elderly, it is hard to decentralize the responsibility for these services without inducing strategic behaviour to obtain more funds. To clarify the relationship between the central and the local levels, the commission proposes to have annual formal talks to reach a common understanding of the economic conditions and regulations. The hope is that such talks can take some of the heat away from the battles concerning service standards and funds now fought in the media.

9 Broader reform: the organization of welfare services

The main lesson we have learned during our involvement in local public sector reform is the important role of the redistributive welfare services. Everything looks so much simpler if the local governments concentrate on local public goods. Distribution issues could be thrown out of the debate, and decentralization of decisions regarding production and financing would be obvious. There is no way to keep national politicians out of local service provision as long as schools, hospitals and care for the elderly are run by the local public sector.

We have been looking for simple solutions such as taking the welfare services out of the local government responsibility. The problem is that the welfare services also have important local characteristics. The education of children probably can be run without the involvement of local politicians. But the location of the schools certainly is an important local decision. And related to the decision about school structure, the class size is one of the issues where the local debate is most energetic. Similar concerns apply for location and organization of care for the elderly and health care. If the 'local' decisions could be separated out, local financing can be limited to local decisions, and all the problems of distribution and macro stability are eliminated. Unfortunately, we have found no simple way of identifying the true local costs from the total of running these services. There is still an open debate whether the local or the central government should run the welfare services.

There is a third way. The Scandinavian welfare states have been unique in their socialization of welfare services that are run by private for-profit and non-profit organizations in other countries. The government monopolies in education and health care are gradually eroding. Market orientation of local government services already can be seen around the country. Even private schools and private hospitals have been established. The voters as consumers demand choice of alternatives. Competition and choice will change the financing and control of the welfare services. The handling of the welfare services will determine the role of the local public sector in the future. Maybe local governments will concentrate on the 'original' task of solving collective local problems. For the sake of the local public sector, we feel sure that more limited responsibilities would work much better in terms of both economic and political criteria.

10 Concluding remarks

The reforms discussed in Norway can improve the trade-offs between efficiency and distribution, between legitimate central control and local accountability. A more stable and evenly distributed tax base reduces the necessity of central government intervention to achieve stability and equality. Local tax discretion for all municipalities in setting a broad property tax available for all municipalities will strengthen local accountability and stimulate local democracy. As always, taxes seen as productive from an economic viewpoint are seldom popular. The reform process may stop because of the unpopularity of the property tax. In this case, there are two alternative ways of achieving more local accountability. The first is the Swedish alternative – a very ambitious tax equalization scheme, which implies that different local tax bases will give limited differences between the municipalities and counties. The other is a local government sector limited to local public goods, where local decisions have limited distributional consequences. In this case the redistributive welfare services must be nationalized or privatized.

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Notes

1. The commission had 13 members; 4 academics, 2 from the Ministry of Local Government and Labour, 2 from the Ministry of Finance, 1 from the Ministry of Education, 1 from the Ministry of Health and Social Affairs, 1 Regional Commissioner (fylkesmann) and 2 from the Association of Municipalities (KS). Both authors of this paper were involved in the commission, Jørn Rattsø as leader and Lars-Erik Borge as its secretary. The main proposals in the grant report (NOU, 1996: 1), delivered in January 1996, were approved by the parliament in June 1996 and implemented in January 1997. The second report (NOU, 1997: 8) was delivered in January 1997 and the parliament will deal with it in the spring of 1998.
2. We use the concept local government to describe both levels of the local public sector, municipalities and counties.
3. Only power stations pay corporate wealth tax. The corporate wealth tax was eliminated by the introduction of a new tax system for power stations in 1997.
4. The national tax rates are increased accordingly, so the taxpayers have not experienced any tax relief.
5. The reference level was increased from 96.2 per cent to 110 per cent of the national average for the municipalities, and from 113.25 per cent to 120 per cent for the counties.
6. This discussion of the Layfield Committee is based on Jackman (1988).

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[4]

Local governments integrated in a welfare state: a review of Norwegian local government performance

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The governance ambitions of the welfare state constrain local government discretion. Local authorities act as agents of the central government in the provision of welfare services. Local governments in the welfare state have responsibilities far beyond the prescriptions of conventional federalist theory. This article draws lessons about the performance of a welfare state system based on an extensive research on the economics and politics of Norwegian local governments, much of it presented in this book. The research outlines a strategic game between local and central governments when services are partly financed by central grants. Further, interest group pressure and strength of the political leadership are shown to affect the local resource allocation. This institutional set-up weakens the basis for a local democracy. The result is local governments with adjustment inertia, in particular slow responses to changes in demography and residential demands. Several studies suggest a significant potential for improving cost efficiency by approaching best practice performance.

1 Introduction

The local public sector in Norway (and the other Scandinavian countries) differs from most other countries. First and foremost, local governments are an integral part of the welfare state. This implies that the sector is larger (as share of GDP) and subject to more extensive centralized regulation and financial control as compared with other countries. A major objective is to provide uniform welfare state services prescribed by the central government. At the same time, local government represents a long-standing tradition of local democracy and self-rule. This attempt at combining local accountability and national distributional goals implies a different type of institution as compared to the standard fiscal federalist model.

This article addresses the performance of the local public sector based on numerous economic and political analyses of the Norwegian system. We start out with the political aspects, the understanding of the decision-making processes. Three characteristics should be noticed. First, the local political party systems replicate the national party structure. While local politicians are squeezed between voter demands and central government regulations, they are also drawn between potentially conflicting geographical and party interests. Second, the local political conflicts are not easily defined along conventional party lines. Since the local decision to tax is