Balance between Decentralization and Merit

The Copenhagen Workshop 2011

Editors: Junghun Kim, Jørgen Lotz and Niels Jørgen Mau

KOREA INSTITUTE OF PUBLIC FINANCE

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The photo shows Frederiksholm Channel, which is the part of the channel surrounding Slotsholmen in Copenhagen.

The tower is part of Nikolaj Church. Nikolaj Church was originally built around 1200. It is one of the oldest churches in Copenhagen and it has a remarkable history. In the medieval period there were two large churches in Copenhagen that served the citizens – Nikolaj Church and The Church of Our Lady – later named the Cathedral of Copenhagen.

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Foreword

Won-Dong Cho

Foreword

A country's system of intergovernmental fiscal relations reflects various aspects of its governmental system. It is not only influenced by economic conditions but also by politics and institutions. It is also an evolving system, continually responding to changes in economic, demographic and political variables. Due to its complexity, few countries seem to be satisfied with their system of intergovernmental fiscal relations. Most countries therefore have the desire to learn from the experiences of other nations. However, fully understanding the intergovernmental fiscal relations of other countries is not an easy task as detailed information is often unavailable to outside observers. Also, countries that have reached the stage of mature decentralization have developed systems of intergovernmental fiscal relations that countries in the early stage of decentralization cannot easily follow. Despite these difficulties, an international comparison of intergovernmental fiscal relations provides a good learning opportunity when the experiences of other nations are understood in a guided manner. One particularly valuable way in which such a comparison can be optimized is by combining the insight of academics and the experiences of practitioners.

In this spirit, the Korea Institute of Public Finance (KIPF) and the Danish Ministry of Economic Affairs and the Interior have been holding jointly-organized biennial workshops since 2007. These workshops have been quite successful in creating a rare opportunity for both renowned academics and experienced practitioners to gather and exchange views on major policy issues relating to intergovernmental fiscal relations. The papers presented at the past two workshops in 2007 and 2009 were later published as books titled "Measuring Local Government Expenditure Needs – The Copenhagen Workshop 2007" and "General Grants versus Earmarked Grants: Theory and Practice – The Copenhagen Workshop 2009". In 2011, the third biennial workshop was held on the theme of a "Normative Framework of Decentralisation and Intergovernmental Fiscal Relations". This book is based on the papers presented at that workshop. We expect this volume, as was the case of the previous two volumes, to offer policy guidelines for practitioners and stimulating research topics for academics.

As the president of a government think-tank long devoted to research on intergovernmental fiscal relations in Korea, I find that the contribution towards establishing worldwide joint research cooperation makes the ongoing collaboration between the KIPF and the Danish Ministry of Economic Affairs and the Interior both meaningful and successful. I hope the biennial workshop we are organizing will continue to provide a stimulating environment and generate interesting results in the future.

President
Won-Dong Cho
Korea Institute of Public Finance

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Opening address

Niels Jørgen Mau

On behalf of the Danish Ministry for Local Government Affairs I am pleased to give an introduction to this international expert workshop – this time with the headline "Efficient instruments for desired balance between decentralisation and merit".

We are very honoured to host the seminar in Copenhagen for the third time in a row – which makes it almost a tradition. This seminar benefits from having both highly regarded academics and experienced experts as participants. This mix of different professional backgrounds provides, as I see it, a superb background for fruitful debates. We know from the 2007 and 2009 workshops that discussions and issues are sharpened by academic methods and logic, as well the relevance ensured by the "civil servant way of thinking".

At the 2007 seminar, the challenges of establishing relevant expenditure need measures were examined, and at the 2009 seminar the dilemma of central versus decentralised financial decision-making via different grant systems was discussed.

In my opinion, the subjects of those two seminars turned out to be exceptionally suitable for sharing experiences and knowledge across borders. In spite of the differences in our institutional backgrounds and organisational approach, it seemed that we were facing considerably similar challenges. However, our methods of handling these challenges were significantly different, which demonstrated both our room for manoeuvring and our potential for learning from each another.

The last two seminars dealt with the issue of what kind of economic tools can be used to ensure appropriate methods of financing local governments. Compared to the previous two seminars, it might be said that the centralisation/decentralisation perspective of the 2011 seminar is somewhat broader, no matter that exactly this perspective was undoubtedly in the back of the heads of many of us when we discussed local financing systems.

This year's topic will perhaps also be somewhat more demanding than the 2007 and 2009 themes in the sense that we have to look through a country-related veil of institutions and organisations that is more dense and complex than was the case when we talked about equalisation and grants. However, this is of course no excuse for not seeking to sort out common features of the systems when we discuss the papers delivered to this workshop.

So, at this 2011 seminar we will dauntlessly look into the dilemma of how to accomplish the desired balance between on the one hand important national policy priorities and on the other the merits of decentralisation.

Taking into consideration the broad and ambitious theme of the seminar, our purpose must be to develop and throw light on at least *some* of the angles of the issue. Of course an attempt to develop a kind of full-scale synthesis of the various systems is not realistic. Nevertheless, we can be sure that there will be important implications to reflect on when it comes to evaluating "one's own" public sector system in different tiers.

The theme includes the pertinent questions of how much autonomy a country wants to establish for the local governments and when (and on which field of politics) centralisation is to be preferred – so the relevance should be secured in advance.

Finally, a few remarks about the centralisation and decentralisation of the public sector seen as a process of development: *First*, it is sometimes heard that the degree of centralisation versus decentralisation is characterised by long waves, i.e. that a trend towards centralisation after a period is succeeded by a tendency towards decentralisation and vice versa. *Second,* the development may instead be viewed upon as being governed by progressive reforms of the public sector, leading towards a more mature and sophisticated society. For instance, in a Danish context the structural reform in 2007 involved certain elements of further decentralisation of certain tasks to municipalities, but in a setting of amalgamated municipalities and regions. *Third*, the global financial crisis that the world has experienced during the last few years has been followed by a national desire for tighter management of public finances and public spending cuts – which will perhaps lead to increased focus on the role of the central government. The workshop does not intend to answer the question of which of these lines of thought may be the most significant – but it may be interesting to have the different viewpoints in mind.

Niels Jørgen Mau
Deputy Permanent Secretary

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Introduction

Junghun Kim and Jorgen Lotz

In the preceding Copenhagen Workshop (2009), where the topic of policies of grants to local governments was discussed, it was noted that earmarking is being employed with increasing frequency, seemingly at odds with the commonly stated objectives of decentralisation and local freedom[1]

But looking at the literature this should not be surprising. Half a century ago the academic literature had already identified two main types of normative frameworks for decentralisation policies.[2] One is the model of "pure fiscal federalism" where local authorities, belonging in the allocation branch, deliver local public goods. Since then, this model has tended to dominate the literature. The other type of framework is what Musgrave called "an entirely different view" where "fiscal federalism is interpreted to be an assurance to each citizen of the federation that special social needs such as elementary education will be provided for adequately in all states". Musgrave concluded that in such cases "the choice is not a matter of fiscal analysis but a matter of how to interpret the nature of the federation, thus involving political no less than economic considerations."[3] Examples of countries where this second model dominates might include the Nordic countries, Korea, Japan, and some East-

[1] A selection of these papers was published in Kim, Lotz, and Mau (2010). Copies of this book are available on request.

[2] See Musgrave, Richard (1959, p. 183). The citation is from his section on "Assurance of Minimum Level of Public Services" as distinct from his following section "Pure Federalism".

[3] Musgrave (1961) added a model of how the goal of horizontal equity leads to use of local government equalisation. As it would be difficult to envisage a system with minimum standards without equalisation only two "clean" models are identified: pure federalism and the entirely different view. See also Richard Bird (2009).

ern European countries. In the academic literature some authors have described the models developed from this second, "entirely different view" as *administrative federalism*.[4]

These two models of decentralisation were the subject of the Copenhagen Workshop 2011 and make up the subject of the present volume.

Based on the experience gained from the 2009 Workshop and this theoretical framework, it was decided that the theme of the 2011 Copenhagen Workshop should be a closer look into the dilemma of how to implement central policy priorities for decentralised services and still preserve the merits of decentralisation. Or, to put it differently, how do we encourage decentralised allocation, local development and experimentation -- and still fulfill national merit wants while doing so? Furthermore, which instruments are most efficient in obtaining centrally desired objectives when the efficiency gains of decentralisation should also still be preserved? Taking both kinds of objectives into account is the challenge governments face in carrying out decentralization. However, there are also two kinds of easily surmised systematic risks. On the one hand, there is the risk that, in its effort to gain control over local government services, the central level will undermine decentralisation's flexibility in meeting local conditions, which is after all the very reason the local level exists in the first place. On the other hand, there is a risk that local authorities will fail to meet national standards for service delivery.

The 2011 workshop's approach to this dilemma was to cover a somewhat broader perspective than the 2009 workshop. The idea was to look at the use of regulation, organization, and other kinds of relationships than those of the grants systems, and tackle concepts such as fiscal federalism, administrative federalism and agency models.

Junghun Kim sets the scene by contrasting two types of fiscal decentralisation: that of unitary Nordic countries and that of federal (regional) countries. In unitary Nordic countries, the governance structure of intergovernmental fiscal relations is rather flexible, making it possible for the central government to play a leading role in determining the size of intergovernmental grants or even that of local budgets. In feder-

[4] Rattsø (2002).

al/regional countries, the intergovernmental fiscal relation is largely dictated by the constitution. Therefore, in many federal countries, intergovernmental grants are determined by more formal channels, such as an intergovernmental forum or agency. Tax sharing that determines regional distribution by law is also a widely used fiscal resource allocation mechanism in federal/regional countries. An exception to this is the US, which, unlike many other federal countries, relies heavily on specific grants and unfunded (or partially funded) mandates. *Kim* argues that Korea is a unitary country by constitution, but that it also has a rigid intergovernmental fiscal structure, which results in the central government widely using specific grants and partially funded mandates to control local budgets. He argues that, due to the lack of the flexibility found in unitary countries or a formal intergovernmental fiscal framework in federal countries, it is hard for both the central and local governments in Korea to deal responsibly and efficiently with the rapidly increasing fiscal burden of social expenditures.

Lars Erik Borge sets out a simple economic analysis of the choice between matching grants and legal means – or consultations – to implement decentralised delivery of services at the standard demanded by the centre. He shows that general grants combined with legal means are preferable to matching grants, as a matching grant for a price-inelastic public service turns out to be a costly way to provide the service at the targeted level. As an alternative to matching grants, general grants may be provided. However general grants alone cannot achieve the objective either, because, if each local authority is compensated for the exact cost for introducing a new service, it punishes those who have had already introduced that service by themselves, and rewards those who have not. But compensating those innovative authorities, who would otherwise become losers, would be too expensive for the centre. Hence the centre is faced with a trade-off between the costs of the compensation and the promotion of innovative policies in local authorities. One way to alleviate this would be to adopt a system of general grants combined with consultations and negotiations between levels of government.

The analytical framework adopted by *Borge* nicely captures the way Nordic countries deal with the balance between decentralisation and provision of merit goods. In the 1990s, the Nordic countries – Denmark, Norway, Sweden and Finland – all adopted a system of general grants that replaced many specific grants. At the same time, since full local discretion over general grants does not guarantee provision of social services that fit central norms, regulation by the central government also plays a significant role. Moreover, as discussed by Lotz (this volume), Moisio (this volume), Mau (this volume) and Allers (this volume), the intrusive nature of central government regulation is kept to a minimum by the active role played by consultations and negotiations between levels of government.

Jorgen Lotz describes how the intergovernmental fiscal relations in the Nordic countries are relatively successful in dealing with the decentralised provision of welfare services. His paper thus provides detailed institutional information on the combination of general grants and regulations discussed in a theoretical framework by Borge. Lotz explains that the introduction of administrative federalism dates back to the early 19th century. As the system of intergovernmental fiscal relations has evolved, local public goods have increasingly been marginalized in the local government agendas. This is because national redistributive public goods, like education and social services, have been delegated to local governments. This trend has continued in many countries up to the present. *Lotz* discusses how this model was developed in several papers presented at the workshop. He argues that the preferred instrument in the Nordic fiscal decentralisation is a mixture of fiscal tools and legal measures. As for grants, he notes a general tendency to use softly tied block grants rather than matching or general grants. In Denmark, this has become part of a comprehensive system of consultations and negotiations. He discusses how the effects of the business cycle on the delivery of local services in Denmark have been neutralized, and how the local government sector is compensated for the costs of acquiring new competences. The latter, he explains, has become a general feature of the European local financial systems.

Antti Moisio describes how the change in Finland from specific to general grants during the 1990s aimed at reducing the detailed regulation of the local policies. Regulation was to be replaced with better information about best practice and information was to be supplied by a new National Institute for Health and Welfare. In spite of these efforts, local authorities complained that government intervention still interfered with local efficiency, and a working group was established to identify unnecessary norms. As was the case in Denmark, annual negotiations are being held between the national government and the Association of Finnish Local and Regional Authorities in order to establish the local costs of implementing new mandatory local competences, introducing a kind of consultative procedure as also discussed by *Borge*. It is also noted that the Finnish government manages local governments almost without any fiscal rules, and yet local governments are not significantly indebted.

Moisio's description of the Finnish system shows again how a decentralised system may successfully provide merit goods. The key point is that the central government's regulation and local discretion must harmoniously coexist. Moisio notes that there are dozens of special laws that regulate municipal service delivery, but that this special legislation does not include any detailed regulation of the scope, content, or ways of organizing those social services. In addition, as in Denmark, a good consultation system is in place between the levels of government in Finland. The four-year fiscal framework involving both the central and local governments (the Basic Public Service Programme and the Basic Public Services budget) is a good example of this consultation as not many countries have adopted medium-term fiscal frameworks that involve both central and local governments.

Pawel Swianiewicz shows that the present situation in Poland is *not* the result of a coherent and conscious implementation of a design of intergovernmental fiscal relations. The present political framework should rather be seen as the result of shifting political objectives, swinging between forces that favour decentralisation as a process of democratisation and forces pushing against decentralisation. The former view dominates the Polish discourse of local government. The latter view is held by central bureaucrats, those who make populist calls for central control of "not accountable local politicians", and those who demand equal access to public services. At present, central policies tend to be favourable to decentralisation, but sometimes true meaning of decentralisation is questioned because the centre tries to hand over problematic services to the local level.

Swianiewicz gives several examples of how the failure to adhere to the principle of fiscal decentralisation has resulted in undesirable administrative consequences. But concerns of excessive regulation are dwarfed by the desire of local governments for more grants from the centre, while there is – as described by *Spahn* in the case of Germany – little local appetite for increased local taxation powers. In Poland, because decentralisation is viewed as an element of a process of democratisation, the balance between decentralised decision-making and the provision of merit goods is more challenging than in the Nordic countries.[5] Thus, in the Polish case, decentralisation is judged more on its political value than on its contribution to the efficient provision of public services, which is the point emphasized in the literature of fiscal federalism. *Swianiewicz* concludes his paper by saying that it is questionable whether local governments in Poland really want more fiscal autonomy since they mostly favour grants and tax sharing over local powers of taxation.

So what should be done in Poland to improve the situation? Swianiewicz leaves this question open. But experiences in the Nordic countries suggest that the promotion of innovation and efficient policies in the local public sector using moderately regulated local fiscal freedom, information about best practices, and consultation between levels of government could be examples for Poland to follow.

In the case of the Netherlands, *Marten Allers* addresses the question: If national standards are applied to services delivered by local authorities, how should the financing then be organised? In the Netherlands conditional grants have been replaced by general grants, or by more broadly described earmarked grants providing more spending discretion for local authorities. In both cases the grants are allocated according to formulas based on objective criteria. He reports that this policy has been "rather successful in reaping the benefits of decentralisation while at the same time ensuring a high degree of similarity in service standards across the country", and he finds that this policy has resulted in more efficient delivery. He also addresses the question of compensating local governments for the costs of acquiring new competences. Allocating smaller funds than the costs before decentralizing is a method forcing local governments to improve efficiency.

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[5] This phenomenon is in fact shared by many countries in Asia and Eastern Europe where a democratization process took place in the late 1980s and early 1990s. For these countries, political motivation rather than economic motivation was a main impetus for decentralisation.

As in the case of Finland, Germany has established a commission to look into the system of regulations of local policies. *Paul Bernd Spahn* takes his point of departure in the observation that the classification of grants does not tell the whole story and an understanding of the regulatory regime is needed as well. He discusses the results of a German survey conducted for the commission of federal regulatory restrictions that affect local administrations and local budgets. The survey resulted in the identification of 300 norms of which the German commission decided to look into 220. In this way, they identified a number of cases where efficiency gains could be achieved through reforms, a number of which have already been implemented. But he adds that these cases do not tell the whole story. Many restrictions are "invisible" as self-imposed norms and are never really questioned. From 2020 the new "*schuldenbremse"* (debt brake) will be an example of an important new norm interfering with the principles of budget separation between tiers of government and budget autonomy.

Notable in the German system of intergovernmental fiscal relations is the wide usage of norms that regulate local administration and local budgets. Given that Germany – unlike Poland – has a well-established decentralised political system, this would appear to be surprising. However, it makes sense considering the fact that the revenue of local governments in Germany is mostly determined by vertical tax sharing and horizontal equalisation. As a result, the central government does not have effective fiscal tools – either general or specific grants – to control local governments' budget. In these circumstances, the desire of the central government to provide social services with national standards can only be met by applying norms and regulations on local government budgets. Whether this kind of intergovernmental relation – tax sharing and norms – is an optimal design to address the balance between decentralisation and merit is an open question. However, as in Poland, fiscal decentralisation needs to be understood in the broader context of the political system, and the comparison between tax sharing and an intergovernmental grant system could be a futile exercise in the German context. However, Spahn's paper shows that the feature common to both Germany and the Nordic countries is the shared perception of the importance of consultations between central and local governments.

Several papers have included descriptions of systems that control local government behaviour for macro-policy reasons. In his paper, *Niels*

Jorgen Mau discusses a special aspect of this. He discusses the reasons why municipalities may fail, and the ways the Danish government handles such cases. The failure of a local authority would make it incapable of delivering the many delegated services for which the centre has strong merit wants, but bailing out the beleaguered local authority would draw on the resources of the rest of society. These, he argues, are strong reasons for the centre to establish rules that may prevent such failures, and to handle their occurrence by building on local responsibility to find ways out of the problems. He presents an original analysis of 30 cases of failure during the period 1988-2011 and concludes that the programmes introduced to handle the problems have, with only a single exception, successfully brought about complete recovery without bail outs of the threatened municipalities. It is emphasized that even though the arrangements of administrative control of the local governments in question are rather centralistic on the surface, in the end local responsibility is a decisive factor in healthy local finances.

In the context of the balance between decentralisation and merit goods, Mau's study shows that, in Denmark, the fiscal soundness of local governments is itself regarded as a kind of merit good, requiring standardization and regulation by the central government. Given that local governments' debt creates a negative fiscal externality, this interpretation seems to make sense. But is central government regulation the main reason why local governments in Denmark have been able to avoid serious debt problems? Another important factor that may have contributed to this result is the budgetary cooperation between the central and local governments in Denmark, which has been implemented since 1980.[6] In federal countries, where the issuance of local debt is considered to belong to the domain of subnational fiscal policy, or in unitary countries, where local revenue is largely subject to the economic business cycle, similarly tight regulation of local debt might be either infeasible or unsuccessful.

The other Danish paper, by *Jens Blom-Hansen et. al.,* also deals with the effects of central attempts to control growth in local budgets. Local authorities with limited freedom to levy taxes may react in different ways. They may, as hoped for by the centre, react by cutting expenditure – but they may also increase their reliance on revenue sources that

[6] See Mau (2010) and Blom Hansen et al. (this volume).

are not subject to limitation. Furthermore, the effects of limitations may depend on the local circumstances and hurt certain groups of local authorities more than others, in a way not desired by the centre. In 2009 and 2010 there were limitations on local tax increases in Denmark that were not present in 2008. *Blom-Hansen et al.* develop an econometric model to compare local behaviour in 2009 and 2010 compared to that in 2008. They find that the response to tax limitations could not be identified, as municipalities had not cut spending, increased revenue from other sources, or broke the imposed tax ceilings. They conclude that, responding to limitations on tax revenues, Danish municipalities chose to simply "stick it out to the bitter end".

The argument put forward by Blom-Hansen et al. has an interesting implication, if it is viewed with Mau's study on local debt management in Denmark. Blom-Hansen et al. essentially argue that local governments faced with tax limitations "stick it to the bitter end" until some of local governments face "economically unsustainable behaviour" (ECB), using the terminology of Mau. This is a hypothesis that needs to be tested, as Blom-Hansen et al. note. However, in a broad context, what Blom-Hansen et al. question is whether tax and expenditure limitation policies can have a permanent effect in Denmark, where local governments are responsible for socially important merit goods – unlike, for example, local governments in the US.

The study by Blom-Hansen et al. thus shows that, when it comes to controlling the size of the local public sector, the central government in Denmark may face a tougher task than is the case in other countries where local governments are less responsible for providing merit goods. In other words, for the countries that opt for "small government", the trade-off between decentralisation and merit might be less of a problem, which reminds the readers why there are different views toward fiscal federalism and administrative federalism in the US and in the European countries.

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Chapter 1

Welfare Decentralization in Korea: In Between Two Models of Unitarism and Federalism

Junghun Kim

1.1. Introduction

Social expenditures in Korea have increased substantially over the past decade. In 1995, social expenditures composed 3.2 percent of GDP, but by 2011 that figure had risen to 9.2 percent. This is still very low compared to other OECD countries, but due to rapid aging and growing political demand, social expenditures are expected to rise significantly in coming years. Faced with the growth of social expenditures, the central government has decentralized the responsibilities for and fiscal burdens of social welfare programs to local governments. The mechanisms for this “welfare decentralization”' have taken two forms: the central government has reduced its matching rates for local welfare expenditures; and it has created block grants with a limited amount of compensation for welfare expenditures delegated to local governments. This process has been controversial, and has been strongly criticized by local governments. The central government, however, argues that local governments should take more responsibility for welfare expenditures since national tax revenue is shared with the local public sector to a significant degree.[7]

The main reason for the controversies and conflicts over welfare decentralization in Korea lies in the weakness of the fiscal institutions deal-

[7] By law, 19.24 percent and 20.27 percent of “domestic tax” (national taxes except earmarked taxes) revenue are allocated to local governments and local education offices, respectively. Since revenue from “domestic tax” is about 80 percent of national tax revenue, about 30 percent of national tax revenue is shared by law with the local public sector.

ing with intergovernmental fiscal relations. Specifically, Korea's fiscal institutions neither possess the cooperative intergovernmental fiscal relations found in unitary countries (such as the Nordic countries), nor an intergovernmental forum or council of the sort present in most federal countries to facilitate dialogue and negotiations between the central and sub-national governments. Korea’s dilemma is that, as far as fiscal decentralization is concerned, it is difficult to identify Korea as either a unitary or a federal country. Unless this fundamental issue is resolved, Korea is likely to be stuck between unitarism and federalism, and left lacking the fiscal institutions that would enable it to respond dynamically to rapidly changing fiscal environments.

This paper is organized as follows: An overview of local public finance in Korea is presented in section 2. In section 3, the recent development of welfare decentralization is discussed. In section 4, the current situation of fiscal decentralization in Korea is critically evaluated. Conclusions are drawn in section 5.

1.2. Overview of local public finance in Korea

The total amount of local revenue in 2010 was 139.9 trillion won, approximately 12 percent of GDP.[8] Of this, 79.4 trillion won was own-source revenue such as local tax and non-tax revenues, with the remaining 55.25 trillion won coming in the form of intergovernmental grants. The size of local debts in Korea is small, at about only 5.17 trillion won in 2010. On average, local governments' own-source revenue and intergovernmental grants respectively compose 56 percent and 44 percent of total revenue.

The total amount of local expenditures was 123.5 trillion won in 2010, slightly lower than the total local revenue due to carry-overs. As can be seen from Table 1.2., there are three government expenditure accounts: for the central government; for local governments; and for local education offices. Local education offices are independent local bodies whose heads are elected by popular vote. They do not collect taxes, but instead receive transfers both from both local governments (Local Education Tax) and the central government (general grants for local education), with those transfers making up about 15% of total government expendi-

[8] The won/dollar exchange rate is around 1,100. The GDP of Korea in 2010 was about 1172.8 trillion won (about $1,000 trillion).

ture. As previously explained in footnote 1, the size of general grants to the public sector is quite large at around 30% of national tax revenue. As a result, the size of local expenditures is larger than central government expenditure, which was about 40 percent of total expenditure in 2010. It is also worth noting that the share of local expenditure has been increasing: As Table 1.2. shows, it was 35.9 percent in 2005 but increased to 45.1 percent in 2010, mainly due to rising intergovernmental grants.

Table 1.1. Revenue of local governments (₩trillion)

	2008	2009	2010
Total	125	137.5	139.9
Own Revenue (share)	73.65 (58.9)	80.84 (58.8)	79.43 (56.8)
Transfers (share)	47.82 (38.3)	53.01 (38.6)	55.25 (39.5)
Local Debt (share)	3.5 (2.8)	3.69 (2.7)	5.2 (3.7)

Source: Ministry of Public Administration and Security, 2011.

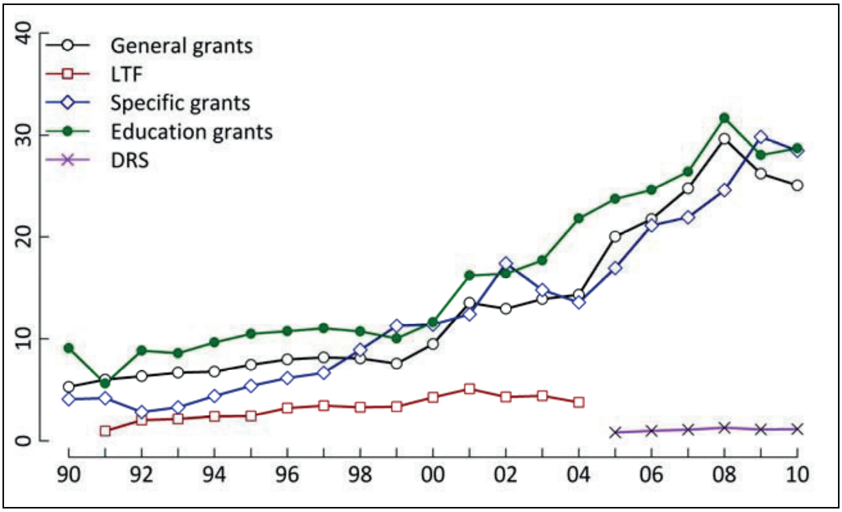
Table 1.2. Expenditure of central and local governments (₩trillion)

	2005	2006	2007	2008	2009	2010
Central (share)	105.45 (50.5)	105.91 (48.4)	108.55 (47.2)	111.13 (46.1)	104.85 (42.3)	110.55 (40.3)
Local (share)	74.88 (35.9)	82.64 (37.7)	88.89 (38.6)	97.61 (40.5)	108.05 (43.6)	123.52 (45.1)
Education (share)	28.32 (13.6)	30.45 (13.9)	32.76 (14.2)	32.47 (13.4)	35.08 (14.1)	39.99 (14.6)

Source: Ministry of Public Administration and Security, 2011.

Apart from general grants, specific grants also play a significant role in local government revenue, being of about the same size as general grants. In the 1990s, several specific grants, mostly those for local roads and environmental facilities, were consolidated into a type of block grant known as the Local Transfer Fund (LTF). This fund existed for fourteen years and was then combined into general grants in 2005. In the 2000s, another effort was made to reduce the size of specific grants. More than one hundred small-sized, specific grants – this time mostly those covering welfare facilities for the elderly and children – were consolidated into block grants under the name of Decentralization Revenue Sharing (DRS). Initially, these grants were to be combined into general grants by 2010, but this has been postponed until 2014 due to disagreements among ministries and local governments. In particular, local governments view DRS as a means for the central government to offload the fiscal burden of welfare programs and want the DRS grants put back into specific grants with higher matching rates rather than being absorbed into general grants. There is a reason for this sentiment. During the 1990s, the amount of specific grants was smaller than that of general grants. However, due to a rapid increase in specific grants for welfare programs to be provided by local governments, the amount of specific grants has grown to be as large as the amount of general grants, as shown in Figure 1.1.[9]

Figure 1.1. Trend of intergovernmental grants (₩trillion)



The trend of intergovernmental grants in Korea shown in Figure 1.1. indicates that the total amount of specific grants has grown quite rapidly in recent years, mainly due to welfare programs being delegated to local governments. In addition, matching rates from the central government have been decreasing as well. The average matching rate for specific grants of the Ministry of Health and Welfare was 73.6 percent in 2007, but this number has steadily decreased, and was down to 68.7 percent by 2011. In terms of absolute size, the fiscal burden on local

[9] In figure 1.1, the sharp decrease in general grants and education grants in 2008 was due to a major tax cut in 2008.

governments has increased by 2.4 times, whereas the burden on the central government has grown by 1.9 times during the same period. Local governments are also concerned that the fiscal burden placed on them for welfare expenditures is likely to continue to increase, as Korea is only in the beginning stage of a rapid increase in social expenditures. The central government, however, views this trend of the increasing burdens being placed on local governments as unavoidable. In the next section, the background of the controversy over welfare decentralization is discussed.

Table 1.3. Budget of the Ministry of Welfare & Health (₩trillion, %)

	2007	2008	2009	2010	2011	growth rate
Total amount	11.3	15.9	19.3	19.2	20.5	16.1
Grants to LG	7.8 (73.6)	11.7 (69.6)	13.9 (69.5)	13.7 (68.8)	14.7 (68.7)	17.2
Matching of LG	2.8 (26.4)	5.1 (30.4)	6.1 (30.5)	6.2 (31.2)	6.7 (31.3)	24.4

Source: Ministry of Public Administration and Security, 2011.

1.3. Recent development of welfare decentralization in Korea

The structure of public finance in Korea is quite different from that of European countries. The share of tax revenue in Korea, including social security, as a percentage of GDP is less than 30 percent, while in most European countries it exceeds 40 percent.[10] The share of social protection in public expenditure in Korea is also very small, at less than 4 percent of GDP.[11] Altogether, the scope of welfare decentralization is limited in Korea compared to European countries, where many welfare programs are provided by local governments.

However the structure of the public sector in Korea is changing rapidly. The first significant change took place in the late 1990s, when severe economic crisis struck Korea. In response to this crisis, the government enforced policy measures to strengthen market discipline in the finan-

[10] As of 2009, the shares of tax revenue as a percentage of GDP in Korea, Denmark, Sweden, France, Germany, Italy were respectively 26.5%, 48.2%, 47.3%, 43.2%, 37.0%, and 43.3% (OECD, Revenue Statistics, 2010).
[11] As of 2006, the shares of social protection as a percentage of GDP in Korea, Denmark, Sweden, France, Germany, Italy were respectively 3.7%, 21.8%, 22.7%, 22.3%, 21.2%, and 18.2% (OECD, Government at a Glance, 2009).

cial sector and to achieve more flexibility in the labor market. As a result, many companies filed for bankruptcy and the unemployment rate almost tripled in a single year, to the effect that more than one million people became newly unemployed. Along with the structural reform measures undertaken in response to this crisis, the government also took steps to strengthen the social safety net. In particular, the government introduced new welfare programs and extended the coverage of existing programs to support the unemployed and impoverished. An important welfare program – the National Basic Livelihood Security Program (NBLSP), a subsidy to the poor – was introduced during this period. The NBLSP replaced the old system to assist the poor with a more flexible criteria and a much larger amount of subsidies.

A notable feature of the NBLSP seen from the perspective of intergovernmental fiscal relations is that it is provided by local governments with the support of matching grants, but the conditions on who can receive benefits and benefit levels are all determined by the central government. As a matching grant, the central government's contribution to the NBLSP is matched by local governments with matching rates that vary with the fiscal capacities of individual local governments. In a strict sense, however, NBLSP is not a locally provided public service since the number of beneficiaries and the amount of co-payments by local governments are all determined by national law. Therefore NBLSP is essentially a partially funded mandate rather than a local public service supported by conditional grants.

The upward trend in social expenditures and the corresponding increase in the fiscal burden of local governments became even more marked in the 2000s. From a political point of view, it was partially due to the left-wing government that took power in 2002. But more fundamentally, however, Korean society is rapidly aging[12] and currently has the lowest fertility rate among the OECD countries,[13] leading to the introduction in the 2000s of many new welfare programs for children and the elderly to address these issues. As in the case of the NBLSP, most of these pro-

[12] The percentage of the population aged 65 years and above in Korea has grown from 5.8 in 1995 to 11.3 in 2010. It is expected to reach 23.4 in 2030 – among the highest in OECD countries.

[13] As of 2009, the fertility rate in Korea, Japan, Denmark, Sweden, France, Italy, and Germany were respectively 1.15, 1.37, 1.84, 194, 1.99, 1.41, and 1.36 (OECD, Society at a Glance, 2011).

grams are provided by local governments, with recipient criteria and the benefit amounts determined by national law. Therefore, from the viewpoint of local governments, welfare decentralization in Korea has proceeded mainly in the form of partially funded or unfunded mandates.

Another notable development in the early 2000s was the then president's ambition for a decentralized country. He made “fiscal decentralization” one of his most important policy priorities, with the goal of making Korea a “decentralized country”. The trend of increasing welfare expenditures and the political movement toward decentralization gave rise to, from a theoretical point of view, a fundamentally difficult question as to how merit goods are provided in a decentralized setting. In practice, however, the difficulty of this theoretical question didn't prevent “welfare decentralization reform” from taking place.

According to article 9 of the Local Autonomy Act, local governments are responsible for providing “public services that enhance resident welfare” as well as several other categories of public services, including services for: the local industrial development of agriculture and commerce; the promotion of education and culture; and protection of the environment. These public services are referred to as “inherent functions” of local governments. More detailed examples are provided in the Local Autonomy Act under each broad category of inherent local functions. Examples of services covered under Category 2 – public services that enhance resident welfare – include welfare facilities, public hospitals, and support for seniors, low-income citizens, and the disabled. Other categories of inherent local functions encompass small- and medium-sized businesses, housing, local economies, and elementary and junior high schools.

Obviously, the definition of local public services in the Local Autonomy Act is too broad to serve as a practical guide for expenditure assignment between the central and local governments. In reality, public sectors such as welfare, education, small- and medium-size businesses, and housing are all major responsibilities of the central government in Korea. However, the Local Autonomy Act – as a legal document – played an important role as a guideline for the debates on fiscal decentralization that took place during the 2000s. As a result, many small-scale welfare programs – mostly subsidies for welfare facilities for the poor, the disabled, the elderly and children – were decentralized. Initially the plan was to leave the responsibility for providing these sorts of public services to local governments so that they could decide whether and to what extent they would provide these "inherent local functions". But local governments were strongly against this. As a result, more than one hundred matching grants for small welfare program were merged into one categorical block grant named Decentralization Revenue Sharing (DRS).

The size of the DRS is not large, at about 0.1 percent of GDP, but many controversies arose after its introduction. Local governments especially are critical of the DRS. There are two main arguments against this new system. One is that redistribution is the central government's function, an argument along the lines of Musgrave's famous theory of the division of state functions across three branches. Another argument against the DRS accepts the notion that local governments may be made responsible for delivering redistributive public services, but only under the condition that they are guaranteed fiscal resources sufficient to fulfill those responsibilities.

There is of course an argument that local governments should be more responsible for welfare programs. Among the proponents of the DRS, the Ministry of Finance argues that, unlike the central government, local governments often do not devote sufficient resources to social expenditures, a category which is in increasing demand in Korea today. From a theoretical point of view, the change of the expenditure composition of local governments should be determined by local residents, and not by the central government. But, as the Ministry of Finance sees it, political pressure for more social expenditures is placed solely on the central government while tax revenue is shared between central and local governments.[14] Given the low tax burden and social expenditures in Korea, an increase in the tax burden – if it happens in the future – is most likely to result from an increased demand for social expenditures. The argument of the MoF then implies that an increase in the central government's tax revenue should either be earmarked for the central government's social expenditures, or the fiscal burden of social expenditures should be vertically shared – either though partially funded mandates, like the NBLSP, or by insufficiently-funded block grants, like the DRS.

[14] As previously explained, about 30 percent of the national tax revenue is distributed in the form of general grants to both local governments and local education offices.

These differences in viewpoint between the Ministry of Finance and local governments do not seem like they will be easily resolved. When the DRS was introduced in 2005, it was scheduled to be absorbed into the system of general grants in 2010. However the plan was extended to 2012, and then extended again to 2014. As for the partially funded mandates such as the NBSLP and subsidies to the elderly and children, local governments are repeatedly making requests to the central government to either increase the central government's share of the fiscal burden or abolish the mandates.

1.4. Assessment

1.4.1. Fiscal institutions for fiscal decentralization

Unitary countries

The root of the controversy in Korea over the allocation of fiscal resources and responsibilities for welfare programs seems to stem from the difficulty of deciding between unitarism and federalism in intergovernmental fiscal relations. An arguably successful fiscal decentralization model for unitary countries is provided by the Nordic countries. This does not mean that controversies over intergovernmental fiscal relations do not exist in these countries: the pendulum of decentralization swings back and forth there as well. However, a notable feature of intergovernmental fiscal relations in the Nordic countries is their ability to change the system of intergovernmental fiscal relations according to changing economic environments.

During the economic crisis in the early 1990s, the central governments of Sweden and Norway were able to control local income tax rates to fight the recession. Changes in the system of intergovernmental grants also took place during this period, transforming earmarked grants into block grants (general grants). These changes were then followed by further adjustments in the structure of local revenue, local expenditures, and regulations that govern intergovernmental fiscal relations. Such dynamic change is not easily observed in many federal or regional countries, where the system of intergovernmental fiscal relations is largely defined by a constitution which takes years to be modified and implemented. For example, Italy changed its constitution in 2001 to strengthen fiscal federalism, but the process of introducing fiscal federalism in Italy is taking place over a very long period of time with much uncertainty (Brosio and Piperno, 2010).

An important fiscal institution that makes intergovernmental fiscal relations in the Nordic countries flexible seems to be the nature of the cooperative intergovernmental relationship that involves the tight interconnection of national revenue and expenditures between central and local governments. In Denmark, local budgets are determined through collective annual agreements between the central and local governments (Mau, 2008). In Norway, the central government announces the amount of growth desired in total local government revenue prior to each fiscal year (Rattso, 2004). The central government of Sweden relies on a fiscal rule – the requirement for a balanced budget – rather than annual negotiations to control local budgets. The level of intergovernmental grants in Sweden is determined, however, by the central government, which has full authority for making this determination (Bonato et al., 2004).

Korea is similar to the Nordic countries in that it is a unitary country with a large local public sector. However Korea does not have the flexible intergovernmental fiscal relations found in the Nordic countries. In particular, it lacks an established system for budget negotiations between the central and local governments. A main reason for this is because the Ministry of Finance, a budget ministry, has little legal authority over local budgets. Laws and regulations regarding local budgets, local taxes and intergovernmental transfers are all administered by another ministry, the Ministry of Public Administration and Security (MOPAS). In theory, budget negotiations can take place between the MoF, MoPAS, and local governments. However, there is no legal mechanism that makes such negotiations binding during budget preparation. Because of the large size of the general grants that are determined by law, the policy tools left to MoF for influencing local budgets are specific grants packaged with mandates.

Federal and regional countries

Unlike the Nordic countries where budget negotiations are led by the central government, local revenues in Korea are largely determined by law. This aspect makes its system of intergovernmental fiscal relations more similar to those of Italy and Spain. These are not federal countries by constitution, but the nature of their systems of intergovernmental fiscal relations is far removed from that of unitary countries. In particular, the budgets of subnational governments are mostly determined by constitutions and laws, rather than through budget negotiations between different levels of government. In addition, tax sharing is an important source of subnational government revenue in Spain and Italy. Because of these similarities, the system of local public finance in Korea can be said to more resemble the systems of Italy and Spain rather than those of Nordic countries.

In federal or regional countries, fundamental intergovernmental fiscal reform requires constitutional change. The current system of intergovernmental fiscal relations in Spain has been shaped by the 1978 constitution. In Italy and Switzerland, the recent fiscal federalism reforms were brought about by constitutional changes made in the 2000s. Intergovernmental forums are an additional fiscal institution for dealing with intergovernmental fiscal relations in federal countries. In Germany, the Financial Planning Council – consisting of federal ministers of finance and economics, state ministers of finance, and representatives of municipalities – provides input for achieving solidarity pacts between federal and state governments (Shah, 2007). In Spain, the Fiscal and Financial Policy Council (CPFF) assesses the evolution of the regional finance system on a regular basis and recommends necessary changes to the central and regional governments (Lopez-Laborda et al., 2007).[15] In Australia, the Commonwealth Grants Commission (CGC) – an independent advisory body – guides the federal and state governments in the determination of intergovernmental grants.

Although Korea has the characteristics of a regional country such as Spain or Italy, there is no intergovernmental forum or agency handling intergovernmental fiscal relations. This may be a natural aspect of a unitary country. But as previously discussed, the decision-making processes on local public finance in Korea are compartmentalized by laws without any formal mechanism for intergovernmental dialogue. In this sense, Korea is stuck with both unitarism and federalism, leading to status-quo bias: it does not have the cooperative intergovernmental fiscal relations found in the Nordic countries, nor the fiscal institutions of federal/regional countries that provide channels for information and ne-

[15] According to Lopez-Laborda et al. (2007), significant changes in subnational finance were initiated by CPFF in 1987, 1991, 1996, and 2001.

gotiation to encourage cooperative dialogue between central and local governments.

Coercive federalism

Despite the large amount of general grants, the size of specific grants in Korea is also very large, and it seems to be related to the lack of fiscal institutions that coordinate the budgets of central and local governments. Given that the total size and distribution formulas for general grants are determined by law and managed by line ministries, the only fiscal tool the central budget office can use to exert influence on local budgets during the budgetary process is specific grants. It is worth noting that there are few OECD countries in which the size of specific grants is as large as that of Korea. The only exception is the U.S., where federal grants to the states consist mostly of specific grants.

What is notable in the system of federal-state fiscal relations in the U.S. is that it is actually quite similar to that of many European countries in that it relies heavily on mandates and regulations as well as intergovernmental grants. A traditional view of the U.S. model of fiscal decentralization is that it is best explained by the Tiebout-Oates type fiscal federalism model which emphasizes mobility-induced competition and aggregation of voter preferences. However, this view has recently been challenged by Baicker et al. (2011), which shows that the rapid growth in state budgets in the U.S. over the last 50 years has been mainly due to education, health and public welfare, which are provided by heavily incentivized federal grants, unfunded or partially funded mandates, and regulations. As argued by authors such as Kincaid (1990) and Posner (1998), the fiscal decentralization model of the U.S. can be at least partially described as "coercive federalism".

Reliance of the central government on unfunded or partially funded mandates is certainly a controversial issue, and opinions on this issue are divided. In a report by ACIR (1994), unfunded mandates were criticized for involving, "inadequate consideration of the costs imposed on the benefits to states and local jurisdictions" and "distortions of state and local government budgets and policy priorities", among others. These are standard arguments, based on the principle of subsidiarity, against the central government's regulatory interventions in local governments. However, there is a view – based on principal-agency theory – that reliance on unfunded or partially funded mandates plays a positive role in controlling the costs of local public services. Huber et al. (2005), for example, argue that mandates combined with unconditional block grants provide an incentive for the state government to minimize the costs of the mandate. Similarly, Spahn (2007) argues that forcing local governments to co-finance local public services can reduce the moral hazards and problems of fungibility created by full compensation from the central government.

Apart from the theoretical arguments, unfunded mandates are also defended for practical reasons. Cole and Comer (1997) argue that unfunded mandates provide a substantial net subsidy to state and local governments and that the fiscal burden of these mandates is actually much larger for the federal government. Amid controversies on the pros and cons of unfunded mandates, the U.S. Congress decided to enact the Unfunded Mandates Reform Act (UMRA) in 1995 to control the growth of unfunded mandates. The effects of the UMRA have been widely debated since then, but it is generally agreed that UMRA has played a positive role: First, it increased the information available for legislative and administrative decision-making by requiring cost estimates for new mandates; second, it improved the quality of legislative decision-making by requiring a separate recorded vote to approve new legislative mandates (Cole and Comer, 1997).

The debates on partially funded mandates in Korea are in many ways similar to those in the US. Local governments in Korea strongly criticize the coercive nature of partially funded mandates for welfare programs. On the other hand, the central government argues that its fiscal burden is greater and local governments should devote more fiscal resources to social expenditures. What is notable in Korea and the U.S. is the absence of fiscal institutions that deal with budgetary coordination between levels of government.[16] Although theoretical elaboration is needed, this fact seems to be linked with the dominant role of specific grants and unfunded mandates in these countries. Compared to the U.S., however, the coercive nature of specific grants in Korea is even stronger as Korea lacks a legal mechanism, like UMRA, to allow for cost estimates

[16] It is interesting to note in this regard that the U.S. Advisory Commission on Intergovernmental Relations (ACIR) was abolished in 1996 after its publication of a report in 1994 entitled "Federally Induced Costs Affecting State and Local Governments", which recommended the abolishment of unfunded mandates (Poster, 1998; Kincaid, 1999).

of partially funded mandates, which in turn leads to debates on cost-sharing methods. With increasing mandates for social expenditures, the demand for fiscal institutions to deal with the nature of coercive fiscal relations embedded in the system of specific grants is likely to increase as well. Whether it is best to address this problem with a legal mechanism such as UMRA or to address it on a more fundamental level by making a definitive choice between a unitary and a federal model of fiscal decentralization is not an easy question in Korea.

1.4.2. Dilemma faced by Korea

The structure of intergovernmental fiscal relations in Korea can be summarized as the result of conflicting forces acting upon the decentralization framework. First of all, Korea is a unitary country by constitution and its people are homogeneous in terms of ethnicity, language, and culture. It is a small country with an area of around 100,000 square kilometers. Therefore, according to the work of Panizza (1999), the degree of fiscal decentralization in Korea should be lower than the average for western European countries.[17] However the share of local tax revenue in Korea is above that average and the share of local expenditure is among the highest in the OECD countries.[18] As far as the size of the local public sector is concerned, Korea is a very decentralized country.

It is of course not rare to find unitary countries that have large local public sectors. The Nordic countries are such examples, where local tax revenue and expenditure shares are among the highest in the OECD countries. Compared to the Nordic countries, however, Korea shares many aspects with federal and regional countries. First, its population of about 50 million is much larger than that of the Nordic countries, which have populations ranging between 5 and 8 million. Many countries among OECD countries with a population greater than 50 million

[17] Panizza (1999) defined the degree of fiscal decentralization as the share of local revenue in total revenue and ran a regression with explanatory variables such as the level of democracy, country size, ethnicity, and the level of income per capita. As expected, the degree of decentralization is positively related to these variables.
[18] The local tax share in Korea and its average in OECD unitary countries are respectively 22 percent and 16 percent as of 2008 (OECD Revenue Statistics, 2009). The local expenditure share in Korea and its average in OECD unitary countries are respectively 55 percent and 30 percent as of 2006 (OECD, Government at a Glance, 2009).

are either federal or regional countries.[19] Second, Korea relies heavily on a system of tax sharing for allocating tax revenues between central and local governments. This reliance on a system of tax sharing for allocating tax revenues across levels of government is also a feature of many federal OECD countries, excepting the US and Canada.[20]

Looked at in this way, the model of fiscal decentralization in Korea is a mixture of those found both in unitary and federal countries. It should be noted that the coexistence of different fiscal decentralization models is not unique to Korea. Banting (2007) categorizes Canadian federalism into three different types; classical federalism; shared-cost federalism; and joint-decision federalism. He then argues that the great difficulties of Canadian federalism lie in the domain of shared-cost federalism, by which costs of major sectors of the welfare state such as health care, post-secondary education, social assistance, and social services are shared between the federal and provincial governments.[21] The problem of establishing a clear-cut model of fiscal decentralization, especially in the area of welfare programs, seems, therefore, to be very difficult even in a federal country like Canada. However, it is even more challenging in Korea, because Korea's decentralization process only began in 1995, and its fiscal institutions related to fiscal decentralization are still rather weak. Borrowing the terminology of Wildasin (2004), Korea is not a maturely decentralized country unlike many OECD countries. Therefore it will take time before a more stable system of fiscal decentralization takes its root in Korea.

1.5. Conclusion

The fiscal decentralization model in Korea can be described as a mixture of the cooperative fiscal federalism found in the Nordic countries,

[19] Among the large unitary OECD countries, the United Kingdom consists of four devolved countries (England, Scotland, Wales, and Northern Ireland). Spain and Italy are federalized countries. Japan, a very large unitary country, historically had a quasi-federal system (Inoguchi, 2007) and federalism in Japan is still a hotly debated topic (Pascha, 1999).

[20] It is notable that both Japan and Turkey, the large non-federal countries, also rely on the system of tax sharing.

[21] By classical federalism, federal and provincial governments make unilateral decisions on public services. In this framework, the federal government makes decisions on unemployment benefits, child benefits, and non-contributory old-age pension and provincial government on worker's compensation. An example of joint-decision federalism is the Canada Pension Plan (Banting, 2007).

the fiscal federalism model of regional countries, and coercive federalism similar to that found in the US. The problem of Korea's fiscal decentralization is the weakness of the fiscal institutions dealing with intergovernmental fiscal relations. One reason is due to Korea's short history of decentralization, which began in 1995. But a more fundamental reason is its inability to decide whether to follow a fiscal decentralization model of a unitary country or that of a federal/regional country. Lacking fiscal institutions that provide channels for budget negotiations between central and local governments, the central budget office relies on specific grants combined with regulations such as partially funded mandates to control the budget of local governments. Although there are theoretical reasons for taking a positive view of partially funded mandates, the proliferation of intergovernmental grants with coercive measures is likely to be a symptom of the lack of efficient and cooperative intergovernmental fiscal tools.

It seems that, in order to efficiently manage the local public sector, the best route Korea, as a unitary country, can take is to follow the cooperative fiscal decentralization model of the Nordic countries. However, Korea's legal and political structures make it difficult for the central government to play a leading role in matters concerning intergovernmental fiscal relations – and, in fact, it is hard to find a completely unitary system among OECD countries with large populations. Given the fact that Korea has many of the characteristics of a regional country rather than of the unitary Nordic countries, it would be desirable to have some kind of intergovernmental forum or agency facilitating negotiations and dialogue across levels of government. This again, however, would be difficult to achieve, at least in a near future, since the concept of fiscal federalism is only weakly understood in Korea.

An immediate issue facing Korea is the establishment of an institutional mechanism for building consensus on how to deal with partially funded mandates. The Unfunded Mandates Reform Act (UMRA) in the U.S. sets an example for solving conflicts and controversies over unfunded mandates through legalistic means. There are some doubts, however, regarding UMRA's effectiveness in controlling the growth of unfunded mandates in the US. Nevertheless, UMRA is a valuable example of a mechanism for determining the total fiscal burden associated with unfunded or partially funded mandates. In a similar vein, as a more easily implemented measure, medium-term projections of the full costs incurred by partially funded mandates could also be effective in improving the process of budgeting for the rapid increase of social expenditures in Korea.

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Chapter 2

Central reforms through local governments: Challenges and design

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2.1. Introduction

In the Nordic welfare states, local governments are important providers of welfare services such as education, health care, and social services. Decentralization is combined with legal regulations to clarify the local responsibilities and to impose minimum standards for and rights to services. Financial equalization levels the playing field and limits variation in service standards across local governments. Decentralized provision is combined with national policies for redistributive welfare services.

Several justifications can be made for decentralized service provision. Local governments are better informed about benefits and costs of policy programs, and decentralization may therefore promote allocative efficiency. This is the essence of the so-called "decentralization theorem" by Oates (1972). Mobility between local governments (Tiebout 1956) may further increase allocative efficiency by making communities more homogeneous. Moreover, decentralization may promote cost efficiency by giving voters the opportunity to move out of inefficient communities and through yardstick competition.

The main justification for central government regulation is the merit-good aspect of welfare services. Education, health, and social services are not local public goods in the traditional sense, but redistributive services that serve equity purposes (Boadway 2006, p. 357). From a national perspective, comparable provision of such services throughout the country is often an important policy objective, and central regulation of local governments can be understood as a means to achieve that objective. This line of reasoning is similar to Musgrave's (1959, p. 183) "entirely different view on federalism", where "fiscal federalism is interpreted to be an assurance to each citizen of the federation that special social needs such as elementary education will be provided adequately in all states." This "entirely different view on federalism" has by many observers been labeled "administrative federalism", see e.g. Schwager (1999).

Decentralization of the provision of redistributive welfare services means that local governments to some extent act as agents on behalf of the central government, and the central government typically becomes involved in the financing of the services. An important question is whether the different mandates imposed by the central government are sufficiently funded. The issue is discussed by several papers in this volume. Spahn (2012) reviews the German case, emphasizing the work of a government commission that was set up partly to investigate whether standards imposed by federal legislation would have financial implications for local budgets. Swianiewicz (2012) argues that standards and norms imposed by the Polish government have increased systematically over the past two decades, and that local governments are financially bound by them.

In this paper I discuss a related issue, the financing and implementation of national reforms in welfare services. The welfare services are developed over time, often in interplay between central and local governments. Some local governments are innovative in terms of developing services. The good services in some authorities are recognized by the central government and may inspire a national reform. In Norway, many examples of such reforms can be found in the educational sector. The expansion of primary education to 9 years, upper secondary education for everyone, before and after care for school children, and full coverage in kindergartens are examples of central reforms initiated by examples of local government innovation.

The rest of the paper is organized as follows: As an empirical background, section 2 presents tasks, financing, and regulation of Norwegian local governments,[22] including a few brief remarks on historical service development. Section 3 discusses reform financing at the macro level, i.e. whether the reform is under- or overfunded. The specific reform implementation is discussed in section 4, with focus on the type of financing and legal regulation. Based on the analysis in section 4, section 5 provides guidelines for reform implementation. Section 6 concludes.

The analysis and discussion in sections 3-6 should be relevant beyond the Norwegian context. It clearly applies to other Nordic and European countries where local governments are responsible for redistributive welfare services. Also in the U.S. there is increasing attention on how state-local spending is affected by federal mandates in the areas of education, health, and public welfare, see e.g. Baicker et al (2012).

2.2. The Norwegian context

The responsibilities of Norwegian local governments have steadily expanded during the last 150 years. In the second half of the 19th century, local governments developed infrastructure related to water supply, sewage, garbage collection, gas and electricity supply, roads, and tramways, as well as welfare services within the fields of education and health care. Local governments were also engaged in housing policy and poverty relief. In the first half of the 20th century, many local governments introduced social security programs such as unemployment benefits and old-age pension. The expansion of responsibilities was partly a result of local initiatives and partly a result of central government mandates.

With the establishment of the welfare state after World War II, a clearer division of labor between central and local government emerged. The central government took over most local social security programs and established a national social security system,[23] while welfare services (education, health, and social services) remained local responsibilities. Expansion and equal access to welfare services were cornerstones in the construction of the welfare state. It became a central government responsibility to provide sufficient funds for the expansion. Intergovernmental grants and regulation of services increased to limit the variation

[22] Section 2 is largely based on Borge (2010, 2012).
[23] Social assistance is the only remaining transfer program at the local level.

in service provision across local governments. Although welfare reforms to an increasing extent are initiated by the central government, innovative local governments are important role models. Good services in some local governments receive attention and may become the seed of a national reform. Examples of such an interplay between central and local government is the extension of primary education to 9 years in the late 1960s, the right to upper secondary schooling in 1994, the lowering of the school age to 6 years 1997, the expansion of services and housing for the elderly during the 1990s, and full child-care coverage in the 2000s.

As of 2011, the Norwegian public sector is divided into three tiers; the central government, the county governments, and the municipal governments. The 19 counties and the 430 municipalities constitute the local public sector.[24] The municipalities and the counties have the same administrative status, whereas the central government has the overriding authority. The sector accounts for nearly 50 percent of government consumption, and their revenues make up nearly 20 percent of (mainland) GDP. Close to 20 percent of the workforce is employed in the local public sector.

Figure 2.1 provides an overview of the municipal responsibilities. It is evident that welfare services within the educational, health, and social sectors account for the bulk of expenditures. The welfare services under municipal responsibility are child care, primary and lower secondary education (1st to 10th grade), care for the elderly (nursing homes and home-based care), primary health care (general practitioners, health centers, and emergency wards), and social services (mainly social assistance and child custody). These services amount to ¾ of the total budget. The more local services include a large number of activities, but make up less than 20 percent of the budget. They can be broadly categorized into culture (libraries, cinemas, sports facilities, etc), infrastructure (roads, water, sewage and garbage collection), and planning (including land use planning), industry, and housing.

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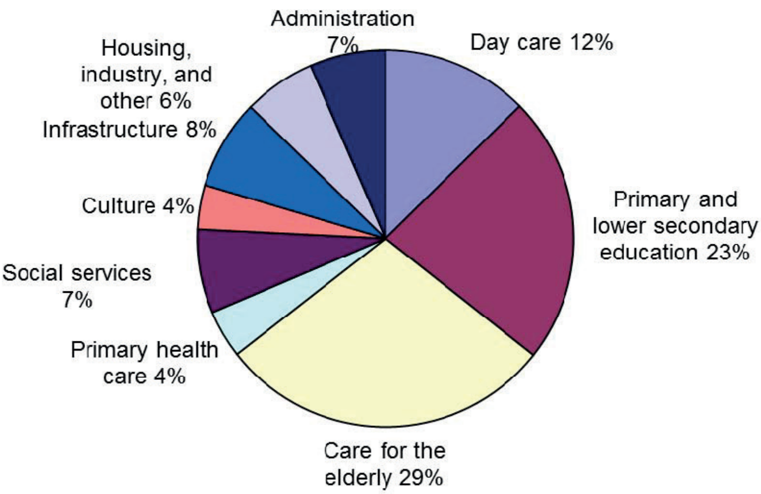
[24] The capital Oslo is both a municipality and a county.

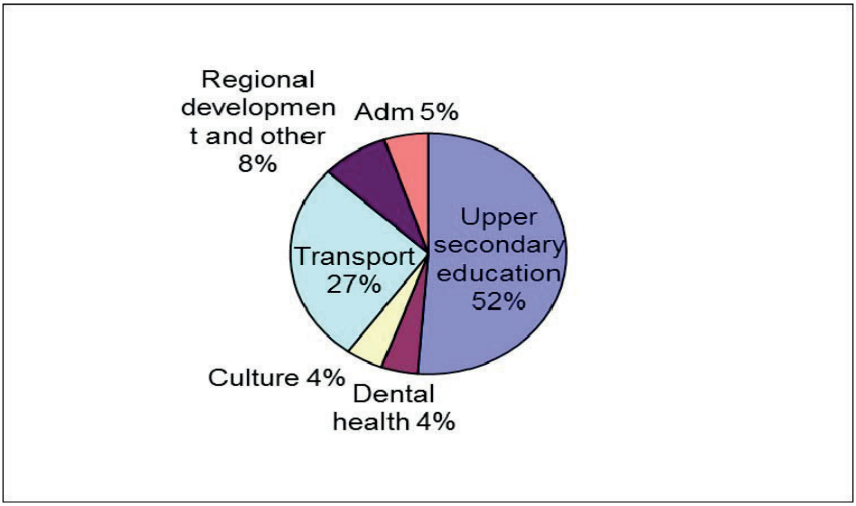
Figure 2.1. Municipal service sectors, percent of current expenditures, 2010



Note: The capital Oslo, which is both a municipality and a county, is excluded.
Source: Local Government Accounts, Statistics Norway.

The main responsibilities of the counties are shown in Figure 2.2. After the national government took over the responsibility for the hospitals in 2002, upper secondary education (general and vocational) has become the most important task for counties, amounting to around half of the total budget. The second largest service sector is transport (roads and public transport), which accounts for ¼ of the budget. The remaining services are dental health (mainly for the young and residents in nursing homes), culture (libraries, museums, sports facilities, etc), and regional development (planning and business development). Together, the welfare services upper secondary education and dental services make up around 55 percent of county expenditures. However, if we consider county transport as part of a national infrastructure, this share increases to more than 80 percent.

Figure 2.2. County service sectors, percent of current expenditures, 2010



Note: The capital Oslo, which is both a municipality and a county, is excluded.
Source: Local Government Accounts, Statistics Norway.

Total local government revenue amounts to nearly 20 percent of GDP, and Tabel 2.1. gives an overview of the major revenue sources. Local revenues (taxes and user charges) amount to slightly more than 50 percent of total revenues, while grants from the central government account for a little over 40 percent. The main differences between the two local government tiers are that the counties are more dependent on central government grants, while taxes and user charges are more important for the municipalities. The municipalities apply user charges on a wide range of services, but technical services (water, sewage, and garbage collection), child care, and care for the elderly account for most of the revenue. User charges cannot be applied to primary and secondary education.

Income tax from individuals constitutes the dominating tax type, both for the municipalities and the counties. It accounts for nearly 90 percent of municipal tax revenues and nearly 100 percent of county tax revenues. The local income tax is a piggy-back tax on a national tax, and formally, local governments may choose their tax rate within a defined maximum. During the last 30 years, however, each and every local government has used the maximum tax rate. In practice, local tax discretion is limited to the property tax, which is a voluntary tax for the municipalities.

Tabel 2.1. The financing of the local public sector (%), 2010

Revenue source	Total	Municipalities	Counties
User charges	12.5	14.2	4.2
Taxes	40.1	41.8	31.7
Grants	42.2	39.5	55.7
Interest and dividend	3.3	2.7	6.3
Other	1.9	1.8	2.1
Total	100.0	100.0	100.0

Note: Oslo, which is both a municipality and a county, is included in the figures for the municipalities. Interest and dividend for the counties include revenues from toll roads.

Source: Local Government Accounts, Statistics Norway and Committee for Assessment of Local Government Economy

The grant system consists of general purpose grants and earmarked grants. In 2010, roughly 30 percent of grant revenues were earmarked. From 2011, a large earmarked grant for child care was included in the general purpose grants scheme, and as a consequence the share of earmarking dropped to 10 percent.

It is the general purpose grant scheme that is most important for the distribution of revenue across local governments. The general purpose grant scheme was introduced in 1986 and has three main purposes; to equalize economic opportunities across local governments, to promote regional policy goals, and to transfer resources to the local public sector. Equalization is achieved through tax equalization and spending needs equalization and is based on objective criteria such as tax base, age composition, and socioeconomic factors. While tax and spending needs equalization promotes equality of service provision, the regional policy grants generate new differences. The justification of the grants is that rural and northern local governments should be able to provide better services than in the rest of the country in order to promote employment and population growth.

At the local level, decision-making is organized around the annual budget and the long-term economic plan. The long-term economic plan covers at least the subsequent four years and provides a forecast of revenues, expenditures, and priorities in this period. The main requirement is operational budget balance. In the budget, current revenue must cover current expenditures, interest payments, and regular installments on debts. Actual deficits are allowed to be carried over, but as a main rule they must be “repaid” within two years. Local governments that do not obey the balanced-budget-rule are listed in the so-called ROBEK register and need to have their budgets and loans approved by the central government.

Most local government services are regulated by national legislation. National laws are in place for services such as child care, education, health care, and social services. The laws specify responsibilities for local governments and what the inhabitants can expect in terms of services. More detailed administrative regulations are specified by the relevant ministries. Local governments are also subject to monitoring and supervision by central government agencies.

2.3. Reform financing at the macro level

I will now turn to the discussion of reform financing. The point of departure is a situation where the central government is contemplating a reform of a specific welfare service provided by local governments. Recent Norwegian examples are the Knowledge Promotion Reform in primary and secondary education (implemented in 2006 to improve learning outcomes), expansion of child care to full coverage (2003-2010), and the Coordination Reform in health care and care for the elderly (starting in 2012). The first stage of a reform process is to estimate aggregate costs in order to assess whether the reform should be implemented or not. Different actors obviously have different interests with respect to calculation of costs. Here, I will distinguish between sectorial interests, local governments, and coordinating ministries such as the Ministry of Finance and the Ministry of Local Government.

Sectorial interests associated with welfare services are mainly concerned with the sectors’ own service. Overestimation of the costs would be in their interest if they can be sure that the reform will be approved, even with a high cost estimate, as this would yield the largest expansion of the service. The advantage of a low cost estimate is that the calculated benefit-cost ratio increases, and thereby also the chances that the reform will be approved. The risk is that the expansion of the service will be lower than if the reform is approved with a high cost estimate. However, for the sectorial interests an underfunded reform may yield a strategic advantage in local budgeting, as some of the underfunding may be covered by cut-backs in other sectors.

The local governments (and their association) have a strong interest in avoiding underfunding of the reform. It would mean that they would have to take part of the responsibility for a partly failed reform, and also for cut-backs in other sectors that may be a consequence of the underfunding. The most preferred outcome for the local governments is overfunding, as this will result in reduced pressure for high efficiency in reform implementation.

The coordinating ministries, the Ministry of Finance and the Ministry of Local Government, would like neither underfunding nor overfunding of the reform. Overfunding is not desirable for obvious reasons. Either fewer resources are available for other projects or taxes would need to be increased. It is less obvious that underfunding is undesirable. Underfunding has the short-term advantage of providing more “space” in the budget. However, since the reform is more likely to fail, there is a risk that more resources must be provided at a later stage. If so, it is better to provide sufficient resources from the outset.

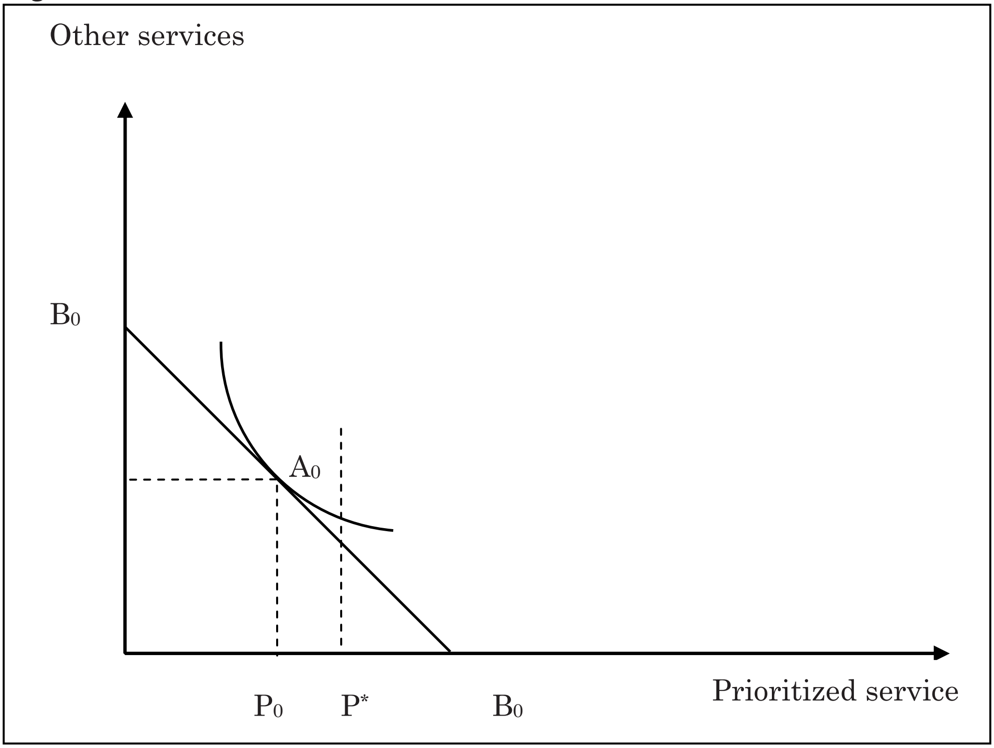
Despite the conflicting interests, there is little disagreement in Norway over the principle that reforms (or new tasks) should be fully financed. On the other hand, there is no legal requirement that reforms must be fully financed. The central government can impose a new regulation or a mandate which increases local government expenditures without providing extra funds (unfunded mandates). As always, the devil is in the details. Agreement on principles does not preclude disagreement on the actual cost estimate. Such disagreement could be the result of disagreement on calculation methods and what type of costs to include in the calculations. The introduction of school start for 6-year-olds in 1997 may serve as an example of the latter. Most 6-year-olds were already in child care partly financed by local governments. An important issue is then whether savings in child-care costs should be deducted from the reform costs or not? The question is whether the mandate is fully funded as long as local governments can offer the same service level for children below 6 years as before the reform (in which case the saved child-care costs should be deducted), or whether it requires that local governments can offer the same number of child-care places as before (in which case the saved child-care costs should not be deducted)? In the latter case introduction of school start for 6-years-old would also lead to increased child-care coverage for children below 6 years.

2.4. Reform implementation at the micro level

After the costs of the reform have been estimated, the next step is to facilitate implementation of the reform in individual local governments. The case is illustrated in Figure 2.3., which shows a local government providing two services; the prioritized service (P) and other services (O).[25] Initially the budget constraint is B_0B_0 and the actual allocation is in point A_0 with service standard P_0 for the prioritized service. The central government wants to implement a better service standard, indicated by P^*. The issue is how to implement a reform of improving the service standard from P_0 to P^*. In the following I will distinguish between legal means and matching grants.

[25] In the Norwegian setting with limited sub-central tax discretion it is reasonable to interpret O as other services provided by the local government. With tax discretion, other services would also include private consumption.

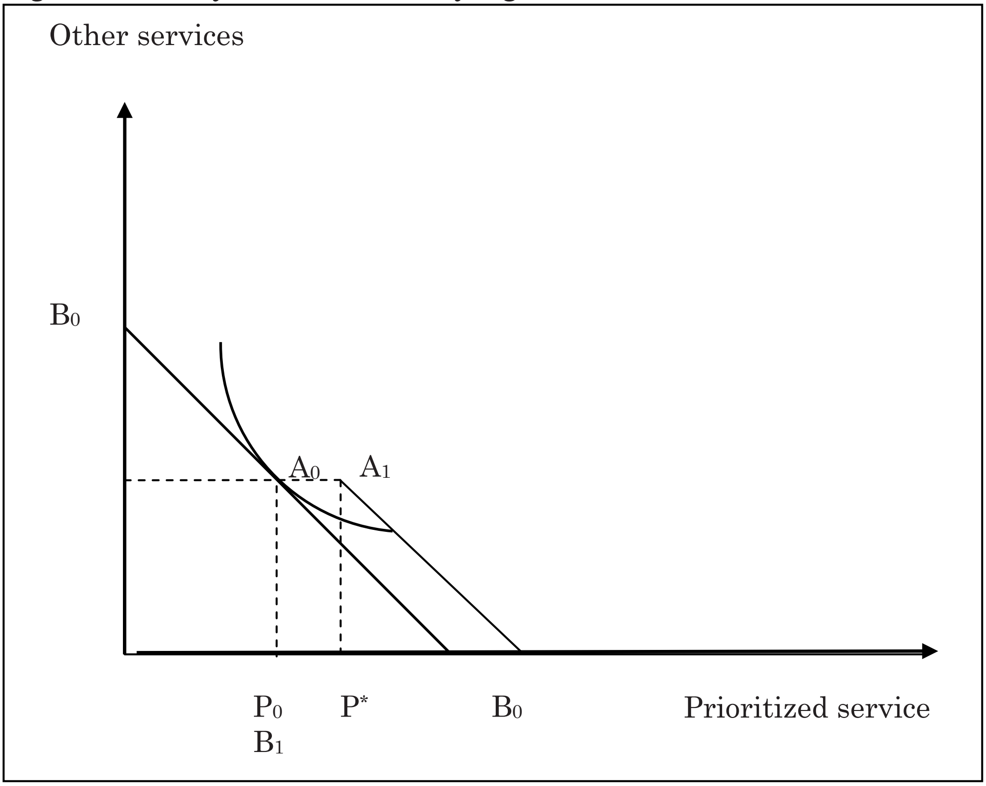
Figure 2.3. The initial allocation



2.4.1. Legal means

Examples of legal means are minimum standards or defined rights to services. An example of a defined right is the right to education, while maximum class size is an example of a minimum standard. Reform implementation by legal means implies that the local government is forced to have a service standard of at least P^*. A requirement to provide P^* would typically be accompanied by more resources. Figure 2.4. illustrates a reform that is fully financed in the sense that the provision of other services will not be affected. Then the central government provides reform financing which yields the new budget constraint A_1B_1. The new allocation will be a corner solution in A_1. Given that legal restriction is enforceable, there is no need for earmarked reform financing.

Figure 2.4. Fully funded reform by legal means



In practice, the financing can be arranged in different ways. First, the same type of reasoning and calculation as shown in Figure 2.4. may be conducted for each and every local government. The central government would then calculate the extra resources that each local government needs to finance the reform without having to reduce the provision of other services. The advantage of this approach is that the reform is exactly fully funded in each local government. The main disadvantages are that it requires detailed information on current service standards and local cost conditions, and that those local governments which had high service standards before the reform are "punished" by receiving relatively small grants.

The alternative is to finance the reform by a general purpose grant that is distributed by objective criteria, ideally designed to capture the variation in spending needs for providing P*. The total size of the grant could be based on more crude calculations of the national costs of the reform.

Given that this cost estimate is not too far from the aggregate reform cost, the reform will be underfunded in some local governments and overfunded in others. The reform will tend to be underfunded in authorities with low initial service standards and overfunded in authorities with high initial service standards. In a political context it may be problematic that the reform is underfunded in some authorities. It may weaken local support for the reform and reduce its legitimacy. The problem of underfunding in some authorities can be reduced or eliminated if the total grant exceeds the aggregate reform cost, but this has the obvious disadvantage of making the reform more costly for the central government.

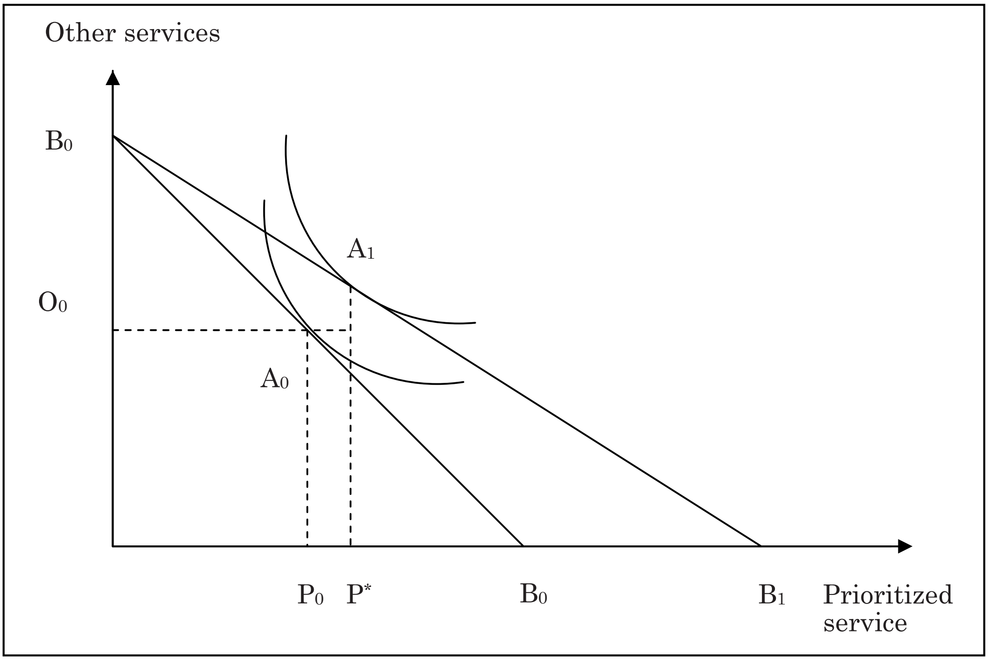
A possible compromise is to base the initial grant distribution on calculations of actual reform costs in each local government and gradually move towards general purpose grants based on objective criteria. This would mean that the problem of underfunding of some local governments in the implementation phase is eliminated, while the "punishment" of authorities with high service standards before the reform is limited to the implementation phase.

The transitional arrangement described above assumes that it possible to calculate the actual reform cost for each and every local government. It could be objected that cost calculations along these lines are complicated and not feasible in practice. However, it has been used in Norway in several cases. A current example is that the central government is contemplating introducing a minimum teacher-pupil ratio in primary and lower secondary education. In each local government the reform cost is calculated as the difference between the number of teachers required by the new norm and the actual number of teachers. Similar approaches, although more complicated, have been applied to school start for 6-year-olds and the recent child-care reform.

2.4.2. Matching grants

The service standard can be improved through financial means without any legal regulation. A standard matching grant for the prioritized service will do the job as illustrated in Figure 2.5. The matching grant reduces the cost of the prioritized service relative to other services, and the budget constraint shifts to B_0B_1. Both the substitution effect and the income effect contribute to increased provision of the prioritized service. By using available estimates for the price elasticity of demand for the prioritized service, the central government can set the matching rate such that the target P^* is achieved.

Figure 2.5. Reform implementation through matching grants

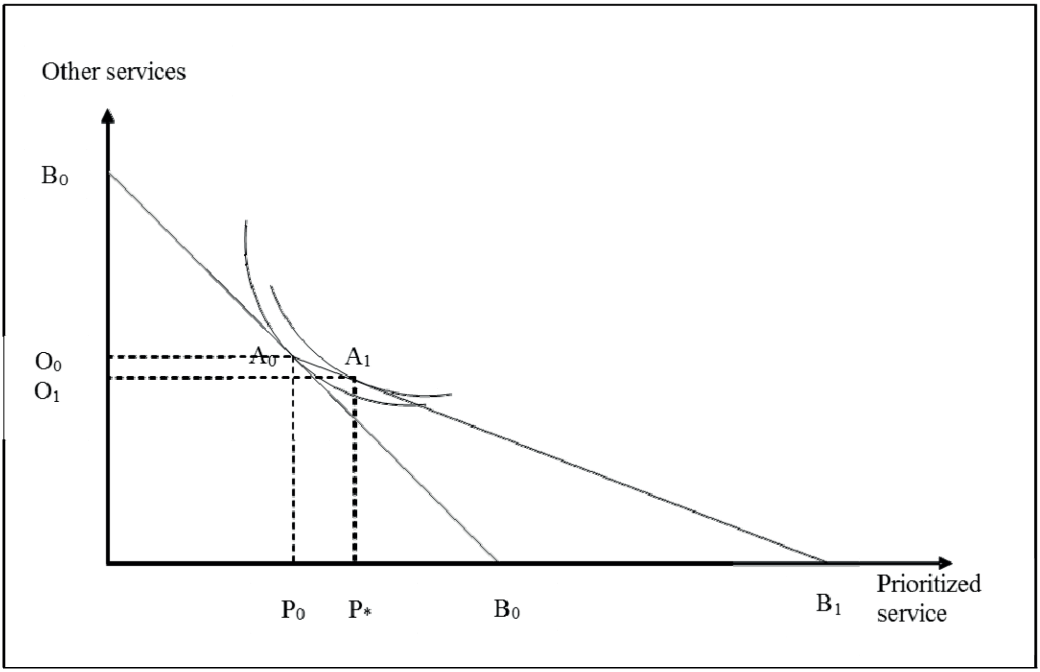


In general, the amount distributed through the matching grant will differ from the cost of the reform, i.e. the cost of increasing the service standard from P_0 to P^*. It can be shown that the matching grant will underfund the reform if demand is price-elastic and overfund the reform if demand is price-inelastic.[26] Only if the price elasticity is -1, the reform will be exactly fully funded. Unfortunately for the central government, most empirical studies tend to find that demand for public services is price-inelastic.[27] A standard matching grant will therefore in most cases

[26] This is just the standard "leakage" results in another wrapping. If demand is price-inelastic, the matching grant will to some extent "leak" to other services.
[27] The U.S. literature is summarized by Oates (1996), who argues that the representative estimate of the price elasticity is in the range -0.2 to -0.4. Also the Swedish studies by Aronsson and Wikström (1996) and Bergström et al (1998), as well as the Norwegian study by Borge and Rattsø (1995), find demand for local public services to be inelastic with respect to price.

be a costly way of financing reforms. This is the case illustrated in Figure 2.5., where a matching grant also leads to increased provision of other services. An additional complication is that the matching rates may need to be differentiated across authorities in order to reach the same target everywhere.

Figure 2.6. Matching grants related to expansion of service standards



Of course central governments dislike unnecessarily costly reforms, and may look for modifications that may reduce costs. One possible modification is to let the matching rate apply to an expansion of service standards only. This case is illustrated in Figure 2.6., where the new budget constraint is $B_0A_0B_1$. The new allocation (A_1) will be south-east of the initial allocation in the segment A_0B_1. It is evident that the service standard will improve for the prioritized service, partly at the expense of other services. Again a proper matching rate can be calculated from information about the price elasticity of demand (in this case the compensated price elasticity). Also in this case the matching rates needs to be differentiated across authorities.

The amount distributed through the matching grant related to an expansion of service standards will be lower than the costs of the reform. This is illustrated in Figure 2.6. by the fact that provision of other services is reduced. The reform can be implemented by grants lower than the costs, but that will come at the expense of unintended cutbacks for other services. However, underfunding can easily be avoided by combining the matching grant with a general purpose grant.[28]

The different matching grant designs involve a trade-off between the amount of reform financing and a desire not "punish" authorities with high service standards before the reform. The standard matching grant represents a quite generous treatment of authorities with high service standards before the reform, since the subsidy also covers existing production. As a consequence, long-term incentives for innovation are not adversely affected. However, for the central government proper long-term incentives come at the short-term cost of overfunding the reform. Overfunding may be eliminated by restricting the matching grant to expansion of service standards, but this would mean that innovative authorities are more severely "punished".

2.5. Guidelines for reform implementation

The previous section discussed two ways of implementing central reforms through local governments, legal means, and matching grants. If possible, implementation by legal means seems to be the preferred solution. With legal means, similar service standards can be achieved throughout the country in combination with a relatively uncomplicated financing scheme. The financing can be arranged by general purpose grants. The grant may be distributed according to actual reform costs in the implementation phase and according to objective criteria later on.

It is much more complicated to implement a national reform through matching grants. The matching rates must be differentiated across authorities in order to achieve the same service standards, and the local response must be predicted. There is also a worry that the complicated reform financing may be a more permanent feature of the grant system since the local authorities may reverse their priorities if the matching grant is abolished and the amount is distributed as a general purpose grant.

[28] The matching rate must then be reduced compared to the situation in Figure 2.4.

Both with legal means and matching grants the central government faces a trade-off between incentives and the amount of grants needed to achieve the desired service standards. The need for extra grants can be kept down by targeting grants towards authorities with low service standards before the reform. But then authorities with high service standards are "punished" for being innovative. Less "laboratory federalism" (see e.g. Oates 1999) and less future innovation may be the consequence. Given the restriction that the reform is not to be underfunded in any local government, the above analyses indicate that incentives for innovation can only be improved by granting more money and thereby overfunding the reform.

Overfunding of reforms is obviously not very attractive for the central government. But are there any alternatives? One possible alternative is to say that the reform should be exactly fully financed in aggregate, but not necessarily for each and every local government. The financing is arranged by a general purpose grant corresponding to aggregate costs and distributed on the basis of objective criteria. The reform will tend to be overfunded in authorities with high service standards before the reform and underfunded in authorities with low service standards. Innovative authorities are not "punished", but that comes at the "cost" of underfunded in authorities with low service standards. The underfunding in authorities with low service standards may be problematic politically. The implementation of the reform may be delayed because some authorities must make cutbacks in other service sectors in order to finance the reform. Political noise in the media may be difficult for the central government to withstand.

It should be pointed out that consultations between the central government and an association representing the local governments may be helpful. The key is that the local government association may coordinate conflicting interests between its members. Authorities with low service standards would like the reform to be fully financed in each and every authority, while authorities with high service standards prefer a financing scheme where the present provision is not taken into account. The association could establish a compromise where the interests of both groups are taken into account.

Consultations between the central government and the Norwegian Association of Local and Regional Authorities (KS) have been formalized since 2001, but do not result in binding agreements. A main purpose of the consultations is to replace economic and law-based means with dialogue. The consultations have the potential to make reform implementation smoother. Borge (2009) argues that the recent child-care reform could have been carried out without a complicated matching grant system if it had been handled within the consultations, but only under the assumption that the consultations resulted in clear targets for coverage which were closely monitored in the process.

The conclusion that reform implementation through legal means is preferred to matching grants is based on the assumption that the service standard which is to be achieved can be clearly defined and written into law. This often is the case in the educational sector, where most examples in this paper are taken from. Right to schooling and right to child care apply to all and are easy to define in legal terms. Things are more complicated in other sectors like care for the elderly. The analogy to the educational sector would be that for instance all elderly above the age of 70 should have the right to 5 hours of home-based care per week, or that all above the age of 85 should be entitled to live in a nursing home. This type of legal regulation is clearly inappropriate. Resources would be wasted, because many people over 85 are still able to live in their own homes, and those under 85 in need of a nursing home may have to live in their own homes. The substantial variation in needs among the elderly is hard to write into law. This is acknowledged in legal formulations like the right to "proper care", but such formulations are far too vague to calculate the necessary costs of obeying the law. As a result, the Norwegian experience is that matching grants are more common in care for the elderly than in education. We observe that matching grants are used from time to time to increase the capacity of for instance nursing homes. They may be effective in boosting service provision, but (as indicated by the analysis in previous section) they are unlikely to guarantee that specific minimum standards are achieved everywhere.

2.6. Concluding remarks

In countries where local governments provide redistributive welfare services, the central government cannot avoid some responsibility for outcomes and service development. Welfare reforms are often designed centrally and carried out locally. However, reforms may be inspired by innovative local governments. When a central reform is to be implemented, there is consequently large variation in the starting point and thus reform costs. This paper has compared reform implementation through legal means and matching grants on the background of the Norwegian experience. It is argued that legal means seems to be the preferred solution when the right to services can be defined in an appropriate way. In both cases, however, the central government faces a trade-off between the amount of reform financing and incentives for service innovation.

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Chapter 3

Decentralization of welfare services or centralization of municipalities?

Jorgen Lotz

3.1. The issue

In 1954 the Danish professor *Philip* examined long-term trends in local government functions in the United States, the United Kingdom, Denmark, and Sweden from 1800 to 1950 (Philip,1954).

Philip found very similar trends in the different countries. The traditional “local public goods” such as street lighting, waste removal, and building permits had played an ever-decreasing role in the agenda of municipal councils, as their importance had been dwarfed by new local competences in delivering education and social welfare services. This process Philip described as a period of centralization, as the local public goods had been the subject of still less political interest compared to the costly new mandates to deliver an increasing number of national welfare goods.

Although this trend has not continued in the USA, the Nordic countries have seen a continuous development of it since 1950. Although Nordic municipalities find it hard to accept, schools, old-age care, and similar fields are not really local public goods. National Parliamentary actions tell us again and again that they are national public goods. This also seems to apply to the Netherlands (*Maarten Allers* in this volume). The present paper explores why and how this local delivery of national public goods has been arranged.

3.2. The set-up of the Nordic public sector: High public spending and a high local share

The Nordic countries, which include Denmark, Finland, Iceland, Norway, and Sweden, are small, unitary, and homogeneous. The population of the Nordic region in total is 24 million. Sweden is the largest country, with nearly 9 million people, and my own country, Denmark, has a population of 5.5 million.

Since the populations are homogeneous, it could be argued that decentralization is easier when people share the same cultural values. But it could also be asked: why decentralize services when the population is homogeneous? I will come back to that question.

The countries all have large public sectors. The tax-to-GDP ratios are among the highest in the OECD, close to 50 percent. The number of public employees is close to 25 percent of total employment. But Nordic citizens also get what they pay for: they have free education, free hospital care for everybody, free old-age care equally available for all in need of it, and the right to subsidized nursery or kindergarten is guaranteed for any child who wants it.

In addition to being large, the public sectors are highly decentralized. Local taxes are about 15 percent of GDP, the local revenue from grants are about 6 percent. Local governments spend much more than the average OECD country on health and social policy purposes (Table 3.1.). It is seen that this extra spending is financed in the Nordic countries by revenue from local income taxes that yield a little more than 10 percent of GDP.

Table 3.1. Measures of decentralization, Nordic countries compared to other OECD countries, recent years

	Average OECD non-Nordic countries	Nordic* average
Local govt. expenditure, percent of GDP Of this: Local welfare expenditure, percent of GDP**	9.2 (4.2)	19.1 (12.3)
Local current revenue (taxes, fees and grants), percent of GDP Of this: Local income tax revenue, percent of GDP	9.0 (1.3)	19.7 (10.6)

* Denmark (data before 2005 reform), Finland, Iceland, Norway, and Sweden.
** Education, health, old-age care, and other social services. Source: IMF,GFS.

The average population size of the local authorities has been increased over time to enable them to perform increasingly complicated functions. This is sometimes done by a gradual process of amalgamation over the years (Finland), but also by more comprehensive reforms (Denmark). Table 3.2. shows the average population size of the two levels of local government – the counties and the municipalities.

Table 3.2. Average size of local authorities in the Nordic countries 1/1 2000

Average size, number of inhabitants	Finland	Sweden	Denmark after 2007 reform	Norway	Iceland
Municipalities	11,400	30,700	54,000	10,300	2,200
Counties	--	422,000	1,100,000	235,700	--
National population	5,146,000	8,861,000	5,330,000	4,478,500	278,700

Some Nordic countries still have a middle tier (the counties). For the first half of the 20th century, the middle tier was an agent of the central government, and its role was to supervise the municipalities. This is no longer true: counties play no role today in supervising municipalities. However, they have their own functions, typically health and hospitals, complicated social care, as well as a role in public transport, planning, and in environmental protection. Counties seem today to be out of favour with the Nordic parliaments, and efforts are being made to slowly deprive them of functions. They have recently been abandoned in Norway. In Denmark they were in 2007 replaced with fewer and larger regions without own taxation rights and with much limited functions.

The center seeks to encourage cost efficiency at the local level Municipalities are being challenged in the name of free choice and competition. These days, the role of local government is exposed to conflicting strategies for more central control and to more competition to improve efficiency and the quality of services.

3.3. Why decentralize in a small homogenous country?

Why do the Nordic countries pursue decentralization policies with the relatively homogenous populations? This policy is based on the belief that local delivery is more cost efficient than central delivery would have been.

Does it work that way? It is difficult to find studies of the quality and costs for services delivered by local branches of national services compared with the same services delivered by local, elected councils. But the national political majority demonstrates, by continuing to give new mandates to local authorities, its conviction that decentralization of the delivery of these services results in at least more consumer-friendly and flexible delivery than the alternative of centrally organized delivery would be.

Obviously it is complicated to decentralize delivery of functions that are closely related to national redistribution. Nordic local authorities provide redistributive services, and redistribution is a national concern, especially when populations are homogeneous and have quite similar and strongly egalitarian preferences. Hence there is an ongoing discussion with local authorities on how best to ensure that local authorities live up to the national aspiration for service quality.

Some feel that the international literature on fiscal federalism has not been helpful in describing this Nordic reality. The perspective is changed when local governments are not homogeneous clubs concentrating on local public goods, but are instead busy delivering central redistribution services. In such cases, you tend to see local government provision of welfare services more as an administrative convenience rather than as part of a system based on welfare economic principles.

In his paper in this volume. *Lars Erik Borge* groups the instruments the center can use to influence the local service quality into three categories: 1) legal means, minimum standards and defined rights to services and the use of softly tied grants (block grants), 2) matching grants and 3) consultations with local government associations. Among these, Borge finds that legal means seem to be preferred and initially to be financed by "block grants". He finds matching grants complicated to use effectively, and consultations, he finds, may be helpful to coordinate conflicting interests between local authorities. In the following, I will comment on these instruments based particularly on Danish experiences.

3.4. Legal measures

As pointed out by *Borge*, legal measure are the most frequently used instrument to control that local delivery lives up to the nationally desired standards. And the way regulation is designed is a source of frequent controversies between the center and the local level.

Local authorities tend to argue that one should primarily control the outcome (do the school children learn to become good citizens?), while Parliament tends to concentrate on the harmonization of inputs (is the ratio of children to teachers low enough everywhere?). Parliament needs visible political action, and if the local arguments were followed, it would bar central interference for years until the results are seen. The need for central action is emphasized by the press, which ever so often brings examples of what they present as service failures. When this is the case the mayor involved often complains that the problems arise because grants are too small, this makes it difficult for the central government to respond to the criticism with other means than more regulation.

3.5. The role of grants policies in getting respect for central priorities

Grants policies are used in different ways in an attempt to find a middle ground between the desire for uniformity and the desire to leave the local authorities room to improve their efficiency and to adapt priorities to local conditions. Matching grants are, as described by *Borge* in this volume, difficult to use. They have superior equalization properties, but they also encourage wasteful, inefficient spending. Many countries have therefore experimented with broadening the scope of the matching grants and make them increasingly similar to “block grants”, which are (Bergvall et al. 2006) grants conditioned in some soft way to broad objectives, and the use of which is not controlled as is the case of earmarked grants.

Maarten Allers, in his paper in this volume, describes how the use of general grants reflecting objective indicators of needs in the Netherlands “has been rather successful in reaping the benefits of decentralization while at the same time ensuring a high degree of similarity in service standards across the country”. What has happened in the Netherlands is that specific grants have been made broader, giving local authorities more spending discretion. At the same time general grants are increasingly tied to specific spending programs, though mostly implicitly.

This way the Netherlands has ended up with what seems to be a general trend towards a system of block grants, which is seen also in Denmark and probably in several other countries, and which seems – according to *Allers* – to work satisfactory in the Netherlands.

3.6. Consultations with local government associations

In Denmark, grants to local governments have for more than 30 years been negotiated in formal, annual negotiations between ministers from the central government and the chairs of the local government associations. Each spring there are intensive negotiations, and when they are concluded, the results are presented on primetime television news with interviews with ministers and top local politicians.

Originally, the main elements in these agreements were that the government is committed to seek approval in Parliament of the agreed size of grants, and that the local associations are committed to recommend to their members that they keep tax rates and expenditure increase rates within the limits agreed upon. The association’s recommendations are not binding for the individual authorities; the idea is that some will raise taxes and some reduce them, but that in total there should be no tax increases for the sector as a whole.

The success of this policy has depended on the discipline among the members of the associations and on the political strength and credibility of the central government to introduce sanctions if an agreement is broken; however both sides have more recently failed in meeting these conditions.

But in spite of the recent failures, the system of negotiations has survived as an instrument of central control over the quality of the local delivery of national welfare services. Present-day agreements are heavy documents covering a wide range of subjects, and they have become an important instrument for bringing the objectives of the central government to the knowledge of the local councils, and to present the central aspirations which are expected to be met. This has to some extent been successful and has helped avoid recourse to earmarked grants; general grants have – as mentioned above – in some ways gradually become more like "block grants".

Another advantage for the central government of the system of negotiations has been to serve as a convenient alternative for the government to negotiations in Parliament. Experience shows that it is difficult for the opposition in Parliament to criticize proposals that have been confirmed by agreements with the local associations. This is important in a country with proportional representative democracy where governments more often than not are minority governments.

In the period between two annual agreements all new legislation proposed by government with consequences for local government functions must also be negotiated with the local associations, a point to which I will return. The involvement of municipal expertise in the drafting of new legislation improves the quality of new legislation with respect to the ease of administration at the local level and helps clarify the purpose of the legislation to the local level.

Although a formalized system for negotiations like the one in Denmark does not exist in the other Nordic countries, dialogue and cooperation with associations of local authorities is a common feature. The Nordic model is thus generally built on a continuing dialogue between the central and the local level.

3.7. National welfare services and cyclical variations

In Denmark, like in many other countries, the local government sector is bound to have a balanced budget, and this together with their financing by tax revenues risks to result in pro-cyclical variation in local government spending. But already Musgrave (1959) noted that cyclical variations in the level of service expenditures of government should "be undertaken only to the extent [the government] finds itself confronted with such fluctuations in the demand for the satisfaction of social wants" (pg. 25). It is up to the center to decide the status of the demand for national public services. This needs not be the same as the cyclical moves would express, although in serious times of crisis cuts have been deemed necessary. For the proper supply of services it is required in all cases that the center is able to control to what extent local services should be subject to cyclical fluctuations. Therefore the linkage between the cycle and the local budgets needs to be severed, and this is done in the most farreaching way in Denmark..

In Denmark, the annual grants fill the ex ante gap for the overall local sector budget between the level of spending that the government sees as desirable and the expected tax revenue with unchanged local tax rates. This means that grants in the budget phase takes care of the countercyclical variation, so that the local government sector is protected from the *foreseeable* effects of the economic cycles. But note that this guarantee is for the local sector as a whole, it is not extended to the individual local authorities, and the mechanism does not work as a gap filler or a soft budget constraint.

A number of legal measures are introduced to protect local authorities against *unforeseen* economic cycles. If local spending on social transfers turns out to increase more than predicted, the Danish government will discuss with the local level the needs for extra grants during the year. In both Sweden and Denmark the income tax revenue transferred to the local authorities during the budget year is not what has been actually collected but what has been determined in the individual local budgets – albeit with full reconciliation in a subsequent year. A final example is that the local share of the company tax transferred to the local authorities in Denmark is not based on actual collections but on of the collections made two years earlier.

3.8. Policies to avoid unfunded local mandates by compensating for new local competences

In order for the size of the grants to finance the desired and planned level of local spending, the central government must also compensate for extra local expenditure caused by new legislation, by delegating existing functions, or by changes in financing.

Danish legislation requires that a minister who proposes legislation with economic consequences for local authorities must negotiate the estimate of the costs involved with the Local Government Associations. The amount will then be deducted from the minister's budget (or added, if it is a proposed legislation that makes local savings possible) and transferred to the local sector as an increase in the general grants. These negotiations take place during the year and usually result in amendments to the draft legislation, so that the local association agrees that the cost estimate is realistic.

This system of compensation sounds reasonable, but it has proved to be a source of much local dissatisfaction. Even though the government compensates the municipal sector as a whole by increasing general grants to cover the total costs, there will always be some municipalities who complain that the compensation is not distributed fairly to those who bear the heaviest consequences of new mandates. From the central government's point of view such demands for individual compensation are impossible to satisfy owing to the asymmetry of information. In most cases, the central government has no way of knowing the detailed circumstances of each individual municipality, and obviously it cannot ask the local authorities since no local authority would have any incentive to reveal its true costs if it knows that its compensation depends on this information (see *Borge* in this volume). All the Nordic countries – with the possible exemption of Iceland – and, as a matter of fact, most European countries declare that they compensate for the costs of new local competences (Lotz.2008).

In the Netherlands (*Allers* in this volume), the compensation has a particular twist. Allers explains that "the central government systematically allocates smaller budgets to municipalities than those used for the services involved before they were decentralised", the idea being to force the local authorities to improve efficiency.

In spite of the problems indicated, both the local and the central side in Denmark find advantages in compensation for new competences. In Denmark the Ministry of Finance likes this system because it prevents line ministers from proposing new and popular measures without having to find the necessary funding. In contrast, the Danish Ministry of Social Affairs dislikes this rule. They claim that when they find that local authorities are not living up to what they see as the intentions of social legislation, and the Ministry therefore wants to give instructions on how the law is to be interpreted, the local authorities claim compensation.

One may wonder why such compensation is paid to local authorities when they have their own taxation power. Should local governments not have to pay for their own spending, and would it not result in more efficient solutions if they had to finance their spending themselves? The answer is that compensation places the responsibility to find financing with the same agent as the one deciding the expenditure, in other words in accountability.

At one occasion, the Danish counties did say that they did not want the grants. They were prepared to increase their own taxation and let the central government keep the grant money. Their purpose was to avoid the central interferences via the grants policy. The Ministry of Finance found this proposal most unhelpful, and the proposal was not implemented; the central government needs to pay grants since grants are a necessary instrument of control of local behaviour.

Summing up: Grants serve three key functions all related to influencing the quality of services. First, they are used to smooth out cyclical movements in the local finances. Second, they serve accountability by compensating — not perfectly and in a much criticised way — for the costs of new functions delegated to the local level. And third, they are used by the central government as instruments of control.

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Chapter 4

Choosing between regulation and local self-government: the Finnish case

Antti Moisio

This paper was prepared for the 2011 Copenhagen Workshop: "Normative Frameworks of Decentralisation and Inter-governmental Fiscal Relations: Efficient Instruments for Desired Balance between Decentralisation and Merit", jointly organised by the Danish Ministry of the Interior and Health and Korea Institute of Public Finance.

4.1. Introduction

The so called Musgrave-Oates-Tiebout model of fiscal federalism is based on four basic assumptions: local public goods, benefit taxation, mobility and no spillovers. Rattso (2002) notes that all these four assumptions are false from the European (and especially Nordic) perspective. This is mainly because central governments have decentralised their redistributive spending, keeping the power over tax bases tightly in central control. The resulting administrative federalism that is practised in European countries instead of "pure fiscal federalism" uses decentralisation mainly to avoid administrative overburdening. But at the same time, decentralised merit good provision requires norms, regulations and fiscal controls to guarantee equity. The key question is then how to implement the regulation so that it works in accordance with the original objectives of decentralisation. Regulation can be harmful if it limits the local discretion "too much".

Against this background, the Finnish case seems just another application of administrative federalism. But there are also a number of specific features that it may be worth describing and discussing. This kind of discussion is especially interesting now, as the present government in

Finland (in power since June 2011) has recently announced that it is determined to push through a radical municipal boundary reform. The main aim of the reform is to create municipalities that will be strong enough to provide the services alone, without need for municipal cooperation and with less central government involvement.

This paper aims to describe and discuss the present decentralisation in Finland with some short remarks on normative framework and financial regulation. The paper is organised as follows: Section two briefly describes the inter-governmental relations in Finland, the municipal tasks and funding, the normative framework and financial regulation. Section three discusses some recent reforms concerning inter-governmental relations. Section four summarises and concludes the paper.

4.2. Inter-governmental fiscal relations in Finland

4.2.1. Municipal structure and tasks

There are currently 336 municipalities in Finland, with a median population just below 6000 inhabitants. The number of municipalities declined only slowly until 2005, when the centre-right coalition government intensified the reform policy. This so called PARAS project[29] succeeded in stepping up the process so that between 2006 and 2010, the number of municipalities was voluntarily reduced by 96 municipalities. But even after this change, Finnish municipalities are small by Nordic comparison. Partly for that reason and due to the financial pressures resulting from the ageing population, the new left-right coalition government announced in 2011 that one of its main tasks between 2012 and 2015 would be a fundamental reform in municipal structures and financing.

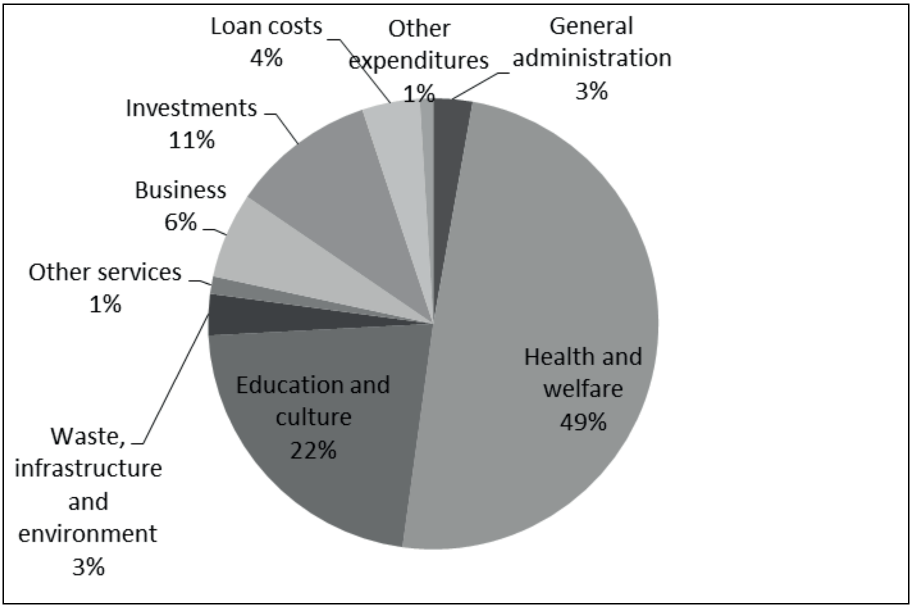
Since there is no intermediate government level, and because the level of decentralisation has been high, municipalities have traditionally been responsible for many important public services. For example, all health care, social welfare and most education services (except university education) are municipal responsibilities. These services comprise about 70 per cent of the municipal sector expenditures (Figure 4.1.). Munici-

[29] The PARAS-project took place between 2005 and 2012. The project is discussed in more detail below.

palities and joint municipal authorities also run or organise cultural, environmental, leisure and planning services. As a result, municipal spending amounts to 65 per cent of total public consumption expenditures and 18 per cent of GDP.

It is clear that the heavy burden of municipal responsibilities and small municipal size forms a major challenge to public service delivery in Finland, as all municipalities, irrespective of their population size, are obliged to provide the same services to their inhabitants. To cope with the situation, the smallest municipalities are usually involved in inter-municipal cooperation and other partnership arrangements. Inter-municipal cooperation is usually practised in health care, but also in social welfare and education services.

Figure 4.1. Total municipal sector (municipalities and joint municipal authorities) expenditure, 2009

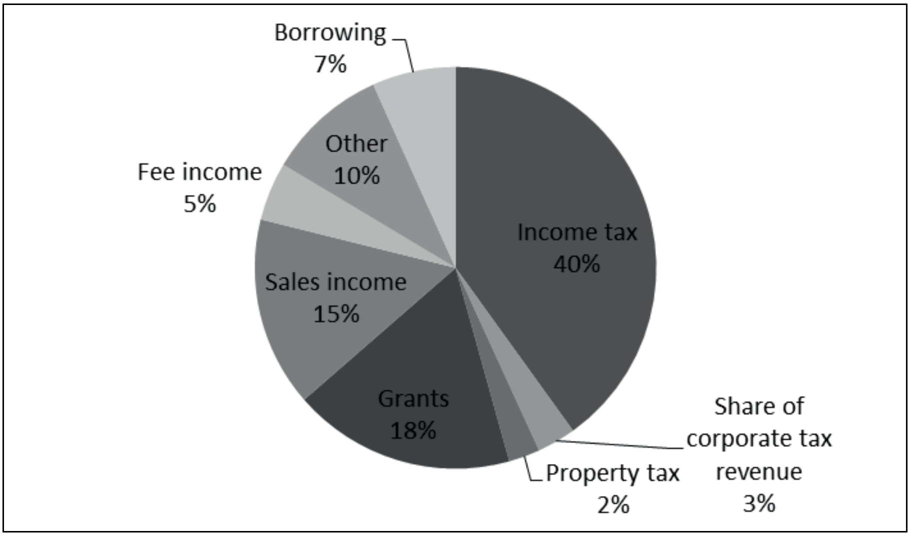


Source: Association of Finnish Local and Regional Authorities.

4.2.2. Own source revenues

Tax revenues, user fees and sales revenue together form nearly 85 per cent of all municipal revenues (Figure 4.2.). The most important revenue source is the municipal income tax, which makes up 40 per cent of all revenues. The municipal income tax is a flat-rate tax, and in 2012, the rate varies between 16.25 and 21.75 per cent of taxable income; the mean rate is 19.81 (Figure 4.3.). The local income tax base is determined by the central government, but municipalities have full control of the rate. During the past few years, the central government has adjusted the tax deductions so that local tax has become effectively like a progressive tax[30].

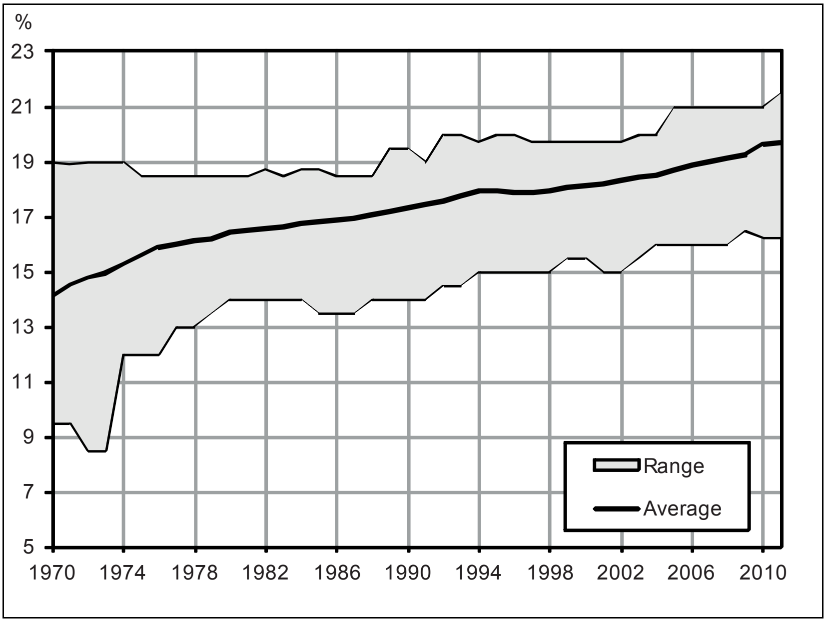
Figure 4.2. Total municipal sector (municipalities and joint municipal authorities) income, 2009



Source: Association of Finnish Local and Regional Authorities.

[30] The centrally determined tax deductions are compensated to municipalities, however.

Figure 4.3. Municipal income tax rates since 1970



Source: Statistics Finland and VATT.

Another municipal tax is the property tax, but in general the share of this tax revenue does not play an important role in municipal finances. Compared to income taxation, municipalities have less discretion over tax rates, because maximum and minimum rates are set by the central government.

The third municipal tax revenue is the corporate tax revenue. This is a central government tax, but the municipalities receive a 27 per cent share of the tax revenue collected in their area. The share was reduced from 32 per cent to 27 per cent from the start of 2012 (the share was 22 per cent before 2008, but as part of the central government fiscal stimulus package the share was temporarily increased to 32 per cent)[31].

Public utilities have traditionally been an important source of funding for some municipalities. Most customer charges are collected for services such as water supply, waste disposal, power supply and public

[31] In March 2012, the government decided to continue to support the municipal revenue base by a higher municipal corporate tax revenue share (27 per cent) until the end of 2015.

transport. At the moment there are about 150 municipally owned public utilities and 1300 public limited companies whose main owner is a municipality. Just under one tenth of social welfare and health expenditure is covered through customer and patient charges.

Municipalities are allowed to borrow for investment purposes and to finance running expenditures. In practice, municipalities mainly borrow from the Municipal Finance, a credit institution owned by municipalities, the Local Government Pensions Institution and the central government. Municipal Finance can borrow money from domestic and international markets, and it is guaranteed by nearly all municipalities through the Municipal Guarantee Board. Municipal Finance has the best possible credit ratings for long-term funding.

4.2.3. The grant system

The Ministry of Finance and the Ministry of Education are jointly in charge of the grant system that forms the basis of fiscal equalisation. The main element of the grant system is the general grant administered by Ministry of Finance (8.4 billion euros in 2012), and that grant aims to offset disparities in public service costs and tax bases. The Ministry of Education operates the general grant for secondary education (1.05 billion euros).

The general grant from the Ministry of Finance is aimed at funding a wide variety of municipal services: child day-care, pre-primary schooling, comprehensive schools, health care, elderly care, services for the disabled and other social services. The grant is based on several formulae that take the service needs and special operating conditions into account. For example, the grant formulae for schooling are based on the population aged 6 years (pre-schooling) and the population aged between 7 and 16 years (comprehensive schooling). In addition, several additional cost indicators such as population density, bilingual status of the municipality and location in the archipelago are used to indicate special circumstances. The needs factors for health care consist of measures for population age structure, morbidity rate and remoteness of the municipality. As for the welfare services, the formulae are based on measures of the population shares of children and elderly people, unemployment and remoteness. In addition, the welfare services formula uses needs indicators for child day-care, child welfare and aid for handicapped.

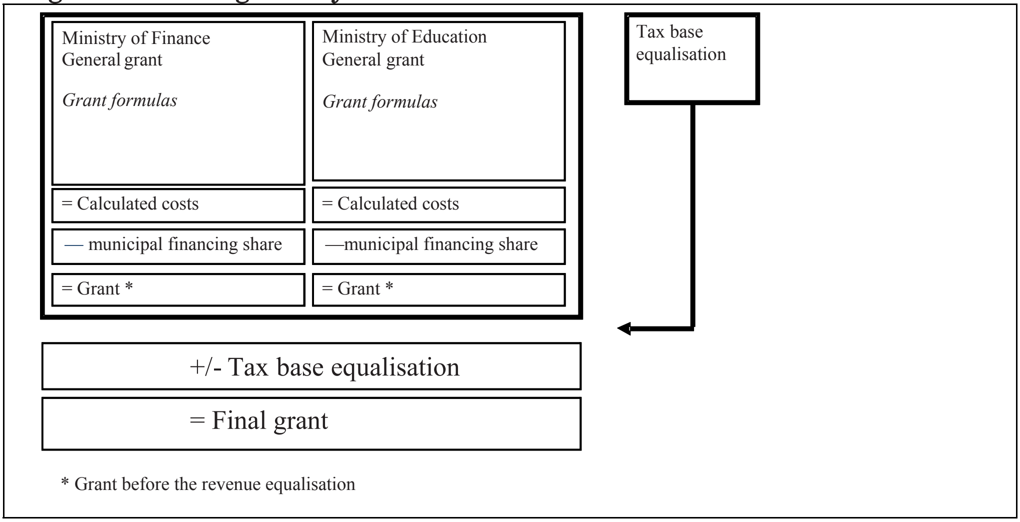
The general grant from the Ministry of Education (general upper secondary schools, vocational schools) can be paid to municipalities or private or non-profit bodies that organise secondary education. The grant is mainly based on number of students.

In the general grant calculation, the so-called "standard per capita cost" is defined as the national per capita average calculated cost. The standard cost per capita is the basis for the municipal "self-financing share", as each municipality is expected to finance 65 percent of the standard cost from its own source revenues. The per capita general grant received by a municipality is then the amount of calculated expenditures that exceed the per capita self financing share.

In addition, the Ministry of Finance operates the revenue equalisation system, which is built into the cost equalisation (Figure 4.4.). The revenue equalisation is based on per capita calculated tax revenues. If the calculated tax revenue[32] for the municipality exceeds the threshold of 91.8 per cent of average per capita tax revenue, 37 per cent of the excess amount will be subtracted from the municipality's cost equalisation grants. Similarly, for municipalities whose per capita calculated tax revenue is below the 91.8 per cent threshold, the municipality will receive a supplement to their cost equalisation grants amounting to the difference between their calculated tax revenues and 91.8 per cent of the country average per capita tax revenue. In other words, no municipal tax revenues are transferred from one municipality to another (transferring tax revenue from one municipality to another would be against the Constitution). The cost equalisation part dominates the grant system: the amount of cost equalisation is worth ten times the effect of tax base equalisation.

[32] The calculated tax revenue for each municipality is: country average tax rate × the municipality's real tax base.

Figure 4.4. The grant system in 2012



4.2.4. Normative regulation

An overview

The block grant reform (shifting from matching grants to block grants) in the early 1990s meant a sharp reduction of central government regulation and involvement in municipal affairs. Since then, the official policy of the central government has been to avoid very restrictive regulations and service standards at the local level. The basic idea after the reform of 1990s was that central government would guide the municipalities mainly by providing information about best practices and factors that affect service quality. For this purpose, the central government founded two expert/research institutions: the National Research and Development Centre for Welfare and Health (later called the National Institute for Health and Welfare) and the Finnish National Board of Education. These organisations are expected to provide up-to-date information and advice to municipalities, practitioners and the general public.

Recently, the Ministry of Finance assigned a working group to evaluate the overall situation of norms and regulations targeted at municipal services. From the municipal side, the expectations of this working group were high, because despite the general policy of ”no regulation” it is believed at the local level that the normative framework is the main obstacle to improving municipal efficiency. However, the working group ended up by not proposing any reduction in norms and other regulations. Instead, they suggested better planning and coordination of existing and future norms (Ministry of Finance, 2011). Whether the outcome of the working group means that there are no unnecessary norms in Finland, or something else, is somewhat unclear. The Finnish framework is described briefly below.

Legal framework

The legal basis of the central-local relationship can be found in the Constitution, but the practical regulation of municipal services is executed through special legislation. In social services, for example, the Constitution determines the citizen´s rights to services, but there are dozens of special laws that regulate the municipal service delivery. Despite this, the special legislation does not include any detailed regulation of the scope, content and ways of organising the social services. Also, there is no legislation on sanctions for not following the norms, either.

A fairly recent trend has been the aim to improve the welfare of special groups by establishing the so-called "subjective rights". A subjective right means that a local service has been considered (politically) very important so that tight regulation by central government is needed. A good example of a subjective right is child day-care: each municipality is by law obliged to provide day-care for every child of a certain age in the municipality. By securing the right to child day-care, the central government wants to guarantee and enhance gender equality in the labour market. There are also plans to introduce subjective rights in elderly care services. Although most of the subjective rights are defined in special laws, some of them are also determined in the Constitution. An example of this type of right is the right to free comprehensive school education.

Another quite recent political trend is to demand more detailed norms and standards. In health care, the so-called "treatment guarantee", which lays down the maximum waiting times of patients for medical treatments (mostly surgery operations), is a good example.

To sum up, despite the original intention of reduced central government intervention and the aim of local self-governance, the importance of norms and regulations has clearly increased during the past ten to fifteen years.

Monitoring

The monitoring of the municipalities is the responsibility of central government regional offices. These units supervise the performance and quality of each of the municipal services in their area. They can also perform detailed inspections, for example by visiting schools and municipal health centres etc. These offices are not very well resourced, however, so the monitoring is not very intensive.

Much of the monitoring of municipal services is delegated to citizens themselves. In addition to local democratic processes, a person who is dissatisfied with the services or does not agree with the decisions made by the home municipality has the right to appeal to Administrative Courts or the Supreme Administrative Court. This kind of appeal can be made against any municipal service or decision concerning the individual or group of individuals (for example, concerning the service availability or eligibility).

Planning

The macro level central-local guidance and control has been executed since 2008 through the so-called Basic Public Services Programme and the Basic Public Services budget (Ministry of Finance, 2008)[33]. These procedures form an integral part of the negotiating procedure between central and local government. Also, the Basic Public Services budget is used when preparing the government budget. The main aims of the Basic Public Services Programme are:

- to evaluate changes in the local government operating environment and the demand for services;
- to monitor the trend in local government finances and changes in local government functions;
- to draw up a plan of the measures required for balancing municipal revenue and expenditure;

[33] The Basic Public Services Programme has run since 2005 as part of the negotiation between municipalities (represented by the Association of Finnish Local and Regional Authorities) and central government (several ministries were involved). Since the outset, the process was used as part of the planning process for the central government budget. Despite this, the Basic Public Services Programme and Basic Public Services budget were not given a permanent role and legal status until 2008.

- to make a proposition for the financing needed for carrying out the statutory local government functions, for developing them and for increasing productivity.

Based on the above, the Basic Public Services budget process evaluates the outlook of local government finances and the impact of the Government budget proposal on local government finances.

The Basic Public Services Programme and the Basic Public Services budget are prepared for four year periods (the most recent one covers 2009-2012). The Ministry of Finance prepares the plans together with other ministries. The Association of Finnish Local and Regional Authorities participates in the procedure as a permanent expert.

4.2.5. Financial regulation

Grant system

So far, the above described developments in the normative area have not affected the grant system much. The grant system is still mostly based on non-earmarked grants. The single block grant (since 2010 there is only one block grant) is determined using variables that describe the service needs and cost factors, so that municipalities themselves cannot directly affect the transfers they receive. Hence, the grant system is mostly neutral from the normative point of view. In fact, the main problem with the present grant system is not lack of neutrality, but poor quality of the indicators used in calculations. To be more specific, the indicators may over- or under-compensate the costs, depending on criteria (Lehtonen et al., 2008). In other words, some of the municipalities receive too much grant whereas others are under-funded. Naturally, this is a question of both equity and economy. But even as it is nowadays quite well known that the grant system could be improved with better indicators, lack of political agreement has so far prevented a comprehensive grant system reform. Instead, the system has been changed step by step, and this has made the system rather detailed and complicated to operate. Also, political demands for more earmarking have been on the rise, but so far the Ministry of Finance has been able to reject most of these proposals.

Another problem of the grant system is the division of costs between central government and municipalities. Every four years, the actual unit costs (municipal spending per pupil, basic health spending per capita) are compared to the calculated unit costs used in the block grant system. If the actual costs exceed those used in the grant system, then according to the agreement between the central government and the municipalities, the municipalities should be compensated with the difference from the past four years. How the compensation works in practice is usually a major cause of disagreement between the Ministry of Finance and the Association of Finnish Local and Regional Authorities. The Ministry of Finance has in some cases refused to pay the full amount of the difference, or at least demanded that the payments should be spread over several years to avoid a positive shock to the municipal finances.

The reasons why grant funding and actual costs may differ are of course many, for example poor productivity development or unexpectedly high demand for the services in question. But in some cases the reason is that the actual cost of recently mandated service has been higher than anticipated. This reason is important, because whenever the central government assigns municipalities a new task, the total cost of the task is estimated in advance, and this estimate is used to determine the grants (since 2010, the central government has agreed to finance 50 per cent of newly mandated tasks, before that the share was between 35 and 42 per cent). In practice, cost estimates have often been inaccurate.

Fiscal rules

It seems to be widely accepted that fiscal rules alone cannot guarantee fiscal discipline at the sub-national level. This is especially the case if there is no political will at the local level, and if there is no central government commitment to a credible ”no-bailout policy” (Ter-Minassian, 2007). Nevertheless, fiscal rules are commonly used to restrict local government spending and revenue.

A comparison with OECD countries shows that in Finland, the fiscal rules concerning local government are less stringent than the OECD average (Sutherland et al., 2006). The Finnish situation concerning fiscal rules that restrict the municipal budgetary decision-making can be summarised as follows:

- **Borrowing**: no constraints on borrowing or debt brakes.
- **Budget balancing**: municipalities are expected to balance their budgets over a four-year period, but there is no sanction for fail-

ing to meet this – failure to balance the budget within the four-year period may lead to further inspection by central government in that municipality.
- **Spending**: no caps or restrictions.
- **Taxation**: no tax rate or tax revenue restrictions (except for property tax rates, which can vary only within a band set by the central government).

Despite the lack of fiscal rules implemented at the local level, Finnish municipalities do not seem to be especially indebted or inefficient by international comparison (Sutherland et al., 2006). However, recent statistics show that municipal debt is on the rise. A big problem in Finland concerning municipal revenues is the volatility of the municipal tax base. This is mainly because of cyclical corporate tax revenues. This volatility of revenue may lead to a "ratchet effect", where municipal expenditure rises in good times but is not reduced in a downturn (Sutherland et al., 2006). As a result, tax rates may be raised to cover the loss. Or, in the absence of borrowing constraints, municipal borrowing is increased.

The new government programme pays attention to these issues, and the government plan is to enhance the macro-level agreement between local and central levels about tasks, expenditures and revenues. At the least, this would mean a refinement of the present Basic Public Services Programme and the Basic Public Services budget processes.

4.3. Recent reforms affecting central-local relationship

The most important past reforms concerning the Finnish central-local relationship and normative framework are the municipal restructuring project, service structure reforms and grant system reforms.

With the aim of reforming municipal size and improve municipal cooperation, the government enacted the Structural Reform Act in 2006. The Act, and the ensuing government-led PARAS-project, required that in primary health care and associated social services, municipalities should reach a population base of at least 20,000. However, in 2010 only a quarter of the municipal health providers (single municipalities or joint municipal authorities) had a population base of more than 20,000. Some flexibility was allowed based on archipelago environments, long distances, and language and cultural situation (diversity). In addition, municipalities were free to decide whether to reach the minimum population bases by municipal mergers or through enhanced cooperation. In cases where a new partnership area is formed, a new joint municipal body must also be established for the management of the relevant tasks. In health care and welfare services, some 67 new cooperative areas will be initiated by the end of year 2013.

Simultaneously, the central government has continued to promote municipal mergers with a special merger grant policy and merger grants. The latest merger programme has been effective since the beginning of 2005, and the programme has been able to reduce the number of municipalities by 96 (through voluntary mergers). Both the merger programme and the Structural Reform Act will end in 2012.

The new coalition government (in power since June 2011) has announced that it will start a new reform programme that aims to create a totally new municipal structure in Finland. The details of the programme are still unknown, but the aim seems to be to reduce the number of municipalities from the present 336 to perhaps even as few as 70 municipalities by 2015. The motivation for the restructuring is to create municipalities that will be strong enough to provide all or most services on their own, without the need for municipal cooperation (except for the most advanced health care). The government also hopes that the new municipal structure will help reach the government targets for public sector financial sustainability, prepare for population ageing and improve public sector efficiency and local democratic decision-making. With this reform, the government ends all previous speculations about new (regional) intermediate government levels and about centralising health care services in Finland.

4.4. Discussion

The small municipal size combined with demanding tasks has always been the main dilemma of the Finnish system. Inter-municipal cooperation has probably solved most of the scale and externality problems, but doubts about transparency and accountability of cooperative decision-making have remained.

The Finnish model of administrative federalism has given much responsibility to municipalities. Despite the recent trend of “subjective rights”, rules and regulations have been kept at a minimum to let the municipalities find the best way to organise their services. All this has worked reasonably well in the past. In fact it has worked so well that it has become central government practice to mandate new tasks to municipalities. This situation has been described by the OECD as follows: ”the central government seems to first “push down” service delivery to the local level, and then evoke municipal autonomy to minimise its involvement and distance itself in the accountability chain” (OECD 2010).

The fact that the Finnish population is ageing has increased the pressure for reform. The small municipalities simply cannot bear their present tasks, not to mention the new tasks, even if they cooperate. The main alternatives on the table have been either to centralise health care, to perform a comprehensive reform of municipal structure, or to establish a new government level (for example regional councils) that would take over responsibility of health and social welfare services. The new government has decided to rely on the so-called “strong municipality model”. This will mean a radical boundary reform, and it will also make most of the present municipal cooperation unnecessary. With this decision, the government shows that it wants to continue and to strengthen the policy of minimising central government involvement.

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Chapter 5

Poland: Between the ideology of local autonomy and the pragmatic convenience of central control

Pawel Swianiewicz

The set of questions asked by the seminar organisers seems to assume a coherent and conscious vision which is implemented in the architecture of inter-governmental fiscal relations. I have serious doubts whether this assumption is really fulfilled in Poland[34].

On the one hand, at the beginning of the political transformation of 1989/1990 decentralisation was almost identified with democratisation. This is easy to understand when one remembers the extremely centralist nature of the communist regime. It is not a unique Polish phenomenon either, but it is rather characteristic for countries enjoying democratic transition. As Coulson and Campbell (2006) wrote on Central-East European countries:

> *In most of the transitional countries a De Tocquevillian myth of localism had flourished in opposition circles in the years preceding the fall of Communism, in which local self-government was to be the incarnation of civil society and everything that the regime was not.*

But Hesse and Sharpe (1991) made similar observations on the (then) new democracies in Greece, Portugal and Spain, where centralisation was often identified with authoritarian regimes. On this background, popular (verbal) support for decentralisation and local autonomy is al-

[34] I also have reason to doubt whether it is met in several other countries, but his paper is focused on the Polish reality, largely ignoring the broader international context.

most self-explanatory. On top of this, there has been an influential lobby of the so-called "founding fathers" of Polish decentralisation reforms – mostly university professors originating from the Solidarity opposition of the 1980s, who have been (and still are) very active advocates of local autonomy[35]. Finally, it should be mentioned that it is almost commonly accepted that decentralisation was one of the most successful reforms, and one which Poland should be proud of. Local politics in Poland – which is perhaps the least partisan among all European countries[36] (Fallend at al 2006, Swianiewicz and Mielczarek 2005) – are often presented as a positive alternative to the compromised central political scene. This type of narrative has dominated the public discourse of local government, providing the positive ground for local autonomy.

On the other hand, there are forces that act in an opposite direction, i.e. impose central level control over local governments. One of them is the central level bureaucracy in the sector ministries, who do not want to lose their power to control. This is very influential when it comes to the preparation of legislation to be adopted by Parliament. Second is the populist, anti-establishment discourse that identifies political elites with corruption, selfish behaviour and other negative features. This discourse often calls for central control over unaccountable local politicians. Thirdly, as identified by Polish sociologists, the Polish political culture is rather egalitarian, and the demand for equal access to services often calls for more state responsibility for the quality of services delivered by local governments; this demand implies tighter control from the centre.

As a result of these contradictory forces, the actual development lacks coherence. Moreover, these positions are not clearly spelt out in any political programmes or ideological manifestos. Nevertheless they may be indirectly identified in the public discourse. The difference in the language used by the last two central governments is a good illustration of

[35] An English language version of their decentralisation manifestos can be found in: Kulesza 2002, Regulski 2003.
[36] Close to 80% of mayors and councillors do not identify themselves with any of the national political parties. They even refuse to call themselves "politicians", since "political" is identified with "partisan", and political parties are very unpopular in the public opinion (Swianiewicz 2009). This naïve stereotype of de-politicised local politics is a very interesting phenomenon that serves as an important background to the issues discussed in this paper; however, the broader discussion of this phenomenon goes beyond the scope of this paper.

this. The Law and Justice (PiS) government under the leadership of Jarosław Kaczyński (2005-2007) provides an example of the lack of trust in decentralised institutions. Its ambivalent attitude towards the strengthening of regional governments (including attempts at introducing a veto power for government-appointed governors in the case of decisions on the allocation of EU Structural Funds[37]), which, according to that government, might lead to disintegration of the country, changes in local electoral law which were subordinated to the logic of political games at a central level, or the suggested limiting of the number of terms a Mayor may serve are just examples of this attitude. In 2007, the change to a Civic Platform (PO)-led government also marked a change in the decentralisation discourse language. The new government made further decentralisation (including promises of extended competencies of regional governments and deregulation of local services) one of the flagships of its political agenda. It is also worth noting that these widely announced plans have found little confirmation in actual legislative changes over subsequent years, but at least the language has changed significantly to become more favourable towards decentralisation.

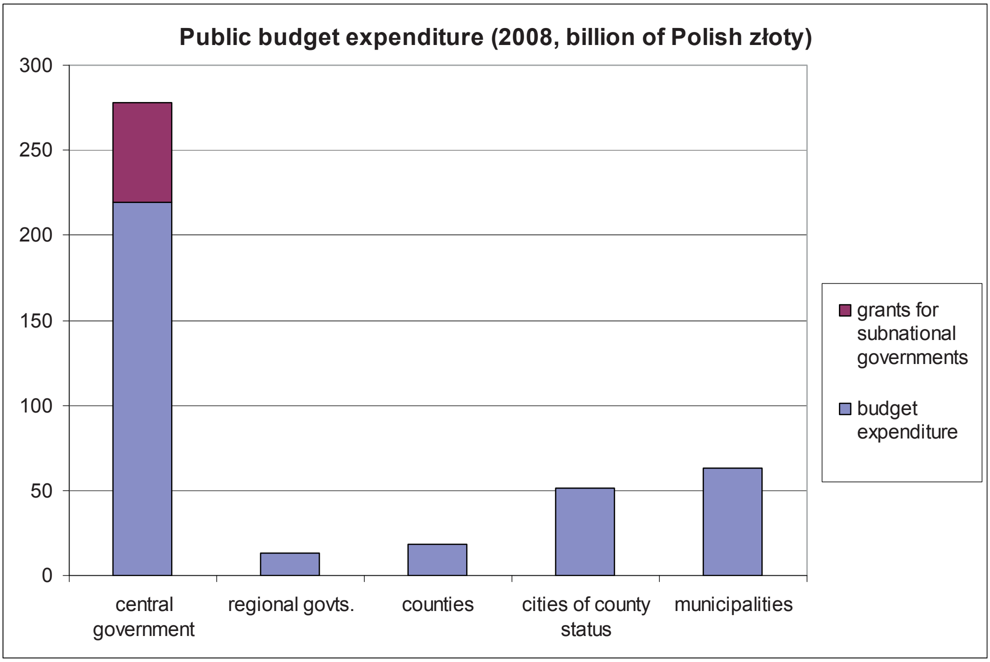
5.1. Fiscal or administrative federalism?

Even if the present situation is not entirely the result of the implementation of a consistent and coherent vision but rather the result of contradictory forces, we can say that the outcome is much closer to the concept of administrative federalism than that of classic fiscal federalism.

Polish local governments are responsible for a wide range of functions. Compared to other countries in Central and Eastern Europe, Polish local government spends the highest share of annual GDP (over 12 per cent). The system consists of three elected sub-national tiers, among which the lowest (municipal) is by far the most powerful –in terms of both functions and financial discretion (see also Figure 5.1.).

[37] The role of regions in managing EU structural funds is briefly explained in the next section of this chapter.

Figure 5.1.



Source: Author's own calculations based on reports from local and national government budget execution (available at www.mf.gov.pl).

The scope of local government functions goes well beyond the classic public goods (as suggested by the fiscal federalism model), but it also includes serious involvement in the delivery of social welfare services, including:

- pre-school and school education (including responsibility for organising the school network and paying teachers' salaries);
- health care (counties and regions are responsible for building maintenance and organisational issues; current costs are financed by the separate health insurance fund);
- several responsibilities related to social protection, such as taking care of the disabled, programmes for the unemployed etc.

After 1996, when municipalities took over responsibility for financing and managing primary schools, education has become by far the largest spending category (see Table 5.1), and in several rural governments it constitutes well over half of the entire current budget. Municipal governments are responsible for pre-school education and primary schools (up to 15 years of age), while counties provide secondary education for 16-18-year old students. Another major spending sector is social welfare (close to 20 per cent of total current spending on both municipal and county levels). Health care plays an important role in the structure of capital spending by counties and regions.

Table 5.1. Structure of expenditures (2009)

A. County and regional tiers.

	Counties (*powiat*)		Regions (*województwo*)	
	Current exp.	Capital exp.	Current exp.	Capital exp.
Education	43.0 %	10.0 %	10.2 %	2.3 %
Social care	21.5 %	3.0 %	16.6 %	0.3 %
Culture	0.5 %	0.3 %	10.4 %	4.9 %
Physical culture and sport	0.2 %	1.9 %	0.9 %	4.1 %
Health care	4.6 %	9.1 %	1.9 %	12.2 %
Public safety and fire protection	6.2 %	3.6 %	-	-
Transport	8.0 %	62.1 %	26.4 %	33.9 %
Agriculture	-	-	3.9 %	3.1 %
Administration	12.6 %	4.0 %	10.9 %	0.8 %

B. Municipal tier

	Cities of county status		Municipalities (*gmina*)	
	Current exp.	Capital exp.	Current exp.	Capital exp.
Education	35.6 %	7.7 %	43.8 %	11.1 %
Social care	14.1 %	2.0 %	20.1 %	0.4 %
Culture	3.4 %	5.3 %	2.9 %	3.4 %
Physical culture and sport	2.0 %	15.7 %	1.2 %	11.5 %
Health care	1.2 %	3.0 %	0.7 %	0.8 %
Communal economy(*)	3.9 %	18.1 %	9.6 %	26.4 %
Transport	16.1 %	30.4 %	4.2 %	32.7 %
Housing	8.2 %	7.3 %	2.4 %	5.3 %
Administration	7.8 %	2.1 %	12.5 %	1.9 %

(*) – water and sewage, solid waste management, street lighting, heating systems, green areas.

Note: Data in the table include budget spending and spending by budgetary enterprises (*zakłady budżetowe*), which are off-budget public funds. The table does not include spending by companies owned by local government units that are formally separate legal entities.

Source: Author's *own calculations based on reports from local government budget execution (available at www.mf.gov.pl).*

Sub-national governments (mainly regional, but also lower tiers) are also heavily involved in the implementation of European regional policy. Over a quarter of the EU Structural Funds for Poland are managed by the Regional Operating Programmes, which are controlled by the elected regional governments, who make independent decisions on the selection of projects to be financed as well as specific allocation of the funds available. At the same time, EU Structural Funds provide a very significant portion of local government investment spending, covering close to a quarter of all sub-national capital spending in recent years (2007-2010). In this way[38], local governments are involved in the multi-level governance system.

5.2. Local autonomy and its limitation in various segments of intergovernmental finance architecture

This section presents combinations of local autonomy and central control (regulations) in the major elements of local government revenues.

5.2.1. Local taxation caps

The municipal tier is the only one that enjoys some limited power of taxation in Poland. The remaining tiers of sub-national governments (counties and regions) are financed through a combination of tax sharing as well as general and specific purpose grants.

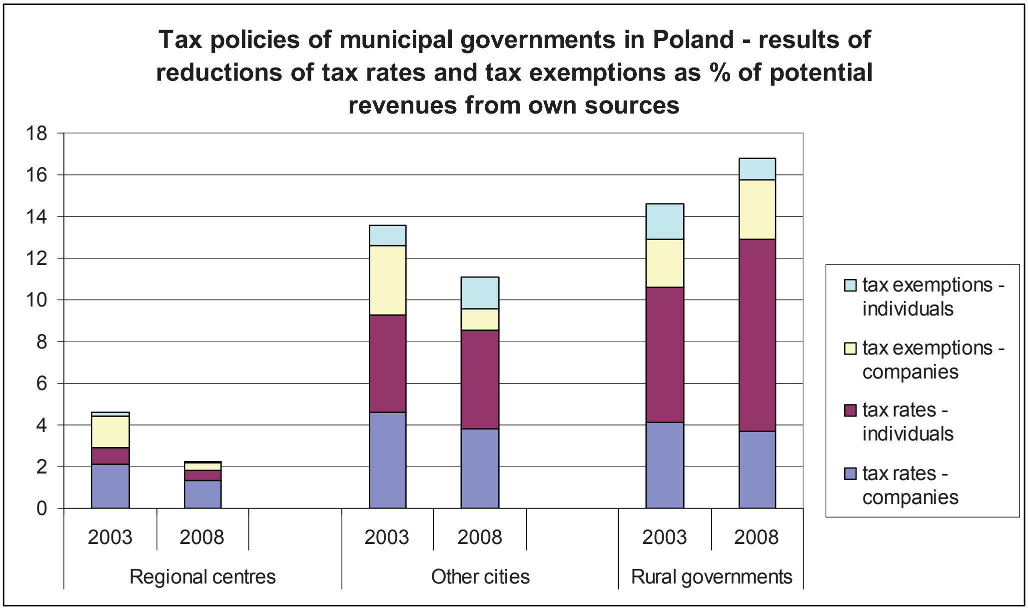
The most important element is property tax, which is collected both from built-up areas and greenfield plots of land (with the exception of agricultural land) and provides more than half of all municipal revenues from their own sources. With some exceptions, property tax is not directly related to the value of the property but is rather charged per square meter (with different rates for commercial and residential properties). In practice, due to the variation in rates, more than 80 per cent of property tax revenues are collected from commercial entities. The other (much less significant) municipal taxes include: agriculture tax (which depends on the quality of soil and is related to the market price of crops), forest tax (levied per hectare), tax on motor vehicles (currently levied only on lorries, buses and tractors), a market charge (levied on traders in designated market places), tourist tax (levied on tourists spending nights in popular tourist destinations) and a few other taxes of minor importance.

[38] As well as through the role of local governments in implementing EU directives related to environment protection, public procurement etc.

In each case the general rule of local autonomy is similar – the local council can set the tax rate as long as it does not exceed the maximum rate. Which is defined by the Law on Local Taxes, and which can be increased automatically every year by the rate of inflation. The unspoken assumption is that some local governments, if left uncontrolled, could be irresponsible enough to harm local companies or citizens by levying too high tax rates, which would kill the local economy and/or provide negative macroeconomic effects.

In practice, different local governments express their tax autonomy to different degrees. The general rule is that big cities apply tax rates at (or close to) the maximum level, while smaller local governments most often decide to reduce rates or offer various incentives and exemptions (see Figure 5.2.).

Figure 5.2.



Source: Own calculations based on reports from local government budget execution (available at www.mf.gov.pl).

This variation is a result of two parallel phenomena:

- higher taxes in big cities compensate to some extent for the lack of a direct relationship between the value of property and the tax

yield. In fact, the maximum rate applied in Warsaw or Kraków is often negligible to the taxpayer (especially for residential property for which the maximum rates are low – not exceeding 0.20 euro per square meter), while the reduced rate in a small provincial town or village might be a heavy burden on the taxpayer;
- setting tax rates is often treated as a more social (populist) policy rather than an economic exercise. In smaller communities, voter pressure on local councillors is more direct, and consequently there is a relationship between smaller communities and lower tax rates (for a more extensive discussion of local tax policies see Swianiewicz, 2011).

5.2.2. Grant system

The grant system is the most obvious element of the imposition of state control over the financial autonomy of local governments. It is most visible in the case of general-purpose grants for current expenditures. Earmarked grants are relatively unimportant in the case of municipalities (less than 20 per cent of total revenues), but in the case of counties they provide close to 1/3 of revenues, and this can be even higher in the case of regions (see Figure 5.3.).

There is a large number of earmarked grant schemes that are controlled by various ministries. The system is somewhat chaotic and rapidly changing, and there is not even a clear inventory of the schemes currently in operation. However, an analysis of the budget report data shows that in 2010, more than 2/3 of these earmarked grants were related to social care (stationary centres for the elderly and mentally handicapped operated by counties, day-care centres for the handicapped operated by municipalities, and social welfare benefits for people in need who do not qualify for unemployment benefits, which are also distributed by municipalities). Another significant portion of the earmarked grants was related to material support for poor students in primary schools (almost 10% of the total value of earmarked grants) and support for the maintenance of regional and county roads (also close to 10% of the total value).

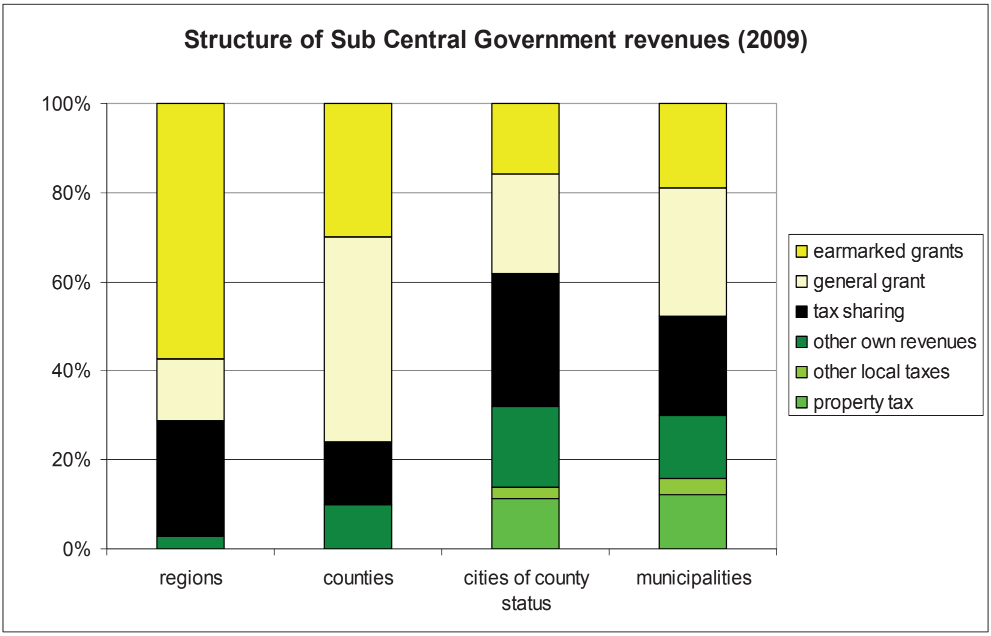
More detailed information on the structure of earmarked grants for current expenditures related to the functions of sub-national governments is provided in Table 5.2.

Table 5.2. The structure of earmarked grants for current expenditures related to own functions of sub-national governments (per cent of total allocation, 2010)

	All sub-national governments	Regions	Counties	Cities of county status	Munici-palities
Transport	9.8 %	35.4 %	15.9 %	1.3 %	9.4 %
Education	9.4 %	0.9 %	0.5 %	6.9 %	15.4 %
- material support for students in schools	*7.8 %*				*13.7 %*
Health care	2.9 %	22.5 %	8.8 %	0.1 %	0.3 %
Social care	68.0 %	3.6 %	67.8 %	85.3 %	62.4 %
- stationary and day-care centers	*26.0 %*		*55.5 %*	*19.6 %*	*13.6 %*
- social benefits	*23.9 %*			*35.3 %*	*32.5 %*
- coping with unemployment	*3.8 %*		*11.5 %*	*3.2 %*	

A separate – and very important – category of specific purpose grants are investment grants, especially those offered through the European Union Structural and Cohesion funds. Defining the goals for which they can be allocated is, of course, a restriction on local autonomy. However, selection and design of the specific projects is determined by local governments. Moreover, it should be mentioned that most of these funds are allocated through Regional Operating Programmes, which have been co-defined (through a series of negotiations between the Polish government and the EU Commission in Brussels) by regional governments, who has had at least partial discretion to decide how much should be allocated to which priority.

Figure 5.3.



Source: own calculations based on reports from local government budget execution (available at www.mf.gov.pl).

The discussion of the role of regions in decisions on how EU funds are to be spent is another example of the ideological debate on local (regional) autonomy and central control. Between 2004-2006 (i.e. immediately after the accession to EU structures), the role of regional governments in managing EU Structural Funds was limited (although still more important than in any other new member state). There was one Integrated Regional Operating Programme for the country at large, and the discretion of regional governments to allocate funds to individual projects was limited.

The discussion before the 2007-2013 financial perspective reflected different attitudes to decentralisation and local (regional) autonomy. The proponents of more discretion for regions followed the argument of more efficient decision-making on a lower level, but the opposition referred to arguments of integrity of the state. In the more extreme variants they argued that autonomy for regions might be the beginning of disintegration of the state and that equalisation policies require strict control from the central level.

A more controversial consideration is to what extent local autonomy is limited through the general purpose grant, which has three major elements: equalising, balancing (i.e. working like a classic "Robin Hood Tax") and education.

In the case of the equalising and balancing elements, the allocation formula is clearly defined by Parliament, the rules are consistent, and local governments are completely free to use the money for whatever function they choose. Nevertheless, it should be mentioned that the "Robin Hood" mechanism has often been questioned by the largest cities and the richest regions, and it has recently been the topic of hot political debate (including the draft law significantly reducing the tax, which is currently being discussed in Parliament).

The case of the education grant is more complicated. The formula is determined each year by the Ministry of Education, so it may appear to be an additional form of central control. However, the formula is the subject of negotiations between the Joint Central-Local Government Committee (where the major local government associations are represented) and local governments, which often exert effective lobbying regarding the final shape of the formula.

The basic rule is that the education grant is allocated proportionally to the number of students that attend schools in a given local government unit, but several additional weights are applied. For example, there may be a special weight for rural schools, for schools with national minority languages, for handicapped pupils and for various types of vocational schools etc. There are more than 30 different weight coefficients in the formula, and the specific list of these coefficients, as well as their precise values, are main topics of debate every year, and they are also the main lobbying subjects addressed by various interest groups in the Joint Central-Local Government Committee. The intensity of discussions is not surprising if we remember that education is by far the most important category in the structure of municipal and county expenditures.

Since the education grant is part of a general-purpose grant, local governments are free to spend it on any services. However, it is first and foremost intended to serve as financing of current expenditures on schools[39]. Local governments often complain that it is not sufficient (sometimes even to cover costs of teachers' salaries), and indeed most of them spend 16 per cent more on schools than they receive in the form of subvention (2009 data). At the same time, there is a group of about 6 per cent of municipal governments (2009 data) which have been able to "save" on the education grant, i.e. spend less on maintenance of schools than they have received in the form of a grant. Usually these savings have more to do with the imperfection of the formula than with the efficiency of spending policies. For example, the "rural weight" (securing about 30 per cent more "per pupil" funds than in the case of "urban" schools) applies to every school located in a formally defined rural territory, regardless of the population density, proximity to urban centres or wealth of the local community.

5.2.3. Fees for local services

Local governments have the discretion to decide the level of several fees and user charges for services delivered. This dimension of sub-municipal autonomy is mostly limited to the municipal tier, which is responsible for the vast majority of services under consideration. It concerns in particular:

- tickets for city public transport,
- water and sewage,
- parking in city centres,
- rents in municipal housing,
- kindergartens.

Local autonomy is usually not unlimited (as discussed further in this chapter), but the room for local policies remains significant. In each of the services mentioned above, the variation of fees between individual local governments can be very significant; the price in city A is often more than twice that in city B.

There are also services that are usually delivered by local governments, but for which municipalities do not have the autonomy to set a price.

[39] Pre-school education is financed entirely from local governments' own source revenues, although the debate on whether to include it in the calculation of education grant has become very vivid over the last 2-3 years.

Instead, the prices for those services (such as central heating) are controlled by a regulator appointed by the central government.

Even in cases where the local government has the discretion to decide, there are often different limitations, which are specified in various sectoral laws. These may take different forms:

- maximum rates (in the case of parking and rents in municipal housing);
- limitation for frequency of changes (the price for water and waste water may be changed only once a year);
- various specific standards and limitations implying the level of user fees.

The case of kindergartens is an excellent example of an unstable and chaotic national policy in this respect. For several years, local governments were able to define their fees in the form of a monthly lump sum paid for every child attending kindergarten. At the beginning of the previous decade it was decided that "basic pre-school education" would be provided free of charge, while additional services (exceeding the basic standard) would still have to be paid for by parents. However, the local governments had to clearly define the additional services they charged for, and yet the definition of the "basic standard" was so vague that it was next to impossible to find a formula for the council resolution that would justify collecting the fees. At the same time, local governments were unable to cover the total costs of pre-school education. The situation was made additionally chaotic by different interpretations of the law by the state supervisory organs (regional governors) and the courts in different regions. As a result, what was allowed in one region was often questioned by the governor in another region.

In 2010 it was decided to clarify the rules. Starting from 2011, 5 hours per day of childcare is delivered free of charge, while local governments may levy fees for additional time in the kindergarten. This regulation raises several points of controversy:

- local governments complain that it imposes an excessive burden of measuring and recording time spent by each child every day in the kindergarten;

- organisation of the kindergarten's work and activities is based on parents declaring how much time they want their children to spend in the facility. Local governments plan their budgets and employ teachers accordingly. However, it is unclear how often parents may change their declarations (and the contracts with teachers are signed for the full school year anyway). What happens if the child does not attend kindergarten for some reason? Most of the courts suggest that the proportional part of the fee should be returned in the case of absence, but local governments complain that it is not possible to plan budgets under such circumstances.

Another point of contention concerns the right of local governments to differentiate fees charged according to certain criteria (for example to lower the fees for families with many children or for families of a low social status). Some courts question these decisions as being in violation of the equal treatment of all clients (service consumers). An amendment to the law on local government is under preparation which will clearly state the right of a local government to differentiate the rates according to its policy criteria, but it is uncertain whether this amendment will be adopted.

5.2.4. Local debt regulation

Debt level limitations are another example of the limitations in local financial autonomy. At the moment, Polish law allows borrowing for capital spending which is ex-post controlled on the basis of the following thresholds:

- accumulated level of debt at the end of a year cannot exceed 60 per cent of annual budget revenues;
- annual debt servicing costs cannot exceed 15 per cent of annual budget revenues.

New regulations will be in place from 2013 which will relate the limits of debt servicing costs not to total revenues, but rather to the level of operating surplus (balance between operating revenues and spending) over the past 3 years. This would relate borrowing capacity more closely to ability to repay the loan.

However, limitations in local autonomy are also related to more general regulations. The Polish Constitution limits the level of public debt (being a sum of central government and local government debt) to 60 per cent of GDP. The Law on Public Finance imposes several limitations once the level of public debt exceeds 50 per cent. This (which is actually the case at the moment) means that the ability of local governments to borrow may be limited due to excessive indebtedness at the central level.

In spite of these relatively strict rules, combined with the fact that sub-national debt is only a small fraction (about 5 per cent) of the total public debt, recent years have brought more central government proposals to impose additional limits for local government borrowing. These suggestions have been protested against by local government associations, who have argued that central government is trying to push the burden of coping with the public budget deficit entirely onto the shoulders of sub-national governments and that this new policy may hamper the local capacity to absorb EU Structural Funds. The debate about this issue has not yet been finally resolved (as of March 2012).

5.2.5. Norms and standards related to locally delivered services

Financial autonomy is limited not only through revenue regulations, but also through externally imposed norms and standards related to locally delivered services. This category includes not only standards defined at the national level, but also standards imposed through EU Directives, which are of increasing importance to Polish local governments. The most important of these standards are those related to environment protection (sewage treatment, solid waste disposal) and public procurement.

Of course, most numerous are the standards defined by Parliament and central government by-laws. Among those that produce the most serious financial implications for Polish local government are regulations on teachers' salaries and employment (which are protected through the special "Teacher's Charter"). Since education is by far the largest single item of local expenditure (in small municipalities often exceeding half of all spending), this regulation is of crucial importance.

Several services, especially those related to broadly-defined social welfare, also have many detailed standards which have implications for the amount and structure of spending. It is difficult to prove quantitatively, but it seems that after the very radical deregulation in the 1990s, the number of these standards has been increasing systematically over the last decade or so, and local governments are increasingly bound by them.

5.3. Do local governments really want more fiscal autonomy?

It is a popular view that there is a "central vs. local" conflict over the scope of local autonomy. According to this view, local governments want more discretion, and they lobby for more favourable regulations in this respect. At the same time, the central level bureaucracy tries to impose stricter control over local government activities. There is no doubt that there is some merit in this description, but the real word differs from this simplistic picture. Sometimes it happens that the central administration favours passing responsibility for problematic services over to local governments. This is sometimes described as the "decentralisation of problems".

At the same time, there are few local lobbyists for more fiscal autonomy, although they are very visible, whereas the majority of local governments are more focused on seeking secure financial resources for the services they are responsible for. For this group, the most troublesome aspect is not the limitation of autonomy but the lack of sufficient transfers from the central level, and more responsibility for the central level (together with a deeper dependence on the transfer system) is welcome.

Once again, the research on kindergartens provides a good illustration of this issue. In recent research conducted on a sample of over 300 municipalities, local politicians and officials were asked how they would prefer to solve the problems related to the lack of sufficient resources to finance the service. Only 10 per cent of the respondents chose the option "correct the system of generating local revenues in a way which would allow for the collection of more resources", while 62 per cent selected "extend the education part of the general purpose grant in order to take into account needs related to kindergartens", and 24 per cent preferred the "special purpose grant for kindergartens". In the same research, when asked about which regulations make management of the service difficult and which limit the level of local autonomy below the appropriate level, 53 per cent of the surveyed local politicians could not give any example of such regulations, while only 43 per cent indicated one or more regulations (Swianiewicz et al 2012).

At a more general level, the extension of local powers to collect their own revenues is not among the most popular subject of local government lobbying related to the preferred changes in inter-governmental financial arrangements. The most often formulated demand related to local revenues refers to the tax-sharing mechanism, while local taxation power is almost absent[40]. This attitude is not difficult to understand; taking on more responsibility for collecting own revenues is related to political risk, while demanding more transfers and support from the central budget is (politically) much safer and more convenient.

The reality of the political interplay between tiers of government and interests related to the trade-off between local autonomy and central level control (related sometimes to responsibility) is more complicated that it may appear.

[40] See results of the survey of local government officials by Motek (2004, p. 151-152).

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Chapter 6

Decentralization with national standards. The case of the Netherlands

Maarten A. Allers

6.1. Introduction

One of the classic reasons for governments to provide goods and services to their citizens is that policymakers consider some goods or services essential or beneficial. Examples of such merit goods are education, health, and social protection. When left to themselves, citizens would not spend enough on these goods, according to policymakers. Therefore, the government steps in.

This approach may, however, conflict with decentralization of government. If subnational governments are free to choose local service levels, in the case of merit goods these levels may be too low in the view of national policymakers. Thus, in some countries, national standards apply to a number of public services. But if national standards apply to locally run spending programs, local jurisdictions must be enabled to finance them. How can this be organized?

This paper starts by describing the institutional and normative environment in the Netherlands, highlighting the strong emphasis on equity considerations and the supply of merit goods in the Netherlands. The second part of the paper zooms in on a particular program which aims to ensure equal access to welfare benefits throughout the country while at the same time making local governments responsible for welfare administration. Local governments receive an intergovernmental grant to finance welfare. In order to give local governments an incentive to minimize welfare spending, this grant is not related to actual welfare payments. Rather, it reflects the local economic and demographic conditions which influence the probability that inhabitants will become dependent on welfare. This program has been rather successful in reaping the benefits of decentralization while at the same time ensuring a high degree of similarity in service standards across the country.

6.2. Institutional background

6.2.1. Subnational government in the Netherlands

There are three territorial levels of government in the Netherlands: central government, provinces (12), and municipalities (418 in 2011). Each level covers the entire country. All provinces and all municipalities face more or less the same responsibilities and have the same tax autonomy. With an average of 40,000 inhabitants, Dutch municipalities are relatively large compared to those in other countries.[41] Municipalities, which spend about eleven percent of GDP, provide many of the services that are of daily importance to citizens: from sewers to refuse collection, from local roads to poverty relief.

Provinces spend relatively little (1.4 percent of GDP). However, provinces have a number of tasks that do not require spending a lot of money, like spatial planning and coordination of regional public transport. There is a third local government level in the Netherlands: the water boards (25 in 2011). The water boards originate from the 12th century and are responsible for keeping the country, an important part of which is below sea level, dry and safe from floods.

Water boards, municipalities, and provinces are each ruled by subnational governments controlled by parliaments, which are elected every four years.

6.2.2. Municipalities

Dutch municipalities finance their spending through specific grants (18% in 2011) and general grants (36%) from the central government, municipal levies (15%), and income from property and market activities (31%). These percentages are based on the 2011 budgets. The last category, income from property and market activities, includes profits from

[41] For EU countries, the average is 5,410 (2007; source: Hoorens, 2008).

housing development projects, which have virtually disappeared since the budgets for 2011 were prepared.

Municipalities receive specific grants from different central government departments. Specific grants are earmarked to finance local government tasks that have been imposed by the central government, whereas general grants are used to finance the autonomous tasks of local governments. In practice, this distinction between specific and general grants has been blurred somewhat in recent years (see also Boerboom and Huigsloot, 2010). On the one hand, specific grants have become broader, giving local governments more spending discretion. The number of specific grants, and the amounts involved, has decreased significantly over the first decade of this century. This reflects the growing insight that local governments should not depend too much on earmarked revenues, because an appropriate local trade-off between the costs and benefits of public services can only be made if municipalities have enough spending autonomy. In 2011, there were 37 different specific grants, distributing a total of 9.2 billion euro (Allers, 2011).

On the other hand, general grants are increasingly tied to specific spending programs, be it mostly implicitly. General grants are paid out of the Municipality Fund. The biggest by far, the General Grant, distributed 15.4 billion euro in 2011. In addition, however, 53 other grants (2.7 billion euro), most of which were created in the last few years, are paid from the Municipality Fund. These grants are formally untied, but in practice only municipalities participating in specific spending programs receive them. This makes them very similar to specific grants. Many of them are former specific grants which have been transferred to the Municipality Fund. Thus, the reduction of the number of specific grants has been partially cosmetic.

The General Grant is formula-based and independent of local spending and taxation. It is an equalizing grant: the formula takes into account the spending needs and tax capacity of individual municipalities. The rather ambitious aim of this scheme is to enable all municipalities to finance equivalent service levels at equivalent tax rates. Municipalities are free to choose higher or lower service levels and corresponding tax rates. The General Grant allocation system, which involves 60 criteria, is one of the most complicated systems in the world. It reflects the great importance that the Dutch attach to equity. Citizens in similar circumstances are considered to have equal rights to government services, independent of where they reside. In, e.g., the United Kingdom, a similar aspiration applies. Neighboring countries like Belgium and Germany, however, take a much more relaxed attitude.

Municipal levies consist of user charges (7% of total revenue; mainly for sewage and garbage collection) and local taxes (7%). Local tax revenue is dominated by the property tax. The only other local tax of any importance is the parking tax, which cannot be raised easily for fear of discouraging potential visitors to local businesses. Since user charges are not allowed to exceed (budgeted) costs, and municipal budgets must be balanced, higher service levels can only be funded by raising taxes, i.e., by imposing higher property tax rates.

Although municipalities are free, in theory, to choose local service levels and tax rates, deviation from service levels or tax rates in other municipalities is only tolerated to a limited extent. Deviation from the norm may easily result in public resistance. Members of the (national) parliament are quick to ask the national government to intervene. Pressure groups use municipalities that spend comparatively much on their preferred services or their clientele as an example for setting a norm that other municipalities are then compared with. It is no surprise, then, that municipalities have been shown to mimic the levels of expenditure and taxation of neighboring jurisdictions (Allers and Elhorst 2011).

6.2.3. Decentralization

Dutch law prescribes that the national government must stimulate decentralization. In the last decade, several important tasks have been decentralized to municipalities. The present government, which came into office in 2010, is determined to continue this policy. In the recent past, large-scale decentralization has been implemented in welfare and social services. In the next few years, youth care will be decentralized from (mainly) the provinces to the municipalities, along with some other social services. Moreover, locally administered welfare is to be merged with entitlement programs for disabled workers, which are currently the responsibility of the central government.

Decentralization is promoted because it is believed to give citizens more control over the public services they need in their daily lives. Municipalities can tailor services to local preferences and needs. That should result in higher welfare than the uniform service levels across the country at large. Another reason to decentralize is that municipalities are supposed to be more efficient. The decentralization of welfare has indeed been rather successful in that respect. However, the central government systematically allocates smaller budgets to municipalities than it spent on the involved services before decentralization. This puts pressure on the local governments' budgets. The central government routinely argues that local governments can do the job more efficiently, and consequently need less money. The Association of Dutch Municipalities, which negotiates on behalf of the local governments, usually ends up by accepting this, because it is strongly in favor of (further) decentralization.

Another problem is that small municipalities find it hard to cope with the continuing flow of new responsibilities. Often, small municipalities do not have enough staff to allow specialization. Many observers question the ability of small local governments to absorb new tasks. As a result, small municipalities merge and amalgamate at an alarming rate. In 1980, there were 811 municipalities. In 2011, the number had been reduced to 418, and the end of this process is not in sight. Belgium (1977), New Zealand (1989), and Denmark (2007) applied a big-bang approach to amalgamation. In the Netherlands, however, amalgamation is an ad-hoc process. There is no grand design guiding the amalgamation process. Hardly a year goes by without some municipalities being merged. No end goal has been defined, such as a desired number of municipalities or a desired minimum size.

There seems to be a paradox here. Decentralization is partly driven by the desire to move decision-making to the lowest possible level of government, in order to allow optimal citizen control. But because decentralization leads to ever growing municipalities, decision-making is transferred steadily to larger units that are further away from the citizen.

6.3. Welfare: decentralization with uniform standards

The drive for decentralization, combined with a strong attachment to equal rights to government services, is exemplified by the way welfare is administered and financed in the Netherlands. In the Netherlands, welfare is a cash-benefit program for people who have insufficient means to support themselves and their families.

6.3.1. Welfare financing

In many countries, welfare is administered locally, but financed by the central government. Decentralization allows public services to be tailored to local preferences. Decentralization may also be more efficient, as knowledge of local conditions and circumstances is needed to successfully run a welfare program. However, decentralized funding of redistributive programs is likely to break down as a result of the migration patterns it brings about. Jurisdictions with high welfare dependencies need to levy high taxes if they are to finance welfare themselves. This drives away richer inhabitants, which results in a need to raise tax rates even higher. Therefore, income redistribution is generally considered the responsibility of the central government. As a result, welfare is usually administered locally, but financed centrally. This raises the question as to how the center can induce local administrators to administer welfare efficiently. If the money comes from elsewhere, why bother restricting welfare benefits to the truly needy?

6.3.2. Matching grant versus block grant

In the Netherlands, eligibility rules and welfare benefit levels are uniform across the country. As a result, welfare migration is not an issue. Until 2001, each Dutch municipality financed 10 percent of the welfare benefits it paid from its own coffers, while 90 percent was reimbursed by the central government through an open-ended matching grant. Clearly, this did not provide a strong incentive to limit welfare payments by helping recipients find work or by clamping down on fraud. Matching grants are not efficient because they reduce the local government's costs towards an extra welfare beneficiary. Therefore, they reduce the local administration's incentive to keep welfare dependency at a minimum. On the other hand, matching grants are equitable because they guarantee that the central government shoulders the same share of every local government's welfare burden. As a result, jurisdictions with high welfare spending needs due to exogenous circumstances receive a larger grant.

Instead of a matching grant, a block grant can be used to finance welfare. Block grants do not depend on local welfare spending. They are aimed at a particular spending category (in this case welfare), but they may be higher or lower than actual local spending on that category. A block grant is efficient, as it does not lower the local cost of additional welfare recipients. But this comes at a price, as there is generally no guarantee that the welfare burden of every local government is shared by the central government to the same extent. Block grant financing may force local governments in economically challenged regions to spend considerable sums of money from their own resources on welfare, while jurisdictions in affluent regions may not need to spend all their grant money on welfare. Welfare is an entitlement program; people who qualify cannot be denied welfare. The grant system should reflect this.

In order to increase the incentive for local governments to administer welfare efficiently, the Netherlands reduced the match rate from 90 to 75 percent in 2001. As from 2004, no reimbursement takes place any more. The matching grants have been replaced by a block grant. If a municipality spends more than its block grant, it bears the extra expenditures itself. If it spends less, it may use the balance as it sees fit. Block grants for welfare are used in other countries as well, e.g., the United States. However, the inequities inherent in the usual block grants are unacceptable in a country like the Netherlands. Therefore, a sophisticated allocation system has been set up.

6.3.3. The Dutch block grant

In the Netherlands, block grants are allocated in such a way that municipalities which operate reasonably efficiently will not need to use their own resources to finance welfare expenditures. The allocation formula is based on an econometric model. At the same time, total grants do not exceed forecasted aggregated welfare expenditures.

The new financing arrangement has been accompanied by greater local autonomy in the treatment of welfare recipients. However, it is important to stress that this new autonomy is limited to administration. Local governments have discretion over the programs they employ to assist recipients in moving from welfare to work, and over the intensity of their fraud investigations. Eligibility rules and welfare benefit levels are still uniform and centrally determined, reflecting the strong Dutch preference for equity. This is an important difference from the 1996 welfare reform in the US. Municipal spending on welfare benefits can only be lowered by reducing caseloads. As assistance to the truly needy cannot be refused, caseloads can only be reduced by weeding out fraudulent beneficiaries and by helping *bona fide* recipients find work.

The national budget available to welfare block grants, referred to as the *macro budget*, is calculated annually based on forecasts of the number of individuals that will be eligible for welfare. These forecasts are made by the independent Netherlands Bureau for Economic Policy Analysis, known by its Dutch acronym CPB. Forecasts are based on the number of existing welfare beneficiaries, the development in the number of unemployed in the previous years,[42] and any regulatory changes that may affect welfare volumes.

The macro budget is allocated between municipalities according to the following rules: for small municipalities (with less than 25,000 inhabitants, home to 9 percent of all welfare recipients), their share of the macro budget in year t depends on their share of welfare expenditures in year t-2. For large municipalities (40,000 inhabitants and more, home to 80 percent of all welfare recipients), a formula applies which includes both demographic characteristics and labor market characteristics. The allocation formula is updated annually. Because a formula that covers smaller municipalities reasonably well could not be derived, this method does not apply to them. For medium-sized municipalities, a hybrid system applies: their share is based partly on their expenditure share in year t-2, and partly on the formula.

It has proven difficult to derive a stable allocation formula. Municipalities may see their calculated share of the macro budget rise or fall considerably from one year to the next. In order to insulate local governments from budgetary shocks too great to cope with, the difference between the block grant and actual welfare expenditures are limited both

[42] People losing their job are normally entitled to unemployment benefit for a period which depends on their employment history. After this period, they may apply for a (usually lower) welfare benefit if they have insufficient means to support themselves and their families.

ex post and ex ante.[43]

Presently, the welfare grant allocation formula contains 14 variables, including number of single parent households, number of lowly educated people, employment growth in the region to which the municipality belongs, and number of disability benefits. The weights of these variables are derived annually from a regression at the municipal level of welfare volumes on the determinants included in the formula.

6.3.4. Problems with the regression- based approach

This approach is not without problems. Municipalities operate at different levels of efficiency, but efficiency levels are not observed. Actual welfare volumes used in the regression analysis are a biased indicator of spending need, which is defined as the welfare spending a municipality would incur if it operated efficiently (as defined above). Since inefficiency is not taken into account, the regression has an omitted variable problem and thus a bias.

A second problem with the regression method is that it gives rise to perverse incentives. Matching grants reduce the marginal cost of welfare spending and thus increase the attraction of working inefficiently. Standard block grants do not have this property. However, the sophisticated block grants discussed here have the property that higher expenditures increase future grants. That is because higher expenditures influence the outcome of the regression analysis on which the future grant is based. This provides perverse incentives to local administrators. Higher past efficiency results in lower welfare expenditures, which in turn translate into lower weights in the regression formula for the variables that reflect the characteristics of the municipality, and therefore

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[43] The *ex post* limit fixes the upper limit of the (positive) difference between actual welfare expenditures and the block grant allocated to a municipality in the same year. If, at the end of the year, welfare expenditures turn out to exceed the grant by an amount of more than 10 percent of expenditures, the municipality receives additional funding *ex post* which finances the additional deficit. This *ex post* deficit limit affects roughly two dozen (out of 441) municipalities every year. In practice, the *ex ante* limit is more important. It has been binding for more than half of all municipalities every year since the introduction of the new grant system. Differences (in absolute value) between the grant allocated to a municipality and welfare expenditures in year *t*-2 are subject to an upper limit *ex ante* of 7.5 percent of welfare expenditures. As of 2009, structural deficits (at least 2.5 percent in three consecutive years) are subject to an upper limit *ex post*, too.

into a lower grant. As a result, poor performance in the past is rewarded. This results in perverse incentives which distort efficiency.

6.3.5. The best of both worlds?

Because the allocation formula is updated annually, policymakers assume that because the new grant design improves efficiency across the board, the regression bias will gradually disappear, and efficiency will improve everywhere. If this was indeed the case, the Dutch would have the best of both worlds: the efficiency of block grants without the inequities usually associated with them.

Unfortunately, this does not seem to be the case. Toolsema and Allers (2012) show that the bias in the regression-based allocation system will only disappear in extreme circumstances. As long as some municipalities continue to operate below the maximum efficiency level (i.e., as long as welfare dependency is not reduced to the absolute minimum in every local jurisdiction), the bias will continue to exist. However, they also show that the perverse incentive is rather limited, at least in the Netherlands. This is generally the case where the number of local jurisdictions is large compared to the number of parameters in the econometric model (Toolsema and Allers, 2012). As a result, the sophisticated block grant presently in use in the Netherlands is rather efficient.

Another problem associated with the regression-based approach is that a perfect econometric model to forecast welfare dependency cannot be found in practice. Welfare dependency seems to depend to a large extent on unobserved variables. As a result, some municipalities seem to receive considerable less grant money than they should, while others get too much. This is another reason why the Dutch system, in addition to being less than perfectly efficient, is also less than perfectly equitable.

Of course, nobody would expect a real-world program to be perfect. The question is whether it is good enough. Clearly, the Dutch think their welfare financing system works pretty well. The introduction of the new financing system in 2004 was followed by a significant fall in welfare dependency (Kok et al. 2007; Van Es and Van Vuuren 2010).[44] The financial incentive to assist welfare recipients in moving from welfare to work, and to investigate fraud, seems to work. Opposition from municipalities which reckon they receive too little grant money is vocal, but not strong enough to affect the welfare financing policy. Presently, the government plans to set up a similar system for related social protection programs which are about to be decentralized.

6.4. Summary and conclusions

The desire to provide merit goods may clash with decentralization of government, as decentralization may lead to different service levels, while merit good considerations compel national governments to set nationwide service standards. This is especially apparent in the Netherlands, a country with a strong egalitarian tradition and an active and decentralizing government.

A case in point is the Dutch welfare program, which is financed by the central government. Although it is administered by local governments, eligibility rules and benefit levels are uniform across the country. This raises a principal-agent problem: how can local governments be persuaded to manage welfare efficiently, i.e., to reduce welfare dependency?

Dutch local governments receive an intergovernmental grant to finance welfare that is not related to actual welfare payments. Grant allocation is based on regression analysis and reflects local economic and demographic conditions which influence the probability that inhabitants will become welfare dependent. Thus, in theory every local government receives enough funds to finance welfare benefits to those who truly need them. If they pay more benefits, they must bear the associated costs themselves. This program has been rather successful in reaping the efficiency benefits of decentralization while at the same time ensuring a high degree of similarity in service standards across the country.

[44] A recent study (Van Vuuren et al., 2011), however, points out that part of the decrease in welfare dependency may be explained by an increase in the number of recipients of a disability benefit. Municipalities may have encouraged people to apply for a disability benefit instead of a welfare benefit, as disability benefits are not financed by municipalities. This highlights the importance of a clear assignment of responsibilities to the different tiers of government, which prevents one level of government to pass the buck to a different one.

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Chapter 7

Hidden constrictions of local autonomy: The case of standards and norms in Germany

Paul Bernd Spahn

7.1. Introduction

The fiscal autonomy of subnational governments is typically evaluated in terms of their revenue and spending sovereignty. The larger the budget share of own revenues, unconditional tax sharing, and grants of which local governments can make unrestricted use, the larger their revenue autonomy – a tautology. Fiscal discretion is enhanced by policy autonomy, e.g. the opportunity to set the rates of own taxes or levy surcharges on shared revenues. This policy autonomy could be restricted (e.g. through lower or upper bands), but is usually considered desirable.[45] However, the crux lies in those grants that have strings attached. It is important to evaluate to what extent such conditions are binding. The result is not obvious because it depends on the recipient government's preference function. For instance a special-purpose grant for a *purely local function* may fully match the recipient's inclinations, in which case the grant frees unconditional resources for other uses and is thus tantamount to an unconditional grant; or it could run counter to such preferences, in which case spending the grant will be a waste of money. This consequence may be mitigated for non-purely local functions that exhibit "vertical externalities" where the grant also reflects

[45] See European Charter of Local-Self Government, Article 9 (3): "Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate."

the preferences of the donor authority, which are successfully transmitted through conditional grants.[46]

On the expenditure side of the budget the convention is to distinguish between spending for own local responsibilities and spending for delegated functions where local governments act on behalf of a higher-level government. The former should usually be restricted only by the size of the local budget; the latter reflects a principal-agent relationship with varying degrees of autonomy as to their local implementation, albeit not to their policy. When exercising spending functions, local governments often face mandatory standards that may be costly and may prevent them from exercising their full autonomy.[47] The extent to which this is observed is often debatable. Time and again, national standard-setting limits the exercise of local autonomy to some extent, mainly through a higher burden on the budget.

Whether genuine or delegated functions of local governments, the European Charter insists on the adequacy of resources to perform local duties (Article 9 (1) and (2)[48]). However, the delineation of own and delegated responsibilities is often blurred for the funding of delegated functions, whether by intention or not. There are indeed inefficiencies in allowing local authorities to tap directly into the principal's budget through full cost recovery, so co-funding is the preferred option to alleviate this problem. But this will of course also negatively affect the financing of genuine local responsibilities and could become a "Trojan horse" if those delegated functions inflate over time – as in social protection, for instance.

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[46] Of course there are also horizontal externalities that could be internalized via conditional grants among local public entities. Yet such grants require the setting up of specific-purpose agencies or other modes of cooperation among local governments that often fail to operate efficiently due to strategic behavior – in particular free-riding. Vertical grants could be used to foster effective cooperation in these cases. For the purpose of this study, horizontal grants with their complexities are however not considered.

[47] In this vein, the European Charter for Local Self-Government stipulates that "local authorities shall, insofar as possible, be allowed discretion in adapting their exercise to local conditions" even for delegated functions (Article 4 (5)). Furthermore, a Recommendation (2011-11) of the Council of Europe based on Article 9 of the Charter instructs that "When higher level authorities take decisions which impose or could result in additional net costs on local authorities, compensation should be given by the higher level authorities to local authorities."

[48] This paragraph reads: "Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law".

This outline of problems relating to the definition of fiscal self-rule indicates that, given the multiplicity of intergovernmental arrangements for sharing power and for financing it, it is extremely difficult to define the revenue and spending autonomy of local governments purely on the basis of budgetary flows and their classification – in particular where fiscal autonomy depends on the recipient's preference function. To render the problem even more complex, fiscal transfers and spending are in fact subject to national (and international) standards and norms that could impose costs on local decision-making and hence, unnoticed, restrict local fiscal autonomy. A number of such restrictions relating to standards and norms are discussed in this paper with reference to German municipal finance, where a Federal Commission has recently looked into the matter and made proposals for a reform to widen local autonomy by eliminating unwarranted barriers resulting from such norms.

While standards and norms usually impinge on the administration and implementation of policies, some restrictions imposed by central legislation may directly affect local policy-making. Such policy restrictions may also go unnoticed because of acquiescence and submission to traditions or fashionable general policy trends. Some examples of such hidden policy constraints are discussed at the end of this paper.

7.2. Objectives of reviewing norms in Germany, and their categorization

In 2010 the Federal government set up a commission to reform local finances with the intention of strengthening their command over public resources and fiscal self-rule (*Gemeindefinanzkommission*). In the context of this endeavor, a "Working Group on Standards" was set up to

- look into the standards imposed by federal legislation that would have financial implications for local budgets;
- estimate the volume of such financial implications and propose measures to reduce them through more flexible standards; and
- evaluate the proposed measures from a technical point of view and draft appropriate legislation for implementation.

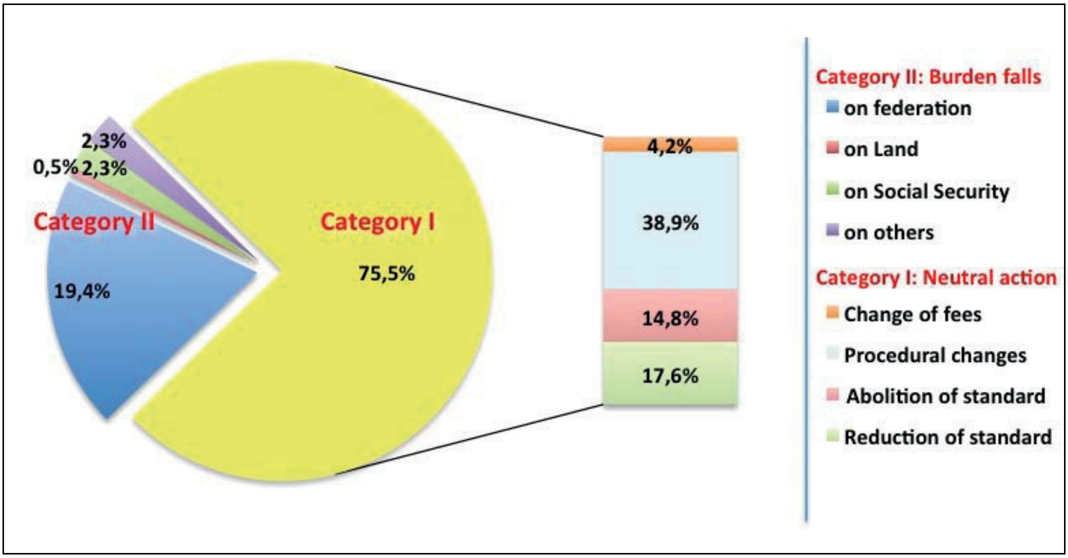
In the Working Group's definition, a standard is "a uniform or unified applicable or desirable way, fixed by federal regulations, as to how a political goal or task is to be fulfilled or performed".[49] These rules can be imposed by federal law, decree, or interagency agreement.

For documentation purposes, the federal Ministry of Finance, the States, and the associations of municipalities organized comprehensive guided surveys and collected multiple complaints on federal regulatory restrictions that affected local administrations and local budgets. Overall, more than 300 norms were identified, of which some 80 were eliminated, either because they were poorly specified or because they could be resolved via State legislation. The rest was retained for further examination. The norms touched upon all areas of policy-making, but the focus was on labor and social policy, interior matters, environment, as well as family, seniors, women, and youth.

The retained notices were then broken down into two groups according to whether a potential shift of financial burden between layers of government was expected or not. For the latter group, the measures were classified according to the following criteria: changes in fees, procedural changes, abolition of the standard, and mitigation or reduction of the standard. The retained norms and their breakdown by category is depicted in Chart 7.1.

[49] "…eine einheitliche oder vereinheitlichte durch Bundesregelungen fixierte anzuwendende oder anzustrebende Art und Weise, wie ein politisches Ziel oder eine Aufgabe erfüllt bzw. durchgeführt werden soll."

Chart 7.1. The breakdown of examined norms by categories



Source: Zwischenbericht Gemeindefinanzreformkommission; own calculations.

It is interesting to note that three quarters of the complaints about norms did *not* entail financial implication for other tiers at all (Category I measures). Among the revenue-neutral measures, municipalities expected significant savings through procedural changes, the reduction of standards, and – to a smaller extent – changes in the fee structure. A full abolition of the standard was proposed only for 14.8% of Category I measures, or 11.1% of the total measures.

The remaining quarter of the proposed measures entailed a shift of financial burdens onto other layers of government, in particular to the Federation (Category II measures). However, if implemented, these proposals would potentially have had significant bearings on local budgets at the margin, which is why much of the debate focused on Category II propositions – mainly in relation to the area of social spending.

In addition, a number of proposals concerned standard-setting through ongoing legislation (Category III). The Working Group considered these awareness-raising indicators and a hint to the federal legislator to consider the costs of standards already during the legislative process. So calculating the costs of setting a standard would become a routine element for future legislation in general.

The different proposals for reform in the area of federal standards were then scrutinized by the various ministries concerned as well as by municipalities and their associations.

7.3. The main concern: costs of social protection

As it turned out, the main concern of local governments was, and is, the high and increasing social expenditures. These municipal costs – except in the three city-states Berlin, Bremen, and Hamburg – represent roughly 1.7 percent of GDP or 29.2 percent of total municipal spending (2010). These figures include only direct transfers to households without any related administrative costs. In all instances, the transfers are based on federal legislation (with the consent of the *Länder*), which determines social entitlements by eligibility and amounts to be paid. True, the legislation also foresees the cofinancing of local social spending by the Federation and the States, but the total of these contributions amounts to only 11 percent of local overall social spending.

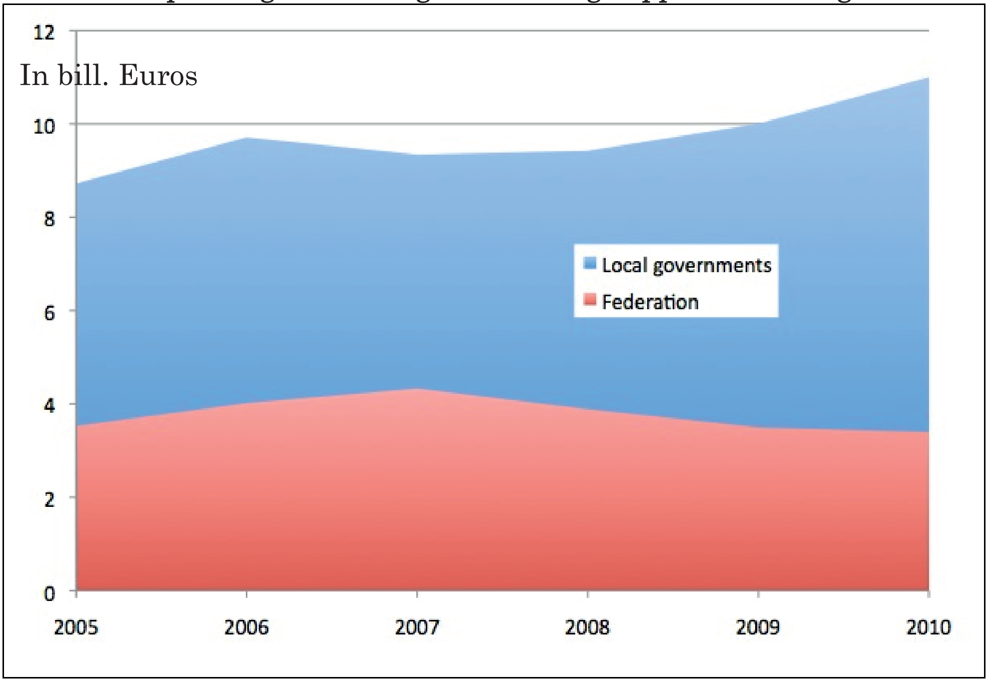
About one quarter of local social spending is made on housing and heating support for the socially weak. For this item, the Federation is committed to making a financial contribution based on a formula, but over the last years, this has worked against the municipal sector. The Federation's contribution declined markedly from about 28.8 percent in 2005 to 23.6 percent in 2010. So this spending item exhibits all the characteristics of a partially funded mandate (see Chart 7.2.) with an increasing financial burden on municipal budgets over time.

Similar trends are observed in other areas of social spending. The second largest social spending item, care for children, has expanded by roughly 45 percent over the last ten years (compared to 16 percent of nominal GDP). The main driving force has not so much been eligibility, but rather legislation which has forced municipalities to apply higher quality standards in nurseries and to comply with certain statutory requirements. In future, this area of local responsibility is expected to grow with the number of eligible children. A federal act on child care establishes that municipalities are to provide day care for 35 percent of all children under the age of three until 2013, and from then on all children will be legally entitled to day care from their first year on. This will further deteriorate local finances, although the Federation has agreed to support local spending for this budget item by a fixed amount that currently represents about 5 percent of the costs.

The picture is not much different for other municipal responsibilities in social spending, such as support for adolescents, aid to families, institutional care, and other supervised forms of living. These spending items are driven by socio-structural elements such as the exposure of young people to family conflicts, lack of parenting skills, the disintegration of family structures due to separation and divorce, unemployment, indebtedness, and so on.

Social spending is also increasing for integration assistance given to disabled persons, where the rate of increase over the last decade has been 55 percent. The rise in the number of persons entitled to these benefits results from increased life expectancy, better medical care, and an increasing number of cases of mental illness. This type of social aid is auxiliary in nature after all other sources of social support have been exhausted, including own contributions by beneficiaries. The latter have, however, been significantly reduced by federal legislation, which has led to the rapid increase in spending indicated above.

Chart 7.2. Spending on housing and heating support according to tiers



Source: Federal Ministry of Finance; own calculations.

A further area of concern in social spending is the basic support for the elderly, which has become a new responsibility of the German local governments. Again, the Federation assures cofinancing of this particular budget item (16 percent of net spending in the year before the previous year), but this responsibility is expected to grow significantly in the future due to demographic developments, disruptions in working careers, and the increasing importance of the low-wage sector, which will reduce the formation of wage-related pension benefits.

It is obvious that municipalities and their associations have focused their attention on Category II proposals, in particular social spending, because most policies to mitigate the impact of federal legislation in this area would entail a revision of existing burden-sharing arrangements. Given the nature of these spending items as pure transfers, a complete takeover of programs by the federal government has also been considered in some instances.

As was to be expected, the federal government has been reluctant to consider Category II measures with large repercussions for its own budget, and it has rejected stipulations that would have allowed municipalities to reduce their spending at the expense of the federation. The typical response of the federal government has been that these problems can only be addressed as part of an overall package that also includes a reform of local revenues. And the municipalities have been reluctant to consider the measures proposed to strengthen their own revenue sources (see below). So the further discussion of most of these issues has been relegated to the "authorities concerned" with little concrete results on how to mitigate the impact of federal norms on municipal budgets in the area of social spending.

However, some proposals for reforming social protection have been retained for further examination. These include, for instance, social assistance to asylum seekers, better targeting of aid for housing and heating, and stricter rules regarding the beneficiaries' own contributions for determining eligibility. Moreover, the complete takeover of nursing services by statutory care insurance providers with compensatory contributions of the municipalities, co-financing by the Federation of the costs for integrating disabled persons, financial contribution from the federal to the cost of child protection may still be considered in a political follow-up. It has also been requested that the Job Centers may become responsible for child benefit for members of the public service, which could attract political support.

Overall it has perhaps been a mistake that municipalities and their associations have focused too much on Category II measures, expecting an immediate budget relief from shifting financial burdens onto others tiers of government and social insurance institutions. This attitude must meet political resistance, especially under the present financial circumstances. By insisting on shifting burdens, local governments have missed the chance to address more fundamental aspects of reforming social security that could have provided budget relief over time. Nevertheless some aspects of rationalizing social security have been discussed in the vein of Category I measures, for instance better targeting, harmonization of eligibility criteria, pooling of competencies, procedural modifications, et cetera. Some of these aspects are discussed in the next section.

7.4. Other areas of concern to municipalities

Apart from social protection, there are a number of other policy areas where municipalities have attempted to shift the financial burden off their budgets. Again, this has been rejected, although some spending items would clearly fall into the responsibility of higher tiers of government, for instance expenditures relating to personal status law such as certification of personal standing, costs of creating electronic registers (anticipated in 2014), or expenses for holding federal elections. In the wake of greater mobility through the abolition of border controls and of combating international terrorism, the municipal costs of cooperation with state and constitutional protection authorities to sustain internal security have remarkably increased. In all those instances the federal government has taken the position that this has to be addressed by State legislation.

Other matters discussed fall into Category I in principle, but nevertheless municipalities have launched an attempt to combine it with financial compensations for alleged additional costs. For instance, through the ELENA Procedure Act of 28 March 2009[50] the federal legislature has decided to facilitate and speed up the procedures for claiming social benefits in future. This is effected through centralized clearing of information, electronically transmitted by employers to the *Zentrale Speicherstelle (ZSS)*, information which social protection agencies can subsequently draw on. This is expected to produce significant savings not only for public institutions, but also for employers who are set free from issuing documentation for the various agencies. However, the municipalities considered that this would entail higher costs for them, which led them to ask the federal government for support, which was of course declined. This example demonstrates that the exercise of diminishing the costs of standards and norms has not always been free of self-interested lobbying.

This is not the place to enter into a full discussion of the different Category I measures proposed, as that would require the reader to be familiar with German legal, institutional, and procedural arrangements. The following should therefore be considered an incomplete set of examples by subcategory of the various proposals considered.

[50] Gesetz über das Verfahren des elektronischen Entgeltnachweises (ELENA Verfahrensgesetz) or Law on the Procedure for Electronic Payments Proof.

7.4.1. Change of fee structures, targeting, and pricing issues

In Germany, municipalities are not fully free to set their fees, user charges, and standard for the provision of services, but require authorization from their respective *Land* authorities and even the federation. So there have been various proposals to achieve greater autonomy for setting the level of fees, for instance for regulating road traffic or for issuing residents' parking permits. Other proposals concern important changes in the fee structure for issuing personal documents, including passports, and the elimination of cost-intensive checks in the case of exemptions from fees.

In other instances, municipalities are not allowed to charge fees for services provided, so a number of proposals to relax this constraint have been made, for example to collect cost recovery fees for information sought on food law breaches. Finally, there are restrictions within the fee structures that render their administration onerous and costly, so municipalities have asked for procedural simplifications in collecting fees and for greater discretion in applying relevant tariff criteria (e.g. pollutant parameters in the case of environmental charges).

On the expenditure side, municipalities aim for greater influence on the design of the echelon for providing services (e.g. for welfare services). Simplification of support schemes may also alleviate financial stress on municipalities, for instance through the use of flat-rate housing allowances or of a standard level of services for the fostering of child development, youths and families. Some proposed measures might reduce the direct costs of a program, but they entail higher administrative and monitoring costs, for instance in connection with better targeting in the case of transporting disabled persons.

Other requests concern the free access of municipalities to services provided by other agencies, for instance the free provision of data from other federal agencies such as the Federal Motor Vehicle Office, or the free provision of standardized computer models for air pollution control plans. This author has argued that "contractual forms of federalism can significantly improve the quality of service delivery in the public sector"[51], which makes a case for interagency transfers on a quid-pro-quo basis ("microtransfers") to compensate for interagency service deliveries. This concept would run counter to the free access to interagency services. It is recognized, however, that the German model of federalism is more "corporatist" than "contractual", so the political instinct is typically biased toward interagency assistance at no cost rather than toward efficiency-enhancing micro-transfers between agents to compensate for service spillovers.

7.4.2. Procedural changes and administrative simplification

A number of proposals to improve existing procedures relate to the better integration of information flows between agencies (in particular between municipalities and social insurance institutions via e-government) and the centralization of certain functions such as payments and direct debits. Similarly, it is expected that budget savings would be achieved by harmonizing the varying eligibility criteria for different social assistance programs and by centralizing such criteria for that type of programs (e.g. for disadvantaged students).

Savings are also expected from the waiver of administrative acts involving excessive case-by-case examination and for repetitive acts such as annual follow-up applications for, and approval of, certain benefits for persons above the age of 65 and/or with permanently reduced earning capacity. Further measures include the simplification of procedures such as reimbursement schemes for child protection or educational aid, or simplification of testing methods (e.g. in compliance with the Vocational Education Act).

Furthermore, certain cost benefits result from the consolidation of procedural requirements involving several public agencies or cost carriers, for instance through allocation of a comprehensive one-stop responsibility for integrating youth welfare services, or reduction of the number of interested parties involved in determining certain transfers such as family benefits.

There are also some restrictions on staffing. For instance, federal legislation may prescribe that certain tasks are to be performed only by civil

[51] Spahn, Paul Bernd (2006), „Contract Federalism“, Handbook on Fiscal Federalism edited by Ehtisham Ahmad und Giorgio Brosio, E. Elgar, Cheltenham, pp. 182-197.

servants. More flexible and needs-based staffing might be achieved by allowing municipalities to hire salaried employees (e.g. veterinarians) or to contract out some services to the private sector. And, as is the case everywhere, procurement rules have been found to be excessively restrictive. Increased thresholds for procurement requirements and negotiated procedures would reduce costs and contribute to alleviate municipal administrative budgets.[52]

Other proposed procedural changes concern the transfer of responsibilities away from municipal authorities. One example is the responsibility for the preparation of noise action plans from municipalities to the appropriate level of the noise source.

There are also examples of complaints about federal legislation affecting municipal budgets which had to be rejected because of international treaties, i.e. supranational directives and interstate agreements may also bear on local finances. For instance the demand to remove restrictions on opting-in rules of social assistance programs may be in conflict with the UN Convention on the Rights of Persons with Disabilities. Or the request to eliminate the Strategic Environmental Assessment in environmental planning or the elimination of external emergency plans for potentially hazardous businesses clearly conflicts with EU directives, and such proposals had to be rejected by the federal government.

7.4.3. Other cost-reducing measures

There are two important areas of federal policies where municipalities complain about significant cost increases without compensatory flows of fund. One concerns the Energy Conservation Ordinance (*Energieeinsparverordnung EnEV*), the other federal legislation to curb illegal activities in the construction industry.

As to the former, municipalities are compelled to renovate the existing municipal housing stock and office buildings to comply with the high energy conservation standards set by legislation, and this has already led to significant setbacks under the current EnEV. These standards will be stepped up in the 5th revision of the act foreseen for 2012. Again,

[52] The Council of Europe has recently discussed potential benefits stemming from procurement through the internet, which do not appear to have been discussed by the Working Group.

this legislation is based on a EU directive (of 2010), which is considered a "common European denominator" for energy efficient buildings throughout Europe, so it has a much wider bearing than just for Germany. Nevertheless the implied burden on German municipal budgets is massive. Therefore representatives of German municipalities have requested that, at least, residential buildings owned by municipalities be excluded from the rehabilitation obligation because it would overstrain their municipal housing associations financially.

As to the latter concern – curbing illegal construction activities – the law has indeed transferred a number of cost-intensive responsibilities for surveillance and monitoring onto municipal governments without compensation, including even the collection of a tax on invoices issued by construction firms (*Bauabzugssteuer*, an installment for income taxes to be paid by the firm).[53] It was to be expected that the federal government would reject these complaints for political reasons, given the sensitivity of the issue.

7.5. Restrictions on municipal policies

7.5.1. Constraints by political norms

German municipalities are guaranteed local self-rule by the Constitution, and they generally comply with the standards set by the European Charter of Local Self-Government. Their budgets are financed through own revenue and State grants that are usually unconditioned, except for some capital grants in support of specific investment programs. And the municipalities enjoy policy discretion in varying the tax leverage for two of their important taxes: taxes on businesses (*Gewerbesteuer*) and on real property. On the expenditure side of the budget, municipalities can set their policy priorities freely within the ambit of their competencies and standards, and they have the right to borrow on the market without restrictions, albeit under surveillance by their respective State governments. So municipal policy may be considered to be basically free of restrictions.

This picture fades in the light of normative thinking firmly entrenched in political behavior. A certain number of political "norms" are not even questioned or, if challenged, they are rejected because of alleged politi-

[53] The *Bauabzugssteuer* can be credited against personal and corporate income taxes.

cal "risks". For instance the pay schedule for municipal civil servants and employees is uniform throughout the nation, and the idea that it could be differentiated according to local circumstances is not even discussed for fear of inter-jurisdictional competition. Or the base of the property tax has not changed for almost half of a century (values were fixed in 1964, respectively 1974), and municipalities are usually reluctant to increase the leverage ratio of this tax for fear of political costs. Over the last decade the annual rate of increase of the average leverage ratio for the property tax was 0.7 percent[54] compared with 4.8 percent for municipal spending in the area of social protection – the largest budget item. So property tax collections have consistently declined as a share of municipal budgets.

Another example of collectively self-imposed political restrictions was revealed when the federal government proposed, to the Working Group "Municipal taxes" of the Commission, a financing model that would have replaced the local business tax with a surcharge on personal and corporate income taxes, including the right to vary the rate, as well as a higher municipal share of VAT. The municipalities and their associations rejected the proposal to tax their citizens based on arguments of inter-jurisdictional tax competition and regional inequities. Conversely, the federal government refused the model where municipalities strengthened the local business tax because it considered it to be detrimental to the substance of business enterprises operating in Germany. This created a policy deadlock, which persists. So the German model of local self-government is still far from the Swiss philosophy of competitive federalism.

7.5.2. Constraints by institutional norms and the ban of new net local debentures

A number of institutional norms affected municipal policy making, but they were not at the forefront of the discussions in the Working Group. Municipalities did not ask for greater policy autonomy, except for greater influence of their social welfare institutions on the design of services, some leeway in setting fees, and greater margins for their own activities in the field of energy saving and climate protection (requesting financial incentives from the senior governments). On the contrary: the general

[54] An exception is the post-crisis year 2010, where the average rate of increase of the national leverage ratio for property taxes was 2.6 percent.

mood was to give up policy responsibilities, especially where tied to important underfunded spending programs. However, an important limitation of municipal policy making was not discussed by the Commission. It resulted from the work of a previous commission on fiscal federalism.[55]

The quest for fiscal discipline and budget coordination in order to reach international norms, for instance the Maastricht criteria for comprehensive public borrowing and debt, as well as concerns about the unbridled expansion of government debt and short-term municipal borrowing in particular[56], led to a nationwide debate on the intergovernmental coordination of public debt, which resulted in a self-imposed new constitutional norm (which has since influenced State constitutional law in Schleswig Holstein and Hessen, for instance): the "debt brake" (*Schuldenbremse*). It amounts to a full injunction to incur new debt for the *Länder*, including their municipalities, from 2020 on. Article 109 (2) of the Constitution (*Grundgesetz*) establishes the principle of structurally balanced budgets for all levels of government. Consequently, deficits can no longer be financed through borrowing, except for the federal budget where a margin of 0.35 percent of nominal GDP is tolerated.[57]

True, this is not a total ban on municipal debt, which would conflict with the European Charter[58], but it will be a constraint over the longer run. It allows municipalities to borrow only when retiring older debentures. In other words: Borrowing is allowed only for the replacement of the existing capital stock, not for its expansion. Even preserving the level of replacement investments will be difficult in the light of escalating federal standards as discussed, e.g. in the area of energy conservation. This will become a severe restriction for a sector that is responsible

[55] The Federalism II Commission (Kommission zur Modernisierung der Bund-Länder-Finanzbeziehungen) was set up in 2007 and concluded its work in 2009.
[56] The cash credits of municipalities have increased dramatically over the last decade, from €6.9 billion in 2000 to €40.5 billion in 2010 – which is an annual rate of increase of 19.4 percent.
[57] There are other exceptions that apply to all levels of government however: (i) borrowing to cope with natural catastrophes and other emergencies; and (ii) anti-cyclical borrowing to mitigate the business cycle, whereby incurring and retiring of debt must be symmetrical and balance over the cycle.
[58] The European Charter stipulates in Article 9 (8): "For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law."

for about two thirds of all public investments in a – hopefully – ever-growing economy. Even if there is no growth, the real value of replacement investment allowed via borrowing will decline with inflation over time.

If applied strictly, this norm will strongly interfere with local budget autonomy, which is why some lawyers now see a contradiction within the Constitution: there may be a conflict between the constitutional debt brake and the general guarantees of *Gemeindeautonomie*. From an economic point of view it is to be expected that municipalities will engage in all sorts of evasion strategies. These can best be studied by looking at countries that have imposed even stricter bans on municipal borrowing, for instance China.[59] Municipalities will simply disguise debt in local investment companies and other off-budget agencies, of which they are the owners, or through clever accounting that masks the true size of the debt. This hidden debt is much more difficult to control than debt on budget, it entails new risks, and it dis-empowers local councils. Moreover, since the debt brake will only work from 2020 on, there is the temptation to anticipate a higher debt level to acquire sufficient *masse de manoeuvre* for later, which is inefficient hoarding.

It remains to be seen what the constitutional norm of the debt brake will mean in practice – consider the destiny of the Maastricht constraints. Of course it could be a device to mobilize local taxation and relax the self-imposed constraint on revenue policies that were mentioned above. But it clearly interferes with the principle of budget separation between tiers of government and the autonomy of their budgets.

7.6. Conclusions

Germany has a vibrant municipal sector, whose budget autonomy and local self-rule are guaranteed by the Constitution. Municipalities also enjoy discretion in setting their rates of important taxes and benefit from unconditional intergovernmental transfers. And they are free to borrow on capital markets. Nevertheless their range of action is constrained by international and federal standards and norms that bear on costs, hence on municipal budgets, which restricts their political options and choices.

[59] See, for instance, "Auditor Warns of Risks From Local Debt in China", *New York Times, Global Business*, June 27, 2011.

Most of the restricting standards and norms have been identified in the area of social policy and other local responsibilities that are underfunded. Relaxing the constraints set by norms is thus tantamount to shifting burdens to other tiers of government or to social security institutions. This has proved to be politically difficult and has not produced tangible results. However, in areas where revisions of standards and norms are possible without affecting other budgets, there are a number of measures that, if implemented, do reduce costs and enhance the budget autonomy of municipalities. In this area significant political progress was possible.[60]

Restrictions on municipal policy making are more difficult to identify because they often result from self-imposed political "norms" that are firmly entrenched in the political "culture" and are not even questioned – such as the uniformity of living conditions or the acceptance of a nation-wide pay scale for public employees. They also reflect a shyness of political leaders and officials to incur risks through greater accountability, for instance when asked to tax their citizens. A striking example came from the work of the Commission when the federal government proposed a widening of local autonomy in the area of income tax, which was rejected by the municipalities and their associations.

One important long-term constraint on municipal policy making will be felt when activating the "debt brake", the interdiction to incur new net debt from 2020 on. This clearly interferes with the principle of budget separation between tiers of government and the autonomy of their budgets.

[60] The Federal Ministry of Finance reports that, by June 2011, 20 percent of all proposals had already been implemented or were in the process of being implemented, and 45 percent of the proposals were relegated to existing Federal-Länder Working Groups or were being treated in the context of ongoing legislation.
("Gemeindefinanzkommission - Ausgangslage und Ergebnisse", Monatsbericht, August 2011.)

Chapter 8

Prevention of unsustainable local government behaviour - some Danish experiences[61]

Niels Jørgen Mau

8.1. Introduction – decentralisation and merit concerning responsible economic behaviour

8.1.1. Public sector, externalities and public goods

The public sector has its foundation in the existence of public goods and externalities.[62]

It is evident that the public sector deals with externalities in environmental protection, parks and recreation, general administration or defence. But externalities are also present for many publicly provided private goods – such as health care, primary schools and elderly care. The element of externality in such cases is "general health situation", "fair distribution", "minimum rights" etc.

In this paper I will explore the view on fiscal policy objectives also as a kind of public good. The subject of this paper is the objective of stable, responsible and sustainable local governments.

When different levels of government exist, the question arises: by what level of government should the different activities be performed, at what level can the externalities best be handled properly or "internalised"? When it comes to the public good "responsible economic behaviour", what level of government should be preferred to perform this task?

[61] I thank Jorgen Lotz for very helpful comments and suggestions.
[62] See the classic description in Musgrave (1959).

8.1.2. Handling economic responsible behaviour – on what level?

It is fairly obvious that economic responsibility primarily rests with the level of government that is responsible for finding the financing. This should be the same level as that where decisions are made about services and their costs, and also where the effects of the activity can be monitored. This reflects the saying that "responsibility and competence should go together".

In Denmark the municipalities are run by elected councils, which are responsible to the citizens/electors for their decisions. This is seen as a key element of a public sector consisting of separate local, regional and central authorities.

However, with a decentralised public sector, conflicts of interests may arise. This is not a Danish problem – in most countries the problems of decentralised responsibility and accountability need to be addressed. It is generally held that central governments have special interests and extra responsibilities when it comes to fiscal policy (surplus or deficit), the overall tax level, as well as efforts to avoid an economically unsustainable public sector. And in this respect there is a special concern to minimise the risk of default of local public authorities.

The reason for this is that the default of a municipality may result in disruption of local services that are deemed essential by the centre. In Denmark, like in probably most other countries, any defaults of local governments increase the risk of a need for bailing out the local government in question at the cost of the rest of the country. Therefore, the central government also has the legitimacy of taking (extra) measures to avoid such situations.

Aspects of creating the appropriate general incentives for the local government sector to carry out expenditures and raise revenues have previously been discussed at the Copenhagen workshop held in 2009 – under the heading "general grants versus specific grants".[63]

This paper addresses the interplay between regulation and grants policies in establishing rules for the budget management of local govern-

[63] See Kim (2010).

ments, taking into account the division of tasks, the system of grants, the local taxation powers, and other revenues. As argued the centre has to take into account the risk of irresponsible local economic behaviour, i.e. "Economically Unsustainable Behaviour" (EUB) of single municipalities? But: how best to address this risk? Or, in other words, how best to handle this aspect of economic risks in connection with decentralisation on the background of the national merit of stable delivery of services delegated to the local level?

In this connection we should also take into account the problem raised by de Figueiredo et al. (2007) as well as the so-called second generation of fiscal federalism, namely that a public sector divided into different tiers must foresee two kinds of systematic risks. On the one hand is a risk that in order to get control of local government behaviour, the central level undermines the advantages of decentralisation that were the reason for having a local level. On the other hand is the risk that local authorities misuse their freedom and pursue irresponsible policies, i.e. display opportunistic behaviour, in stead of being loyal to the responsibilities of decentralised Welfare State.

8.1.3. Programme

This paper seeks to analyse and illustrate some aspects experienced in the Danish public sector, assuming that responsible, sustainable budget policies in most, if not all, countries are ultimately the responsibility of the centre.

First, it will be discussed what motives and conditions can bring a local government in a situation where it may display EUB. Under what circumstances do we have to be especially aware of the risk? Some hypotheses on this subject will be formulated.

Second, in preparation to the evaluation of data, the economic and legal environment of the Danish municipalities will be described in brief.

Third, a small sample of cases will be presented to illustrate the Danish experiences. And fourth, those cases will be discussed in the light of the hypothesis put forward earlier. Our aim is not a formal, statistical verification but rather a kind of evaluation.

Fifth, the type of regulation is assessed – both the successes and the spectacular exception to this. And finally, our conclusions will be presented.

8.2. Theories of explaining local economic behaviour and the risk of EUB

There are many factors which may explain the economic decisions made by local governments when we want to explain the risk of EUB. Is irresponsible behaviour by the municipal board simply to be understood as an aggregation of citizens' preferences – perhaps as represented by the utility function of the so-called median voter? Another question is whether the personal interests of the local politicians lie in getting into power and be re-elected? But we also have to consider the role of local pressure groups and civil servants with their personal motives – wages, prestige, job-security etc.

Without any doubt, attention should be paid to all of these dimensions. Here we will only mention some of the *elements* and conditions that are likely to motivate the economically responsible behaviour of municipalities – as expressed by the decisions made by local politicians and operationalised by the staff and civil servants.

As already mentioned, the *starting point* or *main rule* will be that municipalities will act economically responsible – and not get near to any kind of EUB-situation. Getting a reputation of lax or – even worse – irresponsible economic behaviour will be perceived by the electorate to indicate a lack of management skills. The citizens will possibly see a lack of economic control not only as a risk of budget deficits and "bills to be paid" by the municipality's local taxpayers, but also as a sign of an overall lack of managerial competence. So the not very surprising hypothesis 1 is: municipalities will normally be governed in an economically sustainable way. This does not depend on the behaviour of the central government.

But there may be deviations. If the municipal board feels that it is treated unfairly and finds the municipality hit by external shocks, it may appear justified to relax the economic management, a need which it under the circumstances will be easy to communicate to the inhabitants. This may result in failure to keep budgets and fulfil economic plans. Thus, this leads to hypothesis 2: *external shocks* may increase the risk of a municipality being forced into an EUB-situation.

Such a situation will seem more attractive – or less frightening – if the costs of EUB may in some way be passed on to other municipalities or other parts of the public sector. So hypothesis 3 is: the risk of a municipality encountering an EUB situation is comparatively high if the *costs can be transferred* to other partners in the economy.

On the contrary, if the economy of the municipality is well consolidated, the potential to handle external shocks will be better. Or put in another way – hypothesis 4: An economically *weak municipality* will be more likely to end up displaying EUB than others.

Another aspect is the degree of clear separation of responsibilities. Having a clear political responsibility may make it less likely that a municipality encounters an EUB-situation. A hypothesis 5 may then be that a *weak central political management* means a higher risk of EUB.

If a difficult economic situation has to be overcome, the municipality must have some economic tools at hand. But it is sometimes heard that local governments are in reality restricted by both fixed economic conditions on the revenue side and tight regulation of their service-delivery obligations, which means that they – so they argue – really have no room for economic manoeuvre. So hypothesis 6 is that if the central control is excessive to the extent that the local government's economic *freedom is strongly restricted,* there is a higher risk of EUB.

Finally, a characteristic of decentralisation is that individual local governments may compete for new (perhaps wealthy) inhabitants. But such competition may be costly – whether carried out via taxes or via expenditures – and implies a risk of EUB in the extreme situation. So as hypothesis 7: Local governments' *internal tax-/expenditure-competition* may increase the economic risk of EUB-situations.

8.3. Danish local government finances and borrowing regulations

8.3.1. General characteristics of the financial system

The Nordic countries are characterised by a certain type of decentralisation where the majority of public sector tasks are managed at local government level.

Municipalities in Denmark supply a long range of services – from child care and kindergartens, to elderly care, primary schools and roads, from labour market schemes to income compensation transfers to unemployed persons or households not covered by the unemployment compensation schemes. Other important income transfer schemes are managed and partly financed by municipalities, e.g. early retirement benefits, sick-leave benefits and housing. And finally, an important part of public infrastructure, planning and environmental protection is the responsibility of the municipalities.[64]

To finance those tasks the Danish municipalities have – like those in Norway, Finland and Sweden – as their main revenue sources local taxes, block grants and to some extent also specific grants and – of more modest importance – discretionary grants from the central government. There is a comprehensive formula-driven equalisation system that aims at securing equal economic conditions across local governments.[65] An important part of municipal expenditures are strongly affected by the economic cycle, but the municipal financial system aims at neutralising the effects of the cycle on local finances.[66]

8.3.2. Borrowing regulations of Danish municipalities

As a main rule or starting point, every municipality has to finance all its activities – operating costs as well as investments and debt service – by way of current revenues, i.e. not by loans.

[64] See Mau (2010).
[65] For a more detailed description see Mau (2008).
[66] In The Danish system, such corrections of block grants to compensate for cyclical swings in expenditures and revenues are anticipated in the law or established as a firm tradition, i.e. fairly automatic. This is contrary to many other systems as e.g. the systems in other Nordic countries, where the discretionary element is more important. On some of those aspects, see OECD (2010).

This main rule is, however, modified in two respects. First, the municipalities have so-called automatic permission to raise (long-term) loans for investments in certain areas: investment in areas financed mainly by user fees (e.g. utilities and housing for the elderly), and investments which have been given a special political priority, e.g. urban renewal, energy saving measures and housing for refugees.

Second, the Ministry of the Interior grants discretionary permission to municipalities to borrow funds within annually fixed ceilings of the aggregate value of such approvals.[67]

8.3.3. The overdraft facility rule ("kassekreditreglen")

The final element of the borrowing regulations concerns short-term debt.

The set of borrowing regulation rules acknowledges that municipalities are met with significant fluctuations in day-to-day outlays and revenues. Typically the municipality receives taxes and grants in the beginning of the month but has outlays for wages and transfers later or at the end of the month. To ensure that the general restrictions on borrowing do not interfere with the municipality's daily cash management or forces it to hold unreasonably high cash reserves, municipalities are at liberty to manage short-term debt and short-term positive balances via short-term loans (cash credits) – provided that the annual average of short-term deposits and loans, calculated over the latest 365 days, is positive. This is the so-called "kassekredit-regel" or overdraft facility rule.

This rule is especially interesting in connection with the assessment of a possible EUB-situation. The reason is that a violation of this overdraft facility rule is seen as an early sign of a municipality getting into an EUB-situation. If the local government does not comply with this rule, it acts against the law. Consequently, a municipality having an open conflict with the law must expect sanctions from the central government (the Ministry of the Interior).

[67] For an English description of the Danish system, see Stanton (1996). See also Mau (2002) about the Danish system – and in a European context.

The Ministry has an obligation to react to a violation of the rule. This is done in a standardised manner, consisting of the following elements:

1) the municipality in question is granted a temporary approval to deviate from the overdraft rule for a certain limited period, typically 3-4 years;
2) this approval is given on the condition that the municipality takes steps to restore the economic situation and that such steps result in cash reserves of a certain "robust" magnitude, and that it possibly also takes steps to improve the economic management of the municipality;
3) the central government may or may not add some discretionary grants or loan sanctions to ease the immediate economic situation;
4) the municipality has to report to the Ministry frequently, typically every three months, on the economic (liquidity) situation.

In colloquial language this situation is termed that the local government is "put under administration" (PUA).[68] The popular term "put under administration" is used in the media and by the municipal sector itself and will also be used in this paper.

8.4. The data – municipalities "put under administration" (PUA) in the last decades

Since 1988, 29 municipalities have in 30 cases been granted approval to deviate from the overdraft facility rule, i.e. to incur extra short-term debt for a period of usually 3-4 years on the condition that the authority meet the conditions set by the Ministry. In the jargon, those municipalities have been PUA.[69]

In figure 8.1. the geography of the PUA municipalities are illustrated. Note that due to the structural reform of 2007, the three most recent PUA municipalities cover more than one of the municipalities that were

[68] In Norway, see Kommunal- og Regionaldepartementet (2011), municipalities violating the rules about budget balance are included in a special register, the ROBEK-register ("Register om betinget godkjenning og kontroll" – Register of conditional approval and control). This sanction has some similarities with the Danish "put under administration", but seems to be a more "soft" way of reaction from the central government (and its representatives, "fylkesmannen").

[69] Rules about liquidity existed also before 1988, and some municipalities had to restore a weak financial situation. The rules were, however, different.

independent before the reform. The more specific PUA cases are illustrated in table 8.1.

Figure 8.1. The location of municipalities "put under administration", 1988-2011

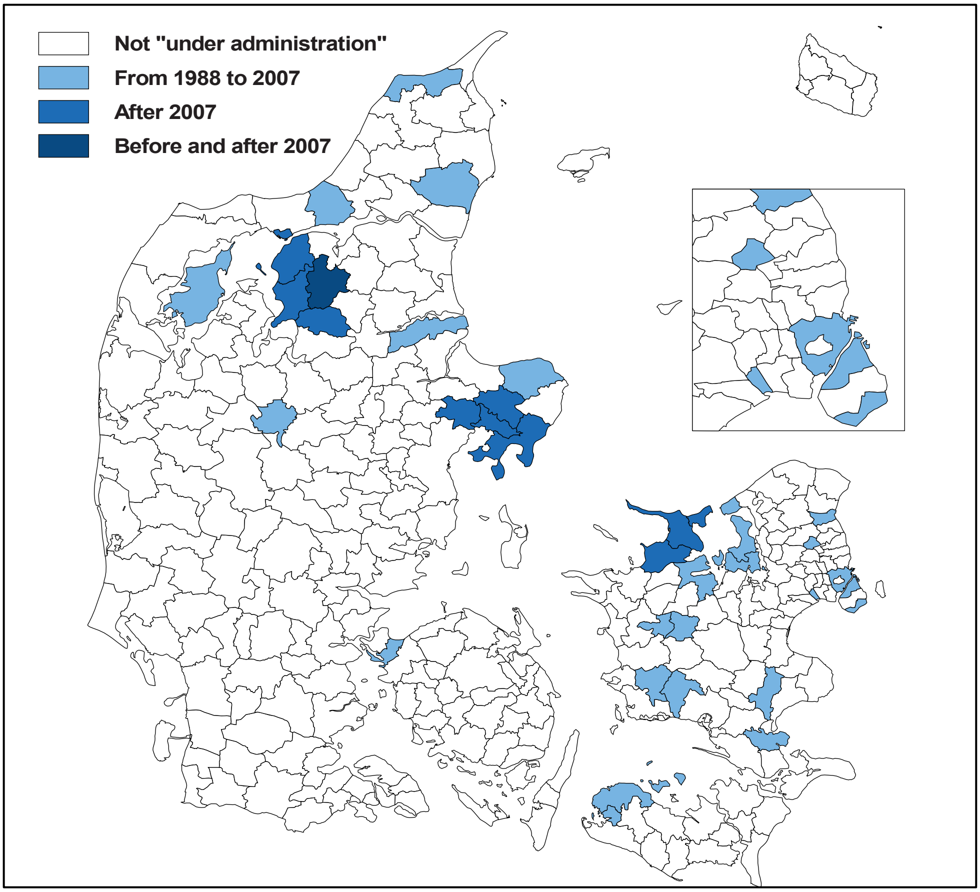


Table 8.1. Characteristics of municipalities "put under administration"/EUB, 1988-2011

Name of municipality/ first year of administration	Small municipality[1] (1)	Problems [2] (2)	High social expenditure needs[3] (3)	Low tax capacity[4] (4)	Weak initial liquidity position[5] (5)	Tax/expenditure competition[6] (6)	Other characteristics reported (7)
Karlebo, 1988		A	+	-	…	X	
Dronninglund,1989		B	-	-	…	X	Ministerial visit *on location*
Skibby, 1989	X	B	-	-	…		
Holbæk, 1990		H,B	-	-	…	X	
Morsø, 1991		B	-	-	…		
Stenlille, 1991	X	B	-	-	…		
Aars, 1992	X	D,B	-	-	…		Sale-and-lease-back of furniture
Nakskov, 1993	X	F,C	+	+	…	X	
København, 1994		G,E	+	-	…		1-year period, 'semi bail-out'?
Hundested, 1996	X	F	-	-	…	X	
Hashøj, 1997	X	C	-	-	…		
Nørre Aaby, 1998	X	C	-	-	…		
Mariager, 1998	X	C	-	-	…		
Ravnsborg, 1999	X	G	+	+	…		5-year period
Jægerspris, 1999	X	A	-	-	…		
Brovst, 2000	X	A	-	+	…		
Vallensbæk, 2000	X	C	-	-	…		
Nørre-Djurs, 2001	X	A	-	+	…		
Dragør, 2002	X	C	-	-	…		
Farum, 2002		D,H	+	-	…	X	Bail-out
Fuglebjerg, 2003	X	C	-	+	…		
Stenlille, 2005	X	A	-	-	+		
Præstø, 2005	X	A	-	-	-		
Hirtshals, 2006	X	C	-	-	+		
Karup, 2006	X	A	-	-	-		
Dianalund, 2006	X	C	-	+	-		
Rønnede, 2006	X	A	-	-	+		
Odsherred, 2007/08		C,A	-	-	+		
Vesthimmerland, 2008		A,H	-	+	-		inherited liquidity

							problems
Syddjurs, 2008/09		A	-	-	+		inherited liquidity problems
Average of municipalities[7]	14,294		17.2 per cent	24.1 per cent	5+ 4-		
Average of all Danish municipalities[7]	17,979 (2006) 50,962 (2007)		20 per cent	20 per cent	...		

[1] Measured as municipalities with less than 18,000 inhabitants, i.e. the average size before the structural reform, assuming 274 municipalities and excluding Municipality of Copenhagen. Number of inhabitants measured from 2006/2007-data. See about categories of municipalities of different sizes, Indenrigsministeriet (2000).
[2] Reported in the application from the municipality or from reports from initial meetings. Categories:
A: deficits on current budget
B: past overestimation of tax base
C: budget errors, financial mismanagement
D: not complying with borrowing regulations
E: displacement of payments, i.e. miscalculations
F: external shocks
G: structural imbalances – "holes" in the equalisation system?
H: other
[3] + = high social expenditure needs. Measured as a social index ≥ 1.04 before 2007 (measured on 2002 data), ≥ 1.10 from 2007 and later years (measured on 2008 data), i.e. municipalities among the highest 20 percentage index values.
[4] Measured as composite tax-capacity ≤ 106,019 DKK before 2007 (measured on 2002 data), ≤ 131,350 DKK from 2007 (measured on 2008 data), i.e. among the lowest 20 percentage tax capacity.
[5] + = Weak position. Measured as average cash reserves according to the cash credit rule for 1 year before being put under administration < 1,000 DKK per inhabitant. The earliest observation is Q4 2003.
[6] Taken as 1) special attention of avoiding future tax increases, or 2) aggressive tax cuts before EUB-situation.
[7] Excluding Municipality of Copenhagen with more than ½ mill. inhabitants.
Source: Indenrigsministeriet (2001, 2007) and data from Ministry of the Interior and Health.

8.5. Discussion of hypotheses in the light of the data

From the data in table 8.1. it is possible to discuss the validity of the hypotheses proposed in section 3. The hypotheses may be confirmed, rejected or modified.

Municipalities normally act in an economically responsible manner (see hyp. 1)

It is not surprising, but encouraging to the political system of the public sector in Denmark, that municipalities normally act responsibly in the sense that EUB-situations are generally avoided. And if such situations occur, they are rather quickly redressed. Over a 24-year period, an average of slightly more than 1 or 2 municipalities annually are PUA. Furthermore, taking into account that up till now no municipality has been PUA since 2008, it may be possible that even fewer municipalities will be brought in that situation in the future. That may be supported by the fact that it seems that small municipalities in particular have been put under administration, since around 70 per cent of them have less than 18,000 inhabitants (before 2007 the share was 77 per cent). The number of small municipalities was drastically reduced by the 2007 structural reform, see *table 8.2.*

Table 8.2. Number of small municipalities < 18,000 inhabitants

	Before reform (2007)	After reform (2007)
Number of municipalities	200 (73 per cent)	7 (7 per cent)

Note: Before 2007, counting the Municipality of Bornholm as 5 single municipalities. Excluding the Municipality of Copenhagen.

This prediction is also supported by some of the other hypotheses, e.g. hypotheses 2 and 3 about external shocks and transfer of costs, which may occur more seldom in large compared to small municipalities, see below.

However, it may be objected that the size of the municipality put under administration is only slightly lower than the average.

Unexpected events may increase the risk of having an EUB-situation (see hyp. 2 and 3)

The evidence is not very clear. What is an external shock? A closure of a big local company is an example, but this is rarely reported as a main course of the financial difficulties – it has been listed only twice, see table 8.1. More often the municipalities in question list unforeseen lack of tax revenues or revenues from sale of land, which may or may not be caused by local cyclical developments, as this is difficult to distinguish from “only” examples of poor budgeting skills. Overestimation of the tax base occurs 6 times (20 per cent). Finally, "simple" budget errors and failures are rather often listed as part of the difficult economic background – 10 times (33 per cent). The latter certainly is not an external shock, although it probably feels as some kind of shock to the local decision-makers.

To conclude, hypothesis 2 may be modified to state that unexpected events – including external shocks – actually increase the risk of having an EUB-situation. But this is certainly not the only reason: reported deficits on current budget, i.e. budgeted expenditures are exceeded. occur 11 times (37 per cent).

Small municipalities are more exposed to EUB than are large municipalities (see hyp. 2, 3 and 4)

This has already been mentioned as a possible conclusion in connection with the line of reasoning behind hypotheses 2 and 3. Moreover, it may be more realistic for a small municipality to hope for a discretionary grant than can be expected by a larger municipality, simply because of the lack of resources available for grants in the Ministry. This means that there is a risk of opportunistic behaviour in the sense that the small municipality takes into consideration the chance of receiving a discretionary grant. Discretionary grants are not registered in table 8.1. but are – together with loans – used in connection with putting up a restoration plan for the economy of the municipality in question.[70]

The only (very) large municipality having experienced PUA (for one year only), the Municipality of Copenhagen, did not directly receive discretionary grants. But an extra grant to the hospital service of the Metropolitan Area may be explained by the need for financial assistance to Copenhagen.[71]

It can also be noted that several small municipalities were PUA immediately before the 2007 structural reform when a larger municipality would take over.

[70] The discretionary grants are not big enough to be indicative of a bail-out situation, see section 6 for description of a bail-out situation.

[71] The Metropolitan Area in this sense includes only the municipalities of Copenhagen and Frederiksberg. The hospital service, called H:S (Hovedstadens Sygehusfællesskab), received from its start in 1995 an extra grant of 1 bn. DKK, which was gradually reduced over the subsequent ten years, Strukturkommissionen (2004), Ch. 24.

Cannot be confirmed: If the central control is excessive so that the local government's economic freedom is strongly restricted there is a higher risk of EUB, And: An economically weak municipality is more likely to end up in an EUB-situation than others. (see hyp. 4 and 6)
It may be expected from hypotheses 4 and 6 that restrictions on economic behaviour for municipalities may be a main reason for bringing a municipality in an EUB-situation.

From table 8.1., column (5), it seems – although based on very few data – there is no close connection between an initially very low level of liquidity (t –1 year) and the timing of PUA. So hypothesis 4 about an exposed initial economic situation having an implication for an EUB-situation cannot be unambiguously confirmed.

Along the same lines the observations in table 8.1. seem to reject hypothesis 6, i.e. that apparently tight restrictions on economic behaviour do not seem to involve a higher risk of being put under administration, as the occurrence of high social expenditure needs, see column (3), and low tax capacity, see column (4), for EUB-municipalities does not deviate in any significant way from the national average. Low tax capacity is seen a little more frequently than the national rate, but high expenditure needs are slightly rarer in the EUB-municipalities. It is worth noting that the equalisation system seems to a wide extent to nullify the economic consequences of differences in taxable incomes and social conditions across municipalities. This suggests that every municipality has degrees of freedom and that external conditions do not in any systematic way lead to EUB.

Local tax competition is not an important reason for EUB (see hyp. 7)
Table 8.1. counts 6 cases (20 per cent) of tax changes being given special attention in the EUB-situation. However, which does not appear from the table, this usually means that as part of the economic restoration plan, the municipality is forbidden to increase taxes (perhaps increases within a limit), so tax competition is not seen directly as (one of the) cause(s) for EUB. Only in the case of Farum Municipality, a period of tax competition was part of the complex of municipal decisions leading to EUB. So, hypothesis 7 is rejected. For the latest years, i.e. since 2001, this is not surprising considering the central government tax freeze policy supported by annual agreements with the municipal sector.

Undecided if weak political management means risk of EUB (see hyp. 5)
Finally, table 8.1. does not illustrate to what extent a weak local political management has been the cause of EUB. The analysis of the cases has given the author the impression that weak political management, e.g. a weak or changing majority of the municipal board, may imply a higher risk for EUB. But naturally such a phenomenon is seldom reported by the municipality itself, i.e. it is rarely reported in the case files and may rather be seen as a catch-all explanation that is too vague to be confirmed without more detailed studies of the different municipal political situations.

8.6. Evaluation of the way of redressing the EUB-situation

8.6.1. The normal course

The method of overcoming the EUB-situation has already been described as consisting of four steps, 1)-4). The question is then: has it worked?

The answer to this question can also be found in table 8.1. and appears mainly positive. Since only one municipality, Farum, has been restored by a bail-out (see next section), the method must have been successful. This is confirmed by the observation (not included in table 8.1.) that almost all of the former EUB-municipalities end up with a level of liquidity significantly higher than demanded.

One municipality, Stenlille, occurs twice in the table, and one municipality (Aars) is part of Vesthimmerland (under administration later). This may serve to illustrate that having had a EUB-situation once does not immunise the municipality from experiencing EUB again – though this is certainly not a typical outcome.

What has been the reason of this success of the method of "putting under administration"? I can offer three kinds of explanations:

- "It is the law": the municipality breaking the overdraft facility rule has to realise that it is in conflict with the rules and must anticipate sanctions from the local supervising authorities ("statsforvaltninger"[72]). Those authorities have the authority to demand that the municipal board adopts a new budget with an improved financial outcome compared to the current 'illegal' budget. If the municipal board refuses to do so, the supervising authority has the right to fine the single members of the board who voted against steps to legitimise the budget situation.

It is remarkable that the situation has never been brought to the point where the supervising authority has taken the sanction steps mentioned above. The possibility has been discussed in certain situations but never brought into play. But still, the fear of the possibility of legal action may be effective.

- Being "put under administration" is noted with displeasure by the other municipalities which is embarrassing to the municipal board – it may even be said to be stigmatising. The local press will naturally cover the problems faced by the municipality in depth. And when assessing the competence of their politicians, the electorate will take into account that they have not been able to resolve the situation themselves – but have needed help from the central government.

If this explanation is relevant, it involves a paradox: on the surface, the instrument of the solution is highly centralistic since the central government intervenes in local government affairs. But the intended effect is reached via the local politicians' responsibility towards the local citizens.

Finally, an element may also be:

- In the extraordinary situation it is legitimate for the central government also to use extraordinary means, including extra grants and loan sanctions. This may relieve the situation somewhat – as described above.

If this kind of explanation is relevant to the success of the method, it is, however, obvious that is must – on the part of the central government – be used with the utmost precaution. In the opposite situation it will be

[72] There are 5 such regional supervising authorities in Denmark.

seen as a temptation to "get under administration" to receive extra grants, and opportunistic behaviour must be foreseen. As a matter of fact, the view has been expressed that the government has been too soft and has created a moral-hazard situation[73]. One mayor has been quoted as saying that "if he runs down his liquidity and expands his administrative costs he can obtain extra grants". My reaction is that this is exaggerated, and the magnitude of extra grants that may come into play is normally only modest. However, one exception has been experienced:

8.6.2. The exception to the rule: the Municipality of Farum

Two municipalities appear twice in the table 8.1. bail-out list. They are the Municipality of Copenhagen and the Municipality of Farum.

For Copenhagen it is questionable to speak of bail-out since the municipality did not directly receive discretionary grants (but some extra funding was made available via the financing of the Metropolitan hospitals – see the text and footnote 10 above).

However, for Farum major discretionary grants were applied:

- When the Municipality of Farum was amalgamated into the Municipality of Furesoe in 2007, the new municipality received about 0.8 bn. DKK as extra grants.
- The economic situation of Municipality of Furesoe was renegotiated in 2011, and the municipality received an extra 0.7 bn. DKK in grants and low-interest loans.[74]

The size of the grants equals more than one year's total budget of Farum Municipality and is a clear case of "bailing out".

The explanation of why it "went wrong" in this situation has, among other issues, been scrutinized by a commission – in session for 10 years.[75] An important factor is the personality of the then mayor, who bullied his council to disregard the borrowing regulations. Also, the

[73] Ibsen and Lotz (2011).
[74] More elements were involved, e.g. major local tax increases. See Indenrigsministeriet (2011).
[75] The commission has had its own permanent staff, own building facilities and own homepage:
http://www.farumkommissionen.dk/farumsubject.aspx?type=farumsubject&id=71200.

book-keeping procedures of the municipality were questionable.[76] The citizens of the municipality received a range of extra services in some of the years, including a major sports stadium and other extensive building projects which they did not pay for immediately.

All in all our assessment of this case is that it is an extraordinary and isolated, however very costly, exception.

8.7. Conclusions

The decentralised decisions on local budgets are the most important functions of the local government sector. Being important at the local level, however, with economically very important municipalities overall sound fiscal policy and economic responsibility also is a national merit-want.

A study of 30 Danish cases of what might be termed municipal "unsustainable economic behaviour", EUB, over a recent 24-year period reveals that the risk of having an EUB-situation is highest in smaller municipalities – which implies a positive scenario for fewer future EUB-situations in Denmark after the amalgamation reform of 2007. The data also indicate that the more easily the municipality can transfer (some of) the costs of EUB to other economic agents, the higher the possibility of having such a situation. That is why the risk of EUB is higher before major structural reforms where the costs of irresponsible economic decisions may be borne in part by future new municipalities.

Having an EUB-situation seems often to stem from internal factors – such as miscalculation of taxes, other budget errors or repeated overruns of expenditure budgets. But external factors cannot be demonstrated to be decisive in the typical case. External shocks, such as major closures of large firms, are seldom seen as a course for EUB, and low tax capacity and high social expenditure needs do not as such occur more often in municipalities experiencing EUB than in other municipalities.

The so-called "put under administration"-arrangements seem to work quite effectively. The EUB-municipalities have their financial difficulties redressed, and their liquidity reserves improved according to – or

[76] The mayor was sentenced to two times two years' prison.

exceeding – the plans. One exception is described of a municipality that was bailed-out, but this was hopefully an extraordinary case that had criminal aspects.

One of the important reasons for the success of the “put under administration” procedure may be the embarrassment or “stigmatisation” effects of the arrangement for the local politicians. So even though the processes are rather centralistic since they intervene in local decisions, their effects work their way through the local environment. That, it is argued, confirms that in the end, local responsibility is a decisive factor for having healthy local finances.

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Chapter 9

Do local tax limitations work? Evidence from Danish local government

Jens Blom-Hansen

9.1. Introduction

The literature on tax and expenditure limitations – TELs – shows that limiting subcentral governments' freedom to levy taxes may have considerable unexpected effects (Mullins & Wallin 2004; Kousser et al. 2008; Skidmore 1999). Entities subjected to such limitations may, as hoped for by the central government, react by cutting expenditure and revenue, but they may also strategically change their revenue structure and increase their reliance on income sources not subjected to limitations. Furthermore, the effects of limitations may vary according to individual characteristics of subcentral governments in patterns not anticipated or wished for by the central government.

However, these findings are mainly based on studies of states and local governments in the USA. The relevance for European countries is not clear. The mechanisms studied in the US setting may be general, but the empirical context is very different. US local governments are a complex mix of single and multi-purpose entities where, furthermore, citizens' initiatives play a large role. In contrast, European local governments are geographically defined multi-purpose entities that rely almost exclusively on representative, not direct, democracy.

The relative paucity of studies of local tax limitations in Europe are probably due to the difficulty of finding a relevant empirical testing ground. Local fiscal systems vary considerably across European countries, but utilizing this variation is difficult because so many other characteristics of local government systems also vary cross-nationally.

There is therefore more potential in studying in-country variation, but local fiscal systems are 'sticky' and show considerable stability over time.

However, in Denmark, traditionally a country with a high degree of decentralization, the central government imposed tax limitations on municipalities in 2009. While this did not make it formally impossible to raise local taxes, the central government now offsets the revenue effect of local tax increases by corresponding cuts in central grants. This has effectively stopped local tax increases. In this sense the Danish tax limitation has worked. But based on the TEL literature referred to above, there is reason to question the broader effects.

The purpose of this paper is to investigate the Danish situation and thus the empirical domain of the TEL literature. Are the key findings from this literature relevant in a European context, in particular for Danish municipalities? In Denmark, municipalities may have kept taxes unchanged, but has their reliance on revenue been shifted to other income sources? Has the tax limitation had a uniform effect in all municipalities, or do the effects vary with the local situation in patterns not expected or wanted by the central government? The Danish setting makes it possible to answer these questions by comparing municipal reactions to the tax limitation across time and place.

The paper is structured as follows: In the following section, we explain the Danish situation in more detail. We then present a review of the TEL literature and tease out the key findings. This makes for three hypotheses that can be tested on the Danish data. Before doing this, we discuss a number of questions related to research design. Endogeneity is a known problem in the TEL literature, but is less relevant in the Danish setting. Measuring the local reaction to tax limitations is also a known problem in the TEL literature. However, the availability of a large number of register data on Danish municipalities makes it possible to set up quite refined measures. In the subsequent section we present the results of pooled regression analyses of 98 municipalities from 2008-2011. The central finding is that tax limitations do indeed prevent income taxes from increasing. However, the growth in expenditure is not affected and there is no trace of increased reliance on non-tax revenue.

9.2. Introducing local tax limitations in Denmark

Denmark is a country that traditionally scores high in international comparisons of local autonomy (Page 1991: 13-42; Boadway & Shah 2009: 273-281). This is partly because Danish municipalities are entrusted with core welfare functions such as schools, child care, old age care, libraries, local culture, and public utilities, and partly because Danish municipalities finance most of their expenditure with personal income taxation. The right to set the rate of this tax source is often considered the cornerstone of Danish local self-government (Blom-Hansen & Heeager 2011).

The local taxation right has never been completely unlimited. For the past decades, local tax levels have been negotiated between the central government and the municipalities' national association in a system known as the budgetary cooperation. These negotiations are conducted annually and normally end with a written agreement on limits to local taxation. This limit, however, covers all municipalities, which means that some extent of flexibility is built into the system. Individual municipalities can increase and lower taxation as long as the general limit is kept. The annual agreement is really a declaration of intent since the local government association cannot enter into agreements that are legally binding for its members. This system has been operative since 1980.

In 2007 a local government reform was implemented which redistributed functions across tiers and amalgamated the 271 municipalities into 98 new large entities (Lassen & Serritzlew 2011). In the years immediately prior to this reform, the central government introduced tight controls of local economic dispositions. Local tax rates were frozen, local liquid assets had to be deposited, fines were introduced on local budget overruns, and capital spending had to be approved by the central government. These initiatives were widely accepted by the old municipalities since there was a consensus that an unhealthy incentive to "spend before closing time" was to be counteracted (Blom-Hansen 2010).

But the understanding was that the controls were to be loosened once the reform was implemented. In 2007 the central government lived up to this understanding. Controls were abandoned, and the central government began its annual economic negotiations with the municipalities' association. In 2008, the first year without individual local tax controls, local taxation increased dramatically, much more than expected by the central government. In response, an individual local tax limitation was introduced. This was a law that introduced sanctions for increasing local income and property tax rates.

The sanctions combine individual and collective elements. In the first year, 75 percent of the revenue generated by the tax increase are offset by a corresponding cut in the individual municipality's grant from the central government. The remaining 25 percent of the increased revenue is neutralized by a cut in the general grant to local governments, the so-called block grant. This is the collective sanction. Together the individual and collective sanctions fully neutralize the revenue effect of increased local taxation. The individual sanction is gradually phased out, with a corresponding increase in the collective element, see Table 9.1. As is also evident from this table, the central government strengthened the individual sanction in 2010, making it even more unattractive to increase local taxes, seen from the perspective of the individual municipality.

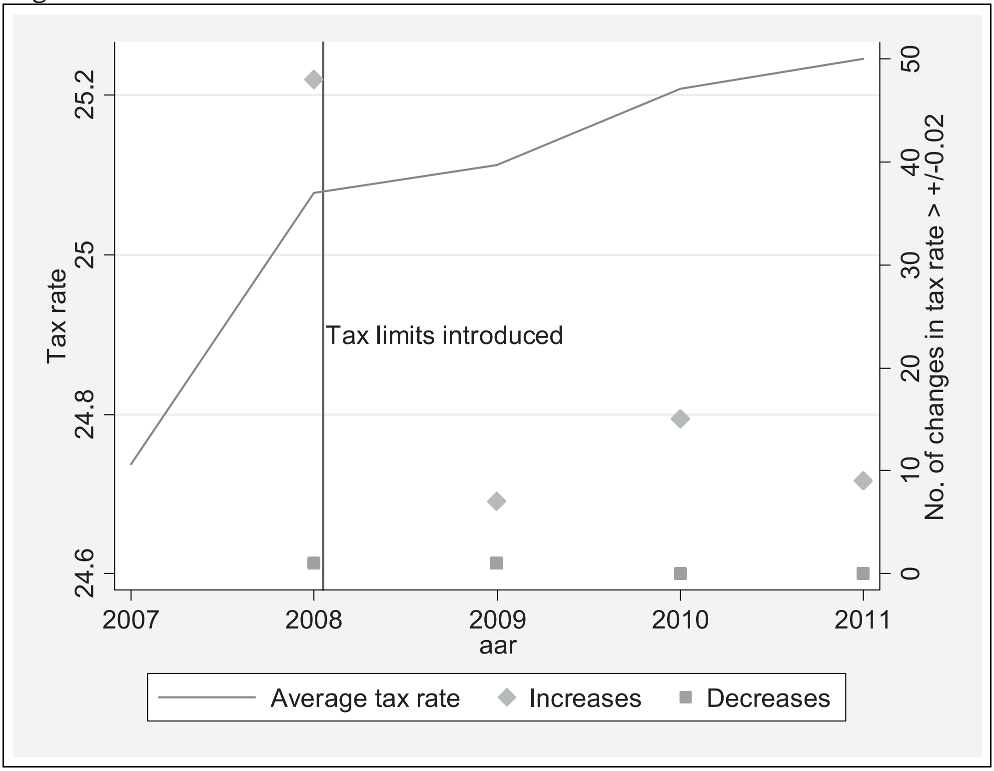
Table 9.1. Local tax limitations in Denmark

	Individual sanction (%)	Collective sanction (%)
Act 477/2008 (effective from 2009)	Year 1: 75 Year 2: 50 Years 3-: 0	Year 1: 25 Year 2: 50 Years 3-: 100
Act 709/2010 (effective from 2011)	Year 1: 75 Year 2: 50 Year 3: 50 Year 4: 25 Years 5-: 0	Year 1: 25 Year 2: 50 Year 3: 50 Year 4: 75 Years 5-: 100

The tax limitations were introduced over explicit objections of the municipalities. Their association found that the limitations were unwarranted, would effectively prohibit municipalities from raising their taxes, and would abolish a central condition for Danish local self-government (KL 2008). When the tax limitation was tightened in 2010, the association protested again and stated that the sanctions were not conducive for trust in the central-local government relationship. According to the municipal association, the sanctions effectively abolished the local taxation right and locked local tax rates at artificial levels (KL 2010).

In sum, the income and property taxation rights of Danish municipalities have been severely curtailed since 2009. Individual sanctions for tax increases dramatically reduce the incentive to increase taxation. As shown in Figure 9.1., local income tax rates have only changed little since 2009, which may suggest that the sanctions are effective. However, based on the findings in the literature on tax limitations in the USA, this conclusion is far from self-evident.

Figure 9.1. Local income tax rates from 2007 to 2011



9.3. Lessons from tax and expenditure limitations (TELs) in the USA

Imposing restrictions on the taxing powers of municipalities is an example of the broader phenomenon of controlling the size of the public sector by institutions. Fiscal rules such as budgetary balance requirements, debt restrictions, expenditure or revenue limitations, and referenda approval of budget decisions are often introduced to curb the development of public budgets (Boadway & Shah 2009: 477-481, 495-497). However, as noted by von Hagen (2002: 264) in a broad research review, "the key insight then is that the effectiveness of fiscal rules is limited at best, because politicians are likely to find ways to circumvent them."

This insight seems particularly relevant for the type of fiscal rule imposed on Danish municipalities in 2009. It is a local tax limitation, which is a phenomenon well-known from the USA where the tax revolt in the 1970s led to numerous instances of tax and expenditure limitations (TELs). Although not the first, the most spectacular TEL is probably California's Proposition 13, which in 1978 imposed restrictions on property taxation by local authorities (Citrin 1979; Danziger 1980). The California tax revolt spread rapidly across the USA, and within two years 43 states had implemented some kind of local property tax limitation. But the revolt was not limited to budgets at the local level. State governments also became the focus of TELs. At the turn of the millennium, there were 53 state TELs in place in 31 states, while only two states had TELs before 1970 (Mullins & Wallin 2004; Joyce & Mullins 1991).

Much literature has examined the effects of such TELs. Three core findings are relevant for an investigation of the Danish local tax limitation. The first is that TELs have had a limited success in reducing spending and revenue growth. Bails (1990) investigated TELs in 19 states in 1976-1985 and concluded that they had only had a small impact on the growth or size of state budgets. Kousser et al. (2008) investigated state and local spending in 49 states in 1969-2000 and found TELs to have very limited effects. Cox and Lowery (1990), updated in King-Meadows & Lowery (1996), compared three TEL states (Michigan, South Carolina, Tennessee) with three comparable non-TEL-states (Ohio, North Carolina, Kentucky) in the years since 1965. They found no evidence in their 1990 analysis and only very weak evidence in their 1996 update that TELs had had an impact on the size of government. Elder (1992) analyzed the impact of TELs on state revenue in the period 1950-1985 and found some impact of expenditure limits, but no impact of revenue limits. Mullins & Joyce (1996) investigated 48 states through the period 1970-1990 and found that TELs had had only a minor effect on the overall size of the state and local public sector.

The second key finding is that limitations on property taxes make local governments shift their revenue reliance to other revenue sources. Shadbegian (1999) investigated the level and structure of local government revenue in 1962-1987 and found that in 29 states, TELs shifted the revenue structure of local government away from property taxes to 'miscellaneous revenue'. Skidmore (1999) examined 49 states in 1976-1990 and found similar results. Kousser et al. (2008; see also McCubbins & Moule 2010), studying 23 states in 1969-2000, found that 15 of 23 states increased charges and fees following the introduction of TELs. Mullins & Joyce (1996) examined 48 states over the years 1970-1990 and found that TELs reduced local taxes, but that these reductions were offset by increases in user charges and 'miscellaneous revenue'. Finally, based on data from 1,400 different municipalities covering all US states, Preston & Ichniowski (1991) showed that revenue or expenditure limits reduce property tax revenue, but increase 'other revenue'.

The third finding is that the effects of TELs are not uniform across localities, but rather depend on local circumstances. Brown (2000) investigated the impacts of TELs imposed on local governments in Colorado and found that they depend on jurisdiction size. Effects are more constraining for small local governments. Mullins (2004) studied local governments in 787 metropolitan counties in 48 states in 1972-1997 and found that the effects of TELs are more constraining in poor and fiscally constrained communities.

On the basis of these findings of TELs in the US context, we investigate the following three hypotheses in the Danish case:

H1: The Danish tax limitation does not limit local expenditure
H2: The Danish tax limitation leads to reduced taxation, but increased reliance on non-tax revenue
H3: The Danish tax limitation has more constraining effects in municipalities under fiscal pressure

9.4. Methods and data

In the literature, most of the studied TELs have been introduced by state legislatures or by voter initiatives (Kousser et al. 2008: 335; Skidmore 1999: 89; Shadbegian 1999: 226, 229-230; Dye, McGuire & McMillen 2005: 216, 221ff). As readily acknowledged in the literature, this creates a problem of endogeneity. Legislatures and voters are not likely to introduce TELs by chance; TELs are created to solve specific problems. For example, it cannot be ruled out that TELs are more likely to be introduced in places where taxes have proven hard to control. If this is the case, the correlation between TELs and tax rates may be biased. Since the Danish TEL was imposed by central government over explicit objections of the municipalities, see section 2 above, they were not introduced in municipalities according to any specifically local criteria, including problems with controlling the tax rate. Analytically, they constituted an external shock.

Our data set include all 98 Danish municipalities through a period of five years, 2007-2011[77], which yields 490 observations. In order to deal with problems of temporal auto-correlation, we analyze annual changes in our dependent variables, rather than levels.[78] To deal with problems of spatial autocorrelation, we use cluster-corrected standard errors.

In order to study the effect of the tax limitation introduced in 2009 on tax and expenditure decisions (H1 and H2), we compare the effect of year dummies on these economic dispositions.[79] Our expectation is that the year dummies will have no effect on expenditure changes, a negative effect on changes in taxation, and a positive effect on changes in non-tax revenue.

To study whether the tax limitation has more constraining effects in municipalities under fiscal pressure (H3), we construct interaction terms of year dummies and indicators of fiscal pressure. Our expectation is that the combination of a tax limitation and fiscal pressure will force municipalities to rely more on non-tax revenue and/or expenditure reductions.

Since income and expenditure patterns in Danish municipalities are known to be influenced by many factors, we control for a number of po-

[77] At the time of writing, 2011 data were not available for all variables, so some analyses only include the period 2007-2010.
[78] In two instances we use levels rather than changes, namely in our analyses of capital income and net loans in Table 9.4. The reason is that these income sources – in contrast to e.g. personal income taxes and current income – have no stable level from year to year. Temporal auto-correlation is thus a minor concern.
[79] The year 2008 is thus used as a baseline. This is less than ideal in the sense that the municipal reform described in section 2 was completed only one year earlier. The municipalities may therefore still not have fully adjusted to the reform. In this sense 2008 may not be an equilibrium year. However, we do not think that the ramifications of the reform should have any systematic influence that may bias our results.

tential alternative explanations identified by prior research (Houlberg et al. 2011; Blom-Hansen 2010; Serritzlew 2005; Mouritzen 1991): changes to the tax base, changes in expenditure needs, municipal amalgamations, partisan ideology, population size, and population density. To ensure the right direction of causality, we analyze the impact of these factors with a one-year lag.

Readers are referred to the appendix for the exact definition and specification of variables.

9.5. Empirical analysis

We now present the results of analyses of local expenditure, tax revenue and non-tax revenue in Danish municipalities from 2007-2010/2011. We first investigate H1 by analyzing how local expenditure is affected by the tax limitations introduced in 2009. Subsequently, we turn to H2 and H3 by analyzing first whether the tax limitations reduce tax increases, and second whether tax limitations induce municipalities to increase income from non-tax sources.

Table 9.2. shows the effect of tax limitations on a broad measure of local expenditure, budgeted current and capital expenditure (excl. utilities). Expenditures are measured as annual change in 1,000 DKK per capita (fixed prices). All 98 municipalities have been included for a period of four years, 2007-2010. Since the tax limitations were in effect from 2009, we can estimate the effect of the limitations on expenditure by including dummy variables for years. This is done in model 1. Although the intention of implementing tax limitations is to curb local expenditure, this turns out not to happen. In 2009, the first year with tax limitations, local expenditure per capita was not significantly lower than in 2008. In 2010, the second year, local expenditure even increased.

Table 9.2. Tax limitations and local expenditure changes

	Model 1	Model 2
Tax limitations		
Year 2008 (Tax limitation not in effect)	Reference category	Reference category
Year 2009 (Tax limitation in effect)	-0.575 (-1.76)	-0.306 (-0.76)
Year 2010 (Tax limitation in effect)	2.227*** (7.60)	2.178*** (6.08)
Fiscal pressure	-	
Balance, current accounts (lag)	-	0.189* (2.13)
Financial equity capital (lag)	-	0.0325* (2.50)
Interactions	-	
Financial equity capital (lag) x Year 2009	-	0.0209 (0.83)
Financial equity capital (lag) x Year 2010	-	-0.0220 (-0.97)
Controls	-	
Annual change in tax base	-	0.0535 (1.16)
Annual change in expenditure needs	-	0.836* (2.52)
Municipality amalgamated in 2007 (1 = yes)	-	0.752** (2.70)
Party ideology (lag) (1 = socialist mayor)	-	-0.336 (-1.49)
Population size (lag)	-	-0.00202 (-0.97)
Population density (lag)	-	-0.162 (-1.00)
Constant	1.520*** (7.24)	0.161 (0.22)
N	294	294
adj. R^2	0.241	0.316

Dependent variable: Annual change in budgeted gross current and capital expenditure (excl. utilities) in 1,000 DKK per cap. Fixed prices. OLS regression with cluster-corrected standard errors. Please refer to the appendix for definitions of variables.
t statistics in parentheses
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

In model 2 we include a number of variables to control for economic conditions and changes, political factors, and types of municipalities. These controls either have no effects or behave as would be expected. For example, in municipalities with less fiscal pressure (measured by their balance and financial equity capital), spending tends to increase more. Increases in expenditure needs (a measure based on objective demographic and socio-economic indicators) leads, not surprisingly, to increased spending, and municipalities amalgamated in 2007 tend to spend more. The important point, however, is that the effect of the dummy variables Year 2009 and Year 2010 does not change. Furthermore, the interaction terms show that fiscal pressure does not affect the impact of tax limitations on expenditure. Fiscal pressure notwithstanding, tax limitations do not reduce expenditure. This corroborates H1: Tax limitations do not curb expenditure.

Table 9.3. shows the effects of the tax limitations introduced in 2009 on changes in the two major taxes that are regulated by the limitation: Personal income taxation and general property taxation.[80] As in Table 9.2, model 1 shows the direct effect; model 2 also includes control variables. Turning first to personal income taxation, the constant in model 1 indicates that the income tax rate in 2008 increased on average by 0.341 percentage points. The dummy for year 2009 is negative, statistically significant, and of a similar magnitude. This indicates that the tax limitations in 2009, as expected by H2, did in fact almost halt increases in income taxes. The average tax increase dropped to 0.341-0.306 = 0.035 percentage points, a negligible increase. The dummy for year 2010 is slightly smaller. Taxes in 2010 increased, compared to 2008, by 0.341-0.245 = 0.096 percentage points. Finally, in 2011 taxes increased, compared to 2008, by 0.341-0.303 = 0.038 percentage points. Hence, tax increases in 2010 and 2011 were also markedly lower than before the introduction of tax limitations. In sum, the tax limitations introduced in 2009 seem to have had a dampening effect on local taxation.

In model 2, four control variables are included. First, we control for changes in the municipal income tax base. This variable turns out not to have any statistically significant effect. Second, in 2010 and 2011 some municipalities were allowed by the Ministry of Interior to increase taxes by being allotted a share of a special "tax pool". This was a minor softening of the tax limitations that was introduced upon negotiations with the local government association. In other words, the affected municipalities were partly exempted from the tax limitation. We control for these exceptions by including a dummy variable indicating whether a

[80] The minuscule tax on business property is also covered by the tax limitation, but not analyzed here.

municipality was allowed to increase taxes. As expected, these municipalities tend to increase taxes. Third, we control for party ideology, which appears to have no effect, however. Fourth, we control for the "safe passage" arrangement. This is a legal entitlement to increase taxes that have been lowered. This arrangement was introduced as part of the original tax limitation in order not to discourage municipalities from lowering taxes. It may seem surprising that this arrangement has a negative (albeit small) effect on taxation. This is probably because tax reductions tend to occur in rich municipalities, which means that they serve to some extent as a proxy for economic soundness. Adding these four control variables does not essentially change the estimate of the direct effect of the tax limitation from model 1.

Turning next to general property taxation, the same picture emerges. The direct effect is estimated in model 1. Here, the constant indicates that property tax rates increased by 0.868 in 2008. The dummies for 2009, 2010, and 2011 indicate that increases then almost stopped. This result is not substantially changed by adding the control variables.[81]

[81] Since the Danish local property tax has a legal maximum of 3.4 per cent and since several municipalities are close to this limit, there is a ceiling effect in local property taxation. To deal with this problem we have run model 2 in Table 9.3. with the lagged level of the property tax as an extra control variable. This variable is, not surprisingly, negative and statistically significant. But it does not substantially affect the results (analysis not shown, but available upon request).

Table 9.3. Tax limitations and local tax increases

	Change in personal income tax rate		Change in general property tax rate	
	Model 1	Model 2	Model 1	Model 2
Tax limitations				
Year 2008 (Tax limitation not in effect)	Reference category	Reference category	Reference category	Reference category
Year 2009 (Tax limitation in effect)	-0.306*** (-6.38)	-0.293*** (-5.67)	-0.611** (-3.46)	-0.561** (-2.59)
Year 2010 (Tax limitation in effect)	-0.245*** (-4.89)	-0.299*** (-6.24)	-0.529** (-2.82)	-0.871*** (-5.13)
Year 2011 (Tax limitation in effect)	-0.303*** (-6.76)	-0.342*** (-6.98)	-0.519** (-2.69)	-0.781*** (-4.27)
Annual change in tax base	-	0.00160 (0.40)	-	0.00948 (0.49)
Municipality alloted share of tax pool	-	0.321*** (6.63)	-	1.927*** (5.72)
Party ideology (1=socialist mayor)	-	-0.030 (-1.20)	-	-0.0003 (0.00)
Entitled to tax increase (”safe passage”)	-	-0.028** (-2.05)	-	-0.055 (-0.88)
Constant	0.341*** (7.72)	0.355*** (7.46)	0.868*** (5.75)	0.874*** (5.38)
N	392	392	392	392
adj. R^2	0.180	0.257	0.035	0.195

Dependent variable: Annual change in income/property tax rate. OLS regression with cluster-corrected standard errors. Please refer to appendix for definitions of variables.
t statistics in parentheses
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

We now turn to non-tax sources of revenue that are not regulated by the tax limitation introduced in 2009. According to H2, when tax limitations are introduced, municipalities will shift from tax revenue to non-tax revenue. The Danish municipalities have several such sources, and we investigate three of the most important ones. First, municipalities may increase capital income, for example by selling land and property. Second, municipalities may increase current income, for example by increasing user charges for daycare. Third, it is possible to increase borrowing. We investigate each of these sources of revenue in three separate regression analyses in Table 9.4. We include the same set of control variables as was used in Table 9.2. Few of the variables have any statistically significant effects on non-tax revenue sources, and none of the significant effects are systematic. The dummy variables for year 2009 and year 2010 are, according to H2, expected to be positive. However, it turns out that non-tax revenue sources are typically not used more in 2009 and 2010 than they were in 2008. This indicates that tax limitations do not lead municipalities to increase their reliance on non-tax sources of revenue.

Table 9.4. Tax limitations and non-tax revenue

	Level of capital income	Change in current income	Level of net loans
Tax limitations			
Year 2008 (Tax limitation not in effect)	Reference category	Reference category	Reference category
Year 2009 (Tax limitation in effect)	-0.331 (-1.51)	0.0322 (0.17)	0.0346 (0.21)
Year 2010 (Tax limitation in effect)	-0.579* (-2.16)	-0.0576 (-0.37)	0.342 (1.78)
Fiscal pressure			
Balance, current accounts (lag)	-0.0535 (-1.30)	0.00829 (0.22)	0.0388 (0.78)
Financial equity capital (lag)	-0.0360 (-1.68)	0.00461 (0.75)	0.00281 (0.20)
Interactions			
Financial equity capital (lag) x Year 2009	-0.00753 (-0.38)	-0.00331 (-0.51)	0.0210 (1.47)
Financial equity capital (lag) x Year 2010	0.00977 (0.42)	-0.00595 (-0.60)	0.0117 (0.73)
Controls			
Annual change in tax base	-0.00279 (-0.10)	-0.0191 (-0.95)	0.0155 (0.75)
Annual change in expenditure needs	-0.155 (-0.88)	0.110 (0.96)	-0.196 (-1.26)
Municipality amalgamated in 2007 (1 = yes)	-0.405* (-2.52)	0.376** (3.12)	-0.254 (-1.15)
Party ideology (lag) (1 = socialist mayor)	0.0590 (0.41)	-0.154 (-1.34)	0.0545 (0.36)
Population size (lag)	0.00435*** (5.75)	-0.000327 (-0.55)	-0.00312** (-2.95)
Population density (lag)	-0.0821* (-2.27)	-0.0362 (-1.51)	-0.0627 (-1.40)
Constant	1.191** (2.90)	-0.0765 (-0.32)	0.859* (2.61)
N	294	294	294
adj. R^2	0.170	0.012	0.037

Dependent variable: Level of capital income/change in current income/ level of net loans. OLS regression with cluster corrected standard errors. Please refer to appendix for definitions of variables.
t statistics in parentheses
* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

According to H3, the constraining effects of tax limitations are stronger for municipalities under fiscal pressure. If this is true, non-tax sources of revenue should be used more in municipalities with a low balance and with low financial equity capital. It turns out that these variables are not related to the use of non-tax resources. Neither main terms nor interaction terms are statistically significant. Regardless of fiscal pressure, tax limitations do not affect the use of non-tax revenue sources.

9.6. Discussion

The results support H1, but not H3, and only partly H2. In other words, tax limitations do curb increases in local taxation, but they do not affect expenditure, and they do not affect non-tax revenue. This may seem strange, even paradoxical. Why do municipalities not choose to increase revenue from other sources when taxes cannot be raised? How can municipalities increase expenditure, not increase taxes, and not increase income from other sources? We speculate that the explanation may be found in the fact that municipalities (as most other polities) have four options when faced with tax limitations:

1. Curb spending. As predicted by H1, this does not happen in the Danish case;
2. Increase income from non-tax sources. In contrast to H2, this does not happen in the Danish case;
3. Increase taxes anyway. As predicted by H2, this does not happen in the Danish case;
4. Play the game of *Stick it out to the bitter end.*

The first three options are not attractive. Curbing spending and increasing revenue from user payments and other non-tax sources will be punished by the voters. Increasing taxes will be punished by central government. The last option is to do nothing. That is, no real solutions are found to the reduction in income sources which the tax limitations represent. Municipalities keep postponing tough decisions as long as possible. This can be done in several ways: One is to use the savings. This makes the municipality much more vulnerable to economic fluctuations, but it is a way, in the short term, to finance increased expenditure without collecting revenue. If this happens, the financial equity capital and liquid assets will drop. Another method is to collect less revenue for capital investment. As long as this happens, the current accounts balance will be low. Table 9.5. shows some signs that this may be what is happening. Although the annual balance on current accounts improved in 2010, financial equity capital and liquid assets have been reduced in the years following the introduction of the tax limitation in 2009.

Table 9.5. Buffers in the municipal economy 2007-2011

	2007	2008	2009	2010	2011
Financial equity capital (per capita)	-7,484	-7,854	-9,106	-9,555	-
Liquid assets per capita (per capita)	4976	4742	3620	3651	3767
Balance, current accounts, tax financed area (per capita)	806	988	291	1,401	-

This approach may be politically convenient, but it postpones rather than solves the problem. Sooner or later investments will be necessary, and liquid assets will be at a minimum. However, if other municipalities reach the breaking point first, this may turn out not to be a problem. When the central government is faced with tough economic problems in municipalities, the implementing agency of the Danish welfare state, it is hard to imagine that tax limitations can be upheld. In other words, tax limitations are not entirely credible in the long run. In this situation, waiting may be a rational strategy. The game of *stick it out to the bitter end* is about waiting until problems in other municipalities have become so severe that the central government has to step in and defuse the tax limitations.

9.7. Conclusion

This paper has taken its part of departure from the – mainly US – literature on TELs. The purpose has been to investigate the empirical domain of this literature. We have found that some of the key insights of the TEL literature seem to apply to the Danish setting, especially the fact that tax limitations may in fact curb the specific taxes they regulate, but still fail to control expenditure. The reason, in the US setting, is often that TELs are not comprehensive, which allows local decision-makers to increase their reliance on other income sources. We have failed to identify this mechanism in the Danish case. At least, revenue reliance is not shifted from local taxes to the three alternative revenue sources we have investigated. An obvious point for future research is to investigate in more detail the potential for revenue shifting in the Danish context.

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Appendix: Explanation of variables used in regression analyses

Variable	Definition in local budgets/accounts	Source
Dependent variables:		
Annual change in budgeted current and capital expenditure (excl. utilities) in 1,000 DKK per cap. (D.bdau)	Expenditure on main accounts 0-6 (excl. main account 1), dranst 1 and 3	www.statistikbanken.dk
Annual change in income tax rate in percentage points (D.upct)	Tax rate is measured in percent of income	www.noegletal.dk
Annual change in general property tax rate in per mil points(D.gpro)	Tax rate is measured in per mil of property values.	www.noegletal.dk
Budgeted capital income (excl. utilities) in 1,000 DKK per cap. (ai)	Income on main accounts 0-6 (excl. main account 1), dranst 3	www.statistikbanken.dk
Budgeted annual change in current income (excl. utilities) in 1,000 DKK per cap. (D.di)	Income on main accounts 0-6 (excl. main account 1), dranst 1	www.statistikbanken.dk
Budgeted net loans in 1,000 DKK per cap. (laan)	Net amounts on account 8.55.00, dranst 6 and 7	www.statistikbanken.dk
Independent variables:		
Aar2009; Aar 2010; Aar 2011	Year dummies	-
Allotted share of tax pool (tildeltp)	Dummy (1=allotted share in tax pool in 2010 or 2011)	Ministry of the Interior
Annual change in tax base in 1,000 DKK per cap. (D.bs)	Weighted measure of budgeted personal income and property values	www.noegletal.dk
Balance, current accounts, tax financed area in 1,000 DKK per cap. [*skattefinansieret driftsresultat*] (drres_r)	Income from taxes, grants and interest minus net expenditure on main accounts 1-6 (excl. main account 1), dranst 1 and 2	www.krevi.dk
Financial equity capital in 1,000 DKK [*finansiel egenkapital*] (ekap_r)	Short and long-term financial assets (net of liabilities)	www.krevi.dk
Annual change in expenditure need as defined in equalization system in 1,000 DKK per cap.	Index of demographic and socioeconomic indicators	www.noegletal.dk

(D.ub)		
Municipality amalgamated in 2007 (ny_kommu)	Dummy (1=municipality amalgamated in 2007 local government reform)	http://www.kmdvalg.dk/kv/2005/adk.htm
Party ideology (borgmest)	Dummy (1=socialist mayor)	http://www.danskekommuner.dk/Borgmesterfakta/
Population size in 1,000 (bef)	No. of inhabitants	www.noegletal.dk
Population density in 1,000 (beftat)	Inhabitants divided by area in km2	www.noegletal.dk
Entitled to tax increase ("safe passage")	Dummy (1=legal entitlement to increase lowered taxes, cf. act 477/2008)	Ministry of the Interior and Health

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Balance between Decentralization and Merit