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LOCAL TAXATION

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debate at the Storting that the wish was to follow the development of municipal charges closely and combine these with property tax with a view to all the taxes and charges on housing not having to increase.

Norwegian Economic National Report

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1 Introduction

The Norwegian local public sector consists of 434 municipalities and 19 counties. As in the other Nordic countries, the local public sector is an important provider of welfare services like kindergartens, education (from primary education to high-schools), primary health-care and care for the elderly. Other important tasks are roads, public transportation, infrastructure, culture and economic development. From January 1 2002 the responsibility for hospitals was moved from the counties to the national government.

The purpose of the paper is to provide an overview of local tax financing of the local public sector in Norway, including recent changes and proposed reforms. The proceeding Section 2 gives a summary of present system. The next three sections discuss the corporate income tax and the personal income tax (Section 3), local tax discretion (Section 4), and property tax (Section 5). Finally, Section 6 offers some concluding remarks.

2 The tax financing of municipal and county governments

Table 1 provides an overview of the financing of the local public sector. Total revenue was slightly above 200 billion NOK in 2003, which amounts to 16 percent of mainland GDP. Local taxes are the most important revenue source and accounts for nearly 50 percent of the revenue. The other main revenue sources are grants and user charges.

Local taxation in Norway is based on the following four tax bases:

- Income tax (individuals)
- Wealth tax (individuals)
- Property tax (individuals and businesses)
- Natural resource tax (power companies)

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Table 1 Sources of revenue, billion Norwegian kroner (NOK) and percentage of total revenue, 2003

	Billion NOK	Percentage of total revenue
Local taxes	97.1	48.1
Grants	71.1	35.2
User charges	30.8	15.2
Other	3.0	1.5
Total	202.0	100.0

Source: National accounts, Statistics Norway

The base for the local income tax is so called general income (alminnelig inntekt), which is labor income, pensions and capital income less allowances. Since 1992 general income is taxed at flat rate of 28 percent and the revenue is shared between the municipalities, the counties and the central government.[1] The tax rate for each government tier is decided annually by the Parliament. The 2004 tax rates are respectively 13 percent (municipalities), 3.24 percent (counties) and 11.76 percent (the central government).[2]

Wealth tax is levied at the municipal and the central government level. The tax base is net wealth less a standard basic deduction. The municipal part of the wealth tax has a flat rate of 0.7 percent, whereas the central government wealth tax has a more progressive rate structure.

Property tax is levied at the municipal level only and comprises both residential and business property. The tax is not available to all municipalities since it is restricted to urban areas and certain facilities (verker og bruk). The law does not provide a definition of these certain facilities, but in practice they are defined as larger works used for production of goods or maintenance. Property tax can be levied on certain facilities without taxing all property in urban areas. Around 230 municipalities (53 percent) levy property tax. Among these 119 levy property tax on certain facilities only, while the remaining 111 tax business and residential property in urban areas as well as certain facilities (Sauar 2003).

Municipal and county governments receive natural resource tax from power companies. The base for the tax is power production above a specified minimum level. The municipal governments receive 0.011 NOK per kWh and the county governments 0.002 NOK per kWh.

1 In the tax system there is a second income tax base, personal income, which is a gross income tax base comprising labor income, income from self employment and fringe benefits. The tax on personal income is highly progressive and is received by the central government.

2 In the most northern part of Norway the central government tax rate is 8.26 percent and the total tax on general income is 25 percent.

Table 2 The composition of the local tax base, billion NOK and percentage of total tax revenue, 2003

	Municipal governments		County governments	
	Billion NOK	Percentage	Billion NOK	Percentage
Income tax[a]	70.5	88.3	16.6	98.8
Wealth tax[a]	4.9	6.2		
Property tax	3.2	4.0		
Natural resource tax	1.2	1.5	0.2	1.2
Total	79.8	100.0	16.8	100.0

[a] The separation between income and wealth tax for the municipalities is based on calculations.

Source: Tax accounts, Statistics Norway

Table 2 reports the revenues from the different tax bases in 2003. As in the other Nordic countries, income tax from individuals is the most important local tax. It amounts to 88 percent of municipal taxes and 99 percent of county taxes. Other taxes constitute a small share of aggregate local tax revenue, but property tax and the natural resource tax are important revenue sources for individual municipalities. The most prosperous municipalities are small rural communities with waterfalls, where property tax and natural resource tax from power companies make up substantial amounts per capita.

Tax discretion

Formally municipal and county governments have substantial tax discretion. The municipalities can choose tax rate within an interval for the income tax, the wealth tax and the property tax. In 2004 they can choose an income tax rate between 9.4 and 13 percent, a wealth tax rate between 0.4 and 0.7 percent, and a property tax rate between 0.2 and 0.7 percent.[3] However, during the last 25 years all municipalities have applied the maximum rates in income and wealth taxation, and in practice tax discretion is limited to the property tax. The municipalities can also influence their revenues through user charges.

County governments enjoy the same formal tax discretion in the income tax as the municipalities. In 2004 they can choose a tax rate between 0 and 3.24 percent. Since the introduction of a separate county tax in 1977, they have all applied the maximum rates. Income tax, wealth tax and natural resource tax can be denoted regulated taxes as there is no variation in the tax rates.

3 In addition they can choose whether to have the property tax or not.

Tax equalization

There is substantial variation in tax revenues across municipalities and across counties. These differences are equalized through tax equalization, which is a part of the block grant system. The tax equalization is based on regulated tax revenue per capita, i.e. income, wealth and natural resource tax for the municipalities and income tax and natural resource tax for the county governments, and do not include the property tax. The tax equalization can be based on tax revenues rather than the tax base because all local governments use the maximum rates.

Municipalities with tax revenue below 110 percent of the average receive a grant that equals 90 percent of the difference between 110 percent of the average and own tax revenue. In addition, half the tax revenue above 134 percent of the average is withdrawn to the state. The tax equalization for the county governments is similar. The differences are that reference level is 120 percent of the average instead of 110 percent, and that there is no state withdrawal of high tax revenues.

In 2003 390 (or 90 percent) of the municipalities received tax equalization grant, whereas the state withdrawal of high tax revenue comprised 16 municipalities. All but one county government received tax equalization grant.

3 The corporate income tax and the personal income tax

The local tax financing in Norway was changed in important respects in the late 1990s. The background was a government expert commission set up to evaluate the financing of the local public sector and to propose reforms (NOU 1996: 1 and NOU 1997: 8). The commission explicitly evaluated local taxes according to the following four criteria derived from the economics literature on tax assignment:

- The principle of residence and benefit taxation
- Low mobility
- Even distribution
- Stability over the business cycles

The abolition and reintroduction of a local corporate income tax

The commission's most controversial proposal was to abolish the corporate income tax as a local tax based on the argument that it did not meet the criteria for good local taxes. First, the corporate income tax was very unevenly distributed between local governments. The max-min ratio was 20:1 across the municipalities and 8:1 across the counties. Second, the corporate income tax was strongly procyclical. It was referred to the booming year 1995 where the aggregate corporate income tax base grew by 21 percent, more than three times the growth of the personal income tax base. At the local level the corporate income tax was even more volatile, mainly because industry is less diversified at the local level. Third, the mobile corporate income tax base encouraged tax competition. The opponents of the proposal argued that the corporate income tax was important in order to give municipalities and counties proper incentives to promote economic development, an argument that also was acknowledged by the commission.

Although the proposal was controversial politically, the parliament decided to abolish the corporate income tax as a local tax from 1999. From 2005 the municipalities will again receive corporate income tax. In the new tax a fraction (that may vary from year to year) of the corporate income tax is reserved for the municipalities. For companies with activity in several municipalities the tax is distributed according to the municipalities' share of the company's employment. In the old tax the distribution was based on a detailed calculation of economic profit in each municipality. The new tax is considered to give a more just distribution of the corporate income tax across municipalities. It also requires less administrative resources, but do otherwise have the same weaknesses.

In order to reduce adverse distributional implications of the reintroduction of a local corporate income tax, the tax equalization for the municipalities is made more ambitious and more symmetric. The symmetric part of the system implies that municipalities with below average tax revenue receive 55 percent compensation (with the average as reference), whereas 55 percent of tax revenues above the average are withdrawn to the state. In addition municipalities with tax below 90 percent of the average will receive an extra 35 percent compensation (with 90 percent of the average as reference).

Why personal income tax?

The personal income tax performs reasonably well according to two of the criteria mentioned above. First, it is quite evenly distributed across local authorities. In Norway, the max-min ratio is around 3:1 across the municipalities and around 2:1 across the counties. Second, it fulfills the residence principle since it is paid to municipalities and counties according to residence.

The main weakness of the personal income tax is its instability over the business cycle. The obvious reason is that labor and capital income is procyclical. In recent years the instability and unpredictability of capital income have received much attention. Realization of capital losses due to falling stock prices has lead to lower tax revenues than projected in 2002 and 2003. The downward adjustment of tax revenues has occurred late in the fiscal year, and it has been difficult for the local governments to adjust spending accordingly. Consequently, the instability

and unpredictability of the income tax has contributed to the weak fiscal performance the recent years.

Although the income tax performs well in terms of the residence principle and even distribution, its role as a major local tax in the Nordic countries is probably best understood in terms of its revenue-raising capacity. The local governments in the Nordic countries are responsible for important welfare services, and as a consequence the local public sector is large (in terms of revenues as share of GDP) compared to most other countries. There has also been a desire to have substantial local financing, which can only be achieved by giving local governments access to tax bases that can generate much revenue. In this context the income tax is an obvious candidate.

Moreover, other taxes that may generate substantial revenue, like VAT or the payroll tax, get a lower score than the income tax on the criteria for good local taxes. The VAT has a more mobile tax base (location of trade centers etc.) and the residence principle is violated due to cross border shopping. The same arguments are relevant for the payroll tax if it is paid to the municipality and county where the employer is located. If it, on the other hand, is paid to the municipality and county where the employee resides, it becomes more similar to the income tax in terms of a local tax. However, because it only includes workers, it has a lower score on the residence principle. Anyway, the regional differentiation of the payroll tax, to stimulate employment in rural areas, makes it unsuitable as a local tax in Norway.

It is argued that the income tax is well suited to achieve substantial tax financing of a large local public sector that is responsible for important welfare services. However, substantial tax financing must be combined with an ambitious tax equalization program to limit differences in service provision. The tax equalization weakens the relationship between the local tax base and local government revenue, and makes the tax financing less real. From a narrow economic perspective that focuses on incentives on the margin (to develop the local tax base), the combination of substantial tax financing and ambitious tax equalization seems unnecessary complicated. The same marginal incentives can be obtained by a combination of less tax financing and a less ambitious tax equalization program. In addition, the macroeconomic control of local government revenue will be improved and the revenue of individual local governments will be more stable.

The narrow economic argument above implicitly assumes that the share of taxes in local government revenue is of little importance. However, in Norway it is widely accepted that the share of taxes in local government revenue is of political importance. Based on the commissions proposal the Parliament has decided to increase the share of taxes in local government revenue to 50 percent. However, there is scope for further investigation of the issue of why and how the tax share is important for local democracy and independence of the central government, and possibly also for economic efficiency.

4 Local tax discretion

If we only consider the tax rules described in Section 2, Norwegian local governments have substantial tax autonomy. The real picture is quite different since all local governments have used the maximum tax rates in income and wealth taxation during the last 25 years. In practice tax discretion is restricted to the municipal property tax.

Why is the discretion in income and wealth taxation not utilized?

Why do we not observe that even a single local government chooses a tax rate below the maximum in income and wealth taxation? One possible explanation is that the local public sector is "underfinanced" (see e.g. Norman 1997), i.e. all local governments have desired tax rate above the maximum. The problem with this argument is that if the local governments were underfinanced, one would expect that they also utilized other revenue sources (property tax and user charges) to the maximum. But they do not. Many municipalities do not use the property tax and have relatively low user charges.

The puzzle is rather why the richest local governments do not reduce their tax rates, and a more reasonable understanding is that the local governments fear that the central government will respond to lower income and wealth tax rates by reducing their grants. A lower tax rate is partly a signal for good economic conditions, and may thereby be a disadvantage in the competition for central government grants. If this explanation is the correct one, increased utilization of the formal tax discretion in the income tax can only be achieved if the central government clarifies the working of the grant system and is able to convince the local governments that the budget constraint is not as soft as they seem to believe.

Possible consequences of more local tax discretion

The main economic argument in favor of local tax discretion is related to the decentralization theorem of Oates (1972): When the local tax rate can adjust to varying spending preferences and cost conditions, a decentralization gain can be achieved compared to a situation with a uniform tax rate decided at the national level.

Borge (2003) provides some tentative calculations of which effects more local tax discretion may have for efficiency (decentralization gains) and service provision. The analysis is based on a median voter model that is calibrated on data for Norwegian municipalities for 1996. The decentralization gain is calculated to nearly 1000 NOK per taxpayer or 3 billion NOK in aggregate. In addition increased local tax autonomy may give a much more equal provision of municipal services. The main driving force is that small, rural communities (with high levels of ser-

vice provision and low private disposable income within the present system) are predicted to reduce their tax rates, whereas larger, urban communities (with relatively low levels of service provision) are expected to increase their tax rates.

In a median voter model tax limits will always be associated with allocative efficiency losses. However, a major argument for imposing such limits is that the median voter model may not be the correct description of the workings of local democracy (e.g. McGuire 1999). To deal with this issue Borge analyzes how the decentralization gain is modified when he allows for overspending and X-inefficiency. The calculations indicate that the net gain is close to zero if tax discretion is combined with overspending of 15 percent or X-inefficiency of 3 percent.

The use of property tax and user charges

Given that the discretion of income and wealth taxation is not utilized, it is of great interest to analyze how the remaining instruments to influence current revenues, property tax and user charges, are applied. A central issue is how property tax and user charges are affected by other revenue sources, mainly block grants and regulated taxes. Property tax and user charges are fiscally motivated if they tend to increase when other sources of revenue become more restricted, and also if they respond positively to the costs of serving the municipal debt. Several empirical analyses (Borge 1995, Hanssen and Pettersen 1995, Spjøtvoll 1995, Follestad 1999, Klungerbo 1999, Borge 2000, Borge and Rattsø 2004) document that this is the case. Many of the studies also find significant effects of political institutions. Both a fragmented local council and a high share of socialists contribute to higher property tax and user charges.

5 The property tax

Both the property tax commission (NOU 1996: 20) and the recent tax commission (NOU 2003: 9) have recommended major changes in the property tax law. A major proposal by the property tax commission was to propose a general property tax that includes all property, not only property in urban areas and certain facilities. The tax commission had a broader mandate and could see the property tax in relation to the wealth tax and the tax on the imputed rent on housing. The commission considered increased property tax as a mean to get taxation of housing more in line with the taxation of other types of capital.

The present property tax does not generate much revenue, only 4 percent of municipal taxes or 0.25 percent of mainland GDP. These figures are low compared to many other countries, partly because Norway has a relatively high wealth tax. From 2005 the imputed rent tax will be eliminated and the wealth tax will be reduced. These changes in the tax system lay the ground for an extended municipal property tax with tax discretion for all municipalities. Based on the international experience, an extended property tax could amount to about 3 percent of GDP. A property tax of this order would be a substantial tax for the municipalities as it would amount to nearly 40 billion NOK or 50 percent of municipal taxes.

6 Concluding remarks

The paper has discussed the tax financing of Norwegian municipal and county governments, including recent changes and proposed reforms. The local tax financing in Norway is similar to the systems in the other Nordic countries in the sense that taxes make up a substantial part of total revenue, the personal income tax is the dominating local tax, and there is ambitious tax equalization. The main difference is that local tax discretion (in practice) is more limited in Norway.

Three commissions (the property tax commission, the local public finance commission and the tax commission) have argued for the introduction of a more general and extended property tax with municipal tax discretion, and proposed reforms in the tax system (lower wealth tax and elimination of the tax on imputed rent on housing) that give room for an extended property tax. However, the general resistance towards taxation of housing may obstruct an economically sound reform of the tax system and the financing of the municipalities.

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Swedish Legal National Report

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The historical framework

1862 ...

Modern local taxation in Sweden started in March 1862 when comprehensive legislation on local government was promulgated by the King and his government. This legislation was a package of three acts which was adopted together by the Swedish parliament, the Riksdag. One of the acts regulated local government in the rural areas of Sweden, another local government in its towns and a third local government in its regions. All three of them entered into force at the beginning of the year 1863.[1] The core part of each of the three acts were provisions on the fundamentals of local government: on basic organisational structures and decision making processes, on matters which local government had to take care of and on the financing of local government. This last part, the provisions on the financing of local government became the point of departure for the development of local taxation in Sweden as it is known today.

The financial concept of 1862 was quite simple: The local or regional entity had to make up a yearly budget which included estimated expenditure and necessary revenue to cover the expenditure. Local taxes were to be the main source of revenue and would be collected locally. The taxes were to be assessed on the same base as three (well established) state taxes by application of the relevant provisions of the Budget Act in force, which for the year 1863 was the Budget Act 1862.[2] The taxes in question were the three – separately assessed and levied – income taxes on immovable property (bevillning av fast egendom), on interests, business profits and independent personal services (bevillning av inkomst av kapital) and on dependent personal services (bevillning av inkomst av arbete).

It is important to note the constitutional context in which the three acts on lo-

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1 Förordning (1862:13) om kommunalstyrelse på landet, förordning (1862:14) om kommunalstyrelse i stad, and förordning (1862:16) om landsting. – The local structure of the Swedish state church was reorganised at the same time following basically the same concept; cf. the three acts of the Riksdag, förordning (1862:15) om kyrkostämma samt kyrkoråd och skolråd, förordning (1863:58) om kyrkostämma samt kyrkoråd och skolråd i Stockholm and förordning (1863:64 s. 3) angående allmänt kyrkomöte.

2 Bevillningsförordning 1862 as published by kungörelse (1861:34) angående den av Rikets Ständer vid åren 1859–1860 års riksdag åtagna bevillning. It was soon after replaced by the Budget Act 1864, i.e. bevillningsstadga 1864 as published by kungörelse (1864:3) angående den av Rikets Ständer vid 1862–1863 års lagtima riksdag åtagna bevillning.