Chapter 7

Taxonomy of grants and local taxes: The Norwegian case

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The chapter discusses a taxonomy of grants and local taxes based on the Norwegian institutional context. A main issue is whether the major local tax, the personal income tax, should be classified as a tax with local discretion or a tax sharing arrangement. Although local governments can formally set tax rates below the upper limit, it would give a more correct picture of the Norwegian system if the local income tax was classified as a tax sharing arrangement. The taxonomy of grants is less problematic, but some earmarked grants constitute a grey zone in the sense that they work as non-earmarked grants. In addition, the VAT compensation scheme should be classified as a non-earmarked grant.

* I am grateful for discussions at the workshop on "Taxonomy of grants and measurement of decentralisation" at the OECD in Paris 10-11 March 2011, and in particular for comments by Niels Jørgen Mau Pedersen.

Introduction

The organisation and financing of sub-central governments is often seen as important for efficiency, distribution and growth. Many studies rely on cross-country variation in fiscal decentralisation to identify the effects of different federal systems. The quality of such empirical studies is highly dependent on the quality of the data describing fiscal decentralisation. Indicators of fiscal decentralisation are regularly published by international organisations such as the IMF, the OECD and the Council of Europe. Much effort is devoted to the development of common definitions and taxonomies to make the indicators comparable across countries.

The purpose of this chapter is to discuss the taxonomy of local taxes and intergovernmental grants using the Norwegian system as reference. Norway is an example of a Nordic welfare state where local governments are responsible for major welfare services. Section 2 provides an overview of the present organisation and financing of the local public sector. Tax financing and grant systems are discussed more thoroughly in sections 3 and 4 as a basis for an evaluation of the current taxonomy.[1] Indicators of revenue decentralisation and local autonomy that are used in the Norwegian setting are presented in section 5. Section 6 makes a general remark on indicators describing incentives for local development policy. Finally, section 7 provides concluding remarks.

The local public sector in Norway

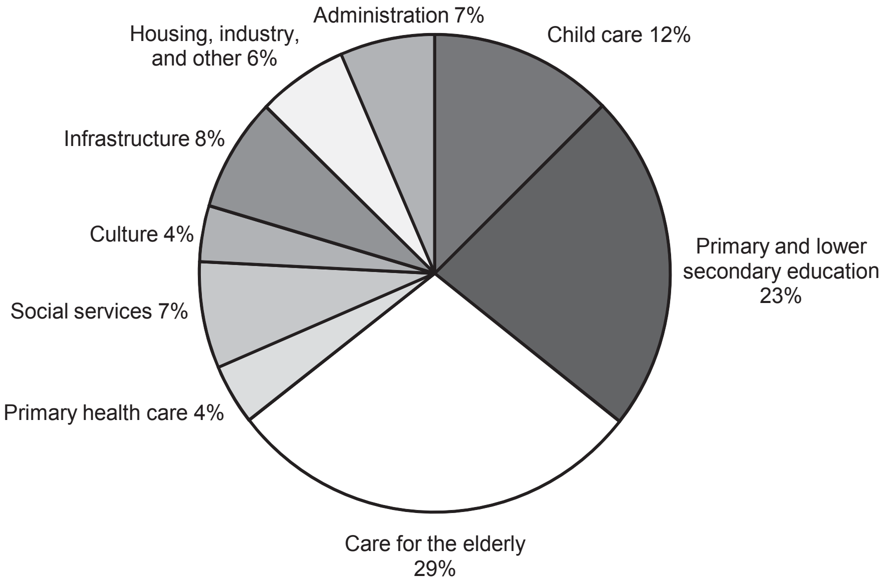
Norway is quite large in terms of area, but small in terms of population. By January 2011 the population size was 4.9 million. The public sector is divided in three tiers: the central government, the county governments, and the municipal governments. The 19 counties and the 430 municipalities constitute the local public sector.[2] The municipalities and the counties have the same administrative status, whereas the central government has the overriding authority. Both municipalities and counties are mainly financed by taxes and grants from the central government. As in the other Nordic countries, the local public sector is an important provider of welfare services. The sector accounts for nearly 50% of government consumption and their revenues make up nearly 20% of (mainland) GDP. Close to 20% of the workforce is employed in the local public sector.

The responsibilities of municipalities and counties are based on the so-called generalist local authority system. This means that all municipalities and all counties have to fulfil the same functions regardless of size. In terms of revenues and expenditure the competencies of the municipalities are much larger than the competence of the counties. This was also the case before the responsibility for hospitals was moved from the counties to the national government in 2002. In terms of revenues the municipal level is now around three times as large as the county level.

Figure 7.1 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 expenditure. 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 centres, 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% of the budget. They can broadly be categorised as culture (libraries, cinemas, sports facilities, etc.), infrastructure (roads, water, sewage and garbage collection), and planning (including land use planning), industry and housing.

Figure 7.1. **Municipal service sector spending**

Per cent of current expenditures, 2010

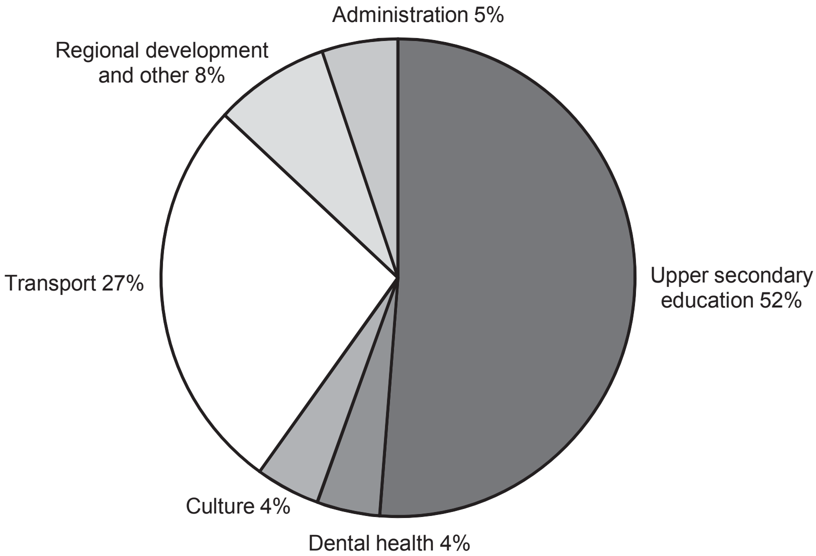


Note: The capital Oslo, which is both a municipality and a county, is excluded.

Source: Statistics Norway, Local Government Accounts.

Figure 7.2. **County service sectors**

Per cent of current expenditures, 2010



Note: The capital Oslo, which is both a municipality and a county, is excluded.

Source: Statistics Norway, Local Government Accounts.

The main responsibilities of the counties are shown in Figure 7.2. After the national government took over the responsibility for the hospitals in 2002, upper secondary education (general and vocational) is the largest task for the counties. It amounts to around half of the total budget. The second largest service sector is transport (roads and public transport), which accounts for a quarter 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% of county expenditure. However, if we consider county spending on transport as part of the national infrastructure, this share increases to more than 80%.

Total local government revenue amounts to nearly 20% of GDP, and Table 7.1 gives an overview of the major revenue sources. Local revenues (taxes and user charges) amount to a bit more than 50% of total revenues, while grants from the central government account for a bit more than 40%. 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 for 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 in primary and secondary education.

Table 7.1. **The financing of the local public sector**

Per cent of total revenues, 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 dividends	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 receipts for the counties include revenues from toll roads.

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

Local tax financing

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)

The base for the local income tax is general income (*alminnelig inntekt*), which is labour income, pensions and capital income less allowances. Since the 1992 tax reform general income is taxed at a flat rate (28%) and the revenue is shared between the municipalities, the counties and the central government.[3] The tax rate for each government tier is decided annually by the Parliament. The 2011 tax rates are respectively 11.3% (municipalities), 2.65% (counties) and 14.05% (the central government).[4] Formally the municipal and county tax rates are maximum rates, and the local councils can in principle set a lower rate.[5] However, during the past 30 years, there has been no deviation from the maximum.

Wealth tax is levied at the municipal and the central government level. The tax base is net wealth above NOK 700 000 (EUR 90 000). The municipal part of the wealth tax has a flat rate of 0.7%, whereas the central government tax rate is 0.4%. As for the income tax the municipal councils can set a tax rate below 0.7%, but this discretion has not been used.

Property tax is levied at the municipal level only and comprises both residential and business property. Before 2007, the property tax was restricted to urban areas and certain facilities (notably hydroelectric power plants),[6] and was in practice not available for all municipalities. The law did not provide any precise definition of urban areas, and several municipalities were taken to court by property owners arguing that their property was not located in an urban area. In 2006, the Property Tax Law was changed to avoid confusion and to increase fairness among tax payers, and since 2007 the property tax can also be levied in rural (non-urban) areas. The change led to increased use of the property tax in rural municipalities. In particular, it became more attractive for municipalities with cottages to introduce a property tax or to extend it to also include non-urban areas.[7] Property taxation of cottages is a prime example of tax exporting, and cottage owners have heavily opposed the introduction of a “cottage” tax. In 2010, a total of 309 municipalities (72%) used the property tax. Among these, 129 taxed certain facilities only. Residential property tax is levied in 170 municipalities, and in a majority of these (145) it applies to both urban and rural areas. The property tax rate may vary between 0.2 and 0.7%.

Municipal and county governments receive the natural resource tax, which is levied on 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.

Table 7.2. **The composition of the local tax base**

Billion NOK and percentage of total tax revenue, 2010

	Municipalities		Counties	
	NOK billion	Percentage	NOK billion	Percentage
Income tax	107.7	87.7	22.3	99.1
Wealth tax	6.7	5.5		
Property tax	7.1	5.8		
Natural resource tax	1.3	1.1	0.2	0.9
Total	122.8	100.0	22.5	100.0

Note: The separation between income and wealth tax for the municipalities is based on own calculations.

Source: Statistics Norway and Ministry of Local Government and Regional Development.

Table 7.2 reports the revenue from the different tax bases in 2010. As in the other Nordic countries, income tax from individuals is the most important local tax. It amounts to 88% of municipal taxes and 99% of county taxes. Although other taxes constitute only a small share of aggregate local tax revenue, the property and natural resource tax are important revenue sources for the municipalities. The most prosperous municipalities are small rural communities with waterfalls, where the property and natural resource tax from power companies make up substantial amounts per capita.

A key concept when classifying local taxes is tax autonomy or the freedom that sub-central governments have over their own taxes. According to Blöchliger and Rabesona (2009), the term tax autonomy encompasses sub-central government's right to introduce or abolish a tax, to set tax rates, to define the tax base or to grant tax allowances or reliefs to individuals and firms. It is obvious from the above discussion that the degree of tax autonomy varies sharply across the different local taxes in Norway.

The municipal property tax is the local tax with the highest degree of tax autonomy. The tax administration is local and as discussed above the municipalities can choose whether to tax property or not, the type of property to be taxed (certain facilities only or a more general property tax), and whether the tax should be restricted to urban areas or not. If the property tax is introduced, it is the responsibility of the municipality to assess property values and to set the tax rate (within an interval). The municipality can decide whether to have a basic deduction for residential property (to make the tax less regressive or more progressive) or not, as well as the size of the basic deduction. New residential property can be exempt from the property tax for a period of time, and this is also a municipal decision. However, the municipalities cannot give tax reliefs on an individual basis, for instance, to attract businesses or to reduce the tax burden for low income households.

At the other end of the scale we find the natural resource tax. For this tax both the base (hydroelectric power production) and the rate (NOK per kWh) is solely determined by the central government, and municipalities and counties have no influence at all. Nevertheless, it is obviously a local tax since the revenue for each local authority is calculated on the basis of power production within its borders. Since the tax is not shared with the central government, it is not a tax sharing arrangement. The split between municipalities and counties have been stable over time.

The income tax (municipalities and counties) and the wealth tax (municipalities) is somewhere in between the municipal property tax and the natural resource tax with respect to tax autonomy. The local income and wealth taxes are similar to the natural resource tax in the sense that they are parts of the national tax system. The tax bases are defined by national legislation and are calculated by a central government agency without any influence from local governments. On the other hand, the degree of tax autonomy is higher in income and wealth taxation since the local governments can set tax rates below the maximum rate. The discretion to set income and wealth tax rates is identical to the discretion in the municipal property tax. Nevertheless, tax autonomy is lower for income and wealth taxation since the centralised tax administration leaves no room for local influence over assessment, deductions, exemptions, etc.

It is uncontroversial to conclude that local income and wealth taxes fall somewhere between the municipal property tax and the natural resource tax. A more interesting issue is whether they come close to the property tax or close to the natural resource tax. The answer depends on whether one emphasises the formal rules or the working of the system.

The formal rules are easy to interpret. The annual decisions at the central level do only specify the maximum tax rates and there is nothing that prevents the local governments from setting lower rates. And since there is no lower limit, local governments even have the opportunity to abolish local taxation of income and/or wealth.

A formalistic approach therefore leads to the conclusion that the local governments have discretion to set their own tax rates on income and wealth and that these taxes come close to the municipal property tax in terms of tax autonomy. The main difference is that income and wealth taxes are administered centrally, while the property tax is administered locally.

The formalistic approach may be challenged by historical developments and the working of the system. After WW II the building of the welfare state was combined with local responsibility for welfare services like education and health care. A large variation in local income tax rates was considered to be in conflict with the aim of equalised provision of welfare services throughout the country, and as a consequence the difference between the upper and lower limits was gradually reduced. In addition local governments with tax rates below the maximum were "punished" by lower grants.[8] By 1970 only five local governments deviated from the maximum income tax rate, and in 1979 the last local government gave in. Since then there has not been a single deviation from the upper limit. The upper limit in the income tax was stable during the 1980s, but has since the early 1990s been adjusted nearly every year. The upper limit is an important tool for the central government to achieve a balanced growth in taxes and block grants. An unbalanced growth in taxes and block grants would have important distributional consequences since taxes as a share of total revenues vary substantially across local governments.[9]

The working of local income and wealth taxation during the last three decades resembles a tax sharing arrangement where the split is determined annually by the central government. This view is also underpinned by other observations. Local political discussions about taxation are limited to the property tax, while discussions about income and wealth tax rates are extremely rare (or do not take place at all). Moreover, the local councils do not need to vote on income and wealth tax rates. If they do not make a vote, the upper limit binds by default.

No matter how income and wealth taxes are classified, it is an interesting question why tax discretion is not used. Why do we not observe that even a single local government chooses a tax rate below the upper limit on income and wealth taxation? A popular explanation by some Norwegian observers is that the local public sector is "underfinanced", *i.e.* all local governments have a desired tax rate above the upper limit. The problem with this explanation is that it is hard to reconcile with the large variation in revenues, service provision and utilisation of other revenue sources (property tax and user charges). Another explanation is that the local governments fear that they will be "punished" by lower grants if they set income or wealth tax rates below the upper limit. This explanation is not water proof either since the grant system is to a large extent based on objective criteria, but it may be rescued by the fact that some grants are distributed on the basis of judgments or negotiations. In the longer term also the objective criteria and the rules of the grant system may be changed to the disadvantage of local governments with tax rates below the upper limit.

In OECD publications (*e.g.* Blöchliger and Rabesona 2009), local income and wealth taxes in Norway are classified as taxes with local tax discretion. This means that the OECD classification emphasises the formal rules.[10] I would rather emphasise the working of the system and classify local income and wealth taxes as tax sharing arrangements. An advantage of this classification is that the tax autonomy of Norwegian local governments will stand out as lower than in the neighbouring countries Denmark and Sweden. Although Sweden had a tax freeze in the early 1990s and Blom-Hansen (chapter 8) argues that local tax discretion in Denmark was *de facto* abolished since the municipal reform of 2007, the (informal) restrictions on local tax discretion are a more permanent feature of the Norwegian system. On the other hand, I agree with OECD (Blöchliger and Petzold, 2009) that local income and wealth taxes in Norway should not be classified as intergovernmental grants. The main arguments are that the tax revenues are locally generated and that the development of the local tax base affects the total revenue of local governments (tax equalisation is partial).

Taxonomy of grants

In the Norwegian context three types of grants are usually distinguished:

- The general purpose grant scheme
- Earmarked grants within the ordinary budget
- Earmarked grants outside the ordinary budget

Earmarked grants outside the ordinary budget are grants related to refugees and labour market policies. These grants vary substantially from year to year and are not taken into account in the "official" calculations of revenue growth by central government ministries. In 2011, the general purpose grant scheme accounted for 73% of total grants, earmarked grants within the ordinary budget for 18% and earmarked grants outside the ordinary budget for 9%.

The general purpose grant scheme

The general purpose grant scheme introduced in 1986 has three main purposes:

- Equalise the economic opportunities across local governments;
- Promote regional policy goals; and
- Transfer resources to the local public sector.

Equalisation is achieved through tax equalisation and spending needs equalisation. The role of the tax equalisation scheme is to reduce the differences in per capita revenue due to differences in tax bases. The present tax equalisation scheme for the municipalities consists of a symmetric part with a compensation rate of 60%. This means that municipalities with tax revenues (per capita) below average are compensated for 60% of the difference and that 60% of tax revenues above the average is withdrawn by the state. In addition, there is an extra 35% compensation for municipalities with tax revenues below 90% of the average. As an example, a municipality with a tax base of 80% of the average first receives 60% of the difference between 80 and 100% from the symmetric part. In addition, this municipality receives 35% of the difference between 80 and 90%. It is also important to notice that tax equalisation only applies to the income tax, the wealth tax and the natural resource tax,[11] while the property tax is not taken into account. The tax equalisation scheme for the counties implies that counties with tax revenues below 120% of the average are compensated for 90% of the difference.

Spending needs equalisation is in place because equalisation of per capita revenues is insufficient to equalise difference in the cost of service provision. Local governments have different cost conditions due to differences in population size and settlement patterns. The age composition of the population affects the demand for important services like child care, education and care for the elderly. And social criteria like the unemployment and divorce rate influence expenditure on social services like social assistance and child custody. The spending needs equalisation scheme hence compensates local governments with unfavourable cost conditions. Spending needs equalisation also covers so-called national welfare services. The spending needs equalisation for the municipalities include child care, primary and lower secondary education, primary health care, care for the elderly, child welfare, social assistance and administration. For the counties, upper secondary education, dental health and transport are included in the spending needs equalisation. Spending needs equalisation is arranged as a pure redistribution between municipalities and between counties. This means that transfers to local governments with needs (per capita) above average are financed by contributions from local governments with spending needs below average.

The equalising grants are largely self-financing and can be carried out without large net transfers from the central government to the local public sector. The spending needs equalisation and the symmetric part of the tax equalisation for the municipalities are completely self-financing. Only the tax equalisation for the counties and the extra tax equalisation for municipalities with a tax base below 90% of the average are financed by the central government. Actually, more than 90% of total block grants are distributed through the so-called per capita grant. The role of the per capita grant is to transfer resources to the local public sector (close the vertical fiscal gap) without distributional implications.

While tax and spending needs equalisation promotes equality of service provision, the regional policy grants create differences. The design of the regional policy grants has changed over time, but during the 1990s they were separated out as specific grants and their regional policy purpose was clarified. The justification of the grants is that rural and northern local governments should be able to provide better services than the rest in order to promote employment and population growth. The regional policy grants are not in any way earmarked for narrowly defined regional development purposes and can, for instance, be spent on welfare services. The grants are now called Grant for Small Municipalities (for municipalities with less than 3 200 inhabitants), Regional Grant Southern Norway (for rural municipalities in Southern Norway with populations below 3 200) and the Northern Norway Grant (for municipal and county governments in the northern part of the country). A requirement for receiving the Grant for Small Municipalities and the Regional Grant Southern Norway is that per capita tax revenue has been below 120% of the average for the last three years. The Northern Norway Grant is paid out as a flat amount per capita (mainly differentiated by county), the Grant for Small Municipalities as a fixed amount per municipality (differentiated by regional policy zone) and the Regional Grant Southern Norway as a mix of a flat amount per capita and a fixed amount per municipality (both differentiated by regional policy zone).

The regional policy grants are major sources of differences in fiscal capacity and service provision. It is not obvious that providing grants to municipalities and counties is the most efficient way of stimulating economic development in rural areas. Other means like direct support or tax reductions for businesses or individuals could be more efficient.[12] And if so, one could achieve a better regional policy and less variation in fiscal capacity by reducing the role of regional grants to local governments. Unfortunately, there is limited knowledge about the effectiveness of regional policy grants, but a study by Berg and Rattsø (2009) indicates the effect on population size is modest.

In addition to the grants described above, general purpose grants consist of a specific grant for fast growing municipalities, a grant to limit reductions in a total block grant from year to year, a merger grant to stimulate consolidation of municipalities and a judgment grant. The judgment grant takes account of specific local conditions not captured by the objective criteria, and also fiscal distress.

Do the grants in the general purpose grant scheme comply with the definition of general purpose grants as defined by the OECD? In OECD (2002, p. 15) a general purpose grant is defined as a grant that is distributed according to objective criteria (and possibly also own tax effort) and that can be used as if it was the receiving sub-national government's own tax revenue. It is clear from the above discussion that all grants in the Norwegian general purpose grant scheme can be used as if they were local tax revenue. With the exception for the judgment grant, they are all distributed according to objective criteria.

Bergvall *et al*. (2006, p. 118) make a distinction between general purpose grants and block grants, which both are classified as non-earmarked grants. A block grant is given for a specific purpose, but since it is not earmarked the use of the grant is not subject to control. The example they provide is a grant to cover all or part of the cost for certain services and where the distribution is based on objective criteria capturing normative costs or spending needs. The purpose is often to improve efficiency since a local government that is able to provide the service at lower than normative costs is not "punished" by lower grants. Before 1994, the spending needs equalisation consisted of grants related to each major service sector (education, health care, etc). These grants were probably better characterised as block grants than general purpose grants. Since 1994, expenditure needs equalisation is handled through single grants that are best characterised as general purpose grants.[13]

Earmarked grants

All grants that are not included in the general purpose grant scheme are labelled earmarked grants. They are conditional in the sense that they must be spent on a specific spending program or a specific purpose and are granted by the corresponding central government ministry. Guidelines for the use of earmarking (Lilleschulstad, 2010) state that earmarking could be used to promote new services or expansion of existing services, for services that are provided only by a few local governments, or to compensate for spending needs that are difficult to capture through objective criteria.

There are a large number of earmarked grants (50-60) and with large variations in design. The menu includes matching grants that affect relative prices, grants distributed on the basis of objective criteria, as well as application procedures with central government discretion. Rather than going into the details of each and every earmarked grant, I will focus on a few grants to illustrate cases where the effect of the earmarking can be questioned.

The first example is an earmarked grant that provides compensation for interest expenses related to investment in school buildings.[14] The point of departure for the grant is an investment frame for each local government determined by the number of pupils, *i.e.* the number of inhabitants 6-15 years for the municipalities (primary and lower secondary education) and the number of inhabitants 16-18 years for the counties (upper secondary education). The investment frame applies for investments during the 8-year period 2009-16. The maximum grant for each local government is the interest expenses related to a loan corresponding to the investment frame. This is an example of a closed-ended matching grant that will work as a non-earmarked grant if the investment frame is lower than the investment that would have been undertaken anyway. The aggregate investment frame is NOK 15 billion (EUR 1.9 billion). As a comparison, the capital Oslo (comprising 12% of the population), spent NOK 9 billion on investment in school buildings during the 9-year period 1997-2005. The earmarked compensation for interest expenses is therefore unlikely to affect local government priorities compared to a situation where the same amount was given as a non-earmarked grant.

Another example is a grant to county governments for regional development. The grant is distributed partly on the basis of objective criteria and partly by discretion. There are not very detailed guidelines on how to spend the grant and the counties are mainly evaluated according to results. The grant amounts to less than 50% of county spending on regional development and is therefore unlikely to affect priorities.

The grants for interest compensation and regional development are examples of grants that constitute a "grey zone" between earmarked and non-earmarked grants. They are earmarked in the sense that they must be spent on a specific service or for a specific purpose, but they more or less work as non-earmarked grants (general purpose grants or block grants). However, it is reasonable and also in line with OECD definitions (OECD, 2002, Bergvall *et al*., 2006) to classify them as earmarked.[15] They do not comply with the definition of general purpose grants (cannot be used as if they were tax revenue) or block grants (will be reduced if spending becomes sufficiently low). The distinction between matching and non-matching earmarked grants can be understood as an attempt to separate between earmarked grants that affect local priorities and earmarked grants that do not. However, the correspondence will not be perfect. I guess the grant for interest compensation is classified as a matching grant, while the grant for regional development is classified as a non-matching grant. In general there are two sources that contribute to the imperfect correspondence: *i)* closed-ended matching grants that do not affect local priorities will be classified as matching, *ii)* and grants of the non-matching type may affect local priorities if they are in relation to the service or activity they are earmarked for.[16]

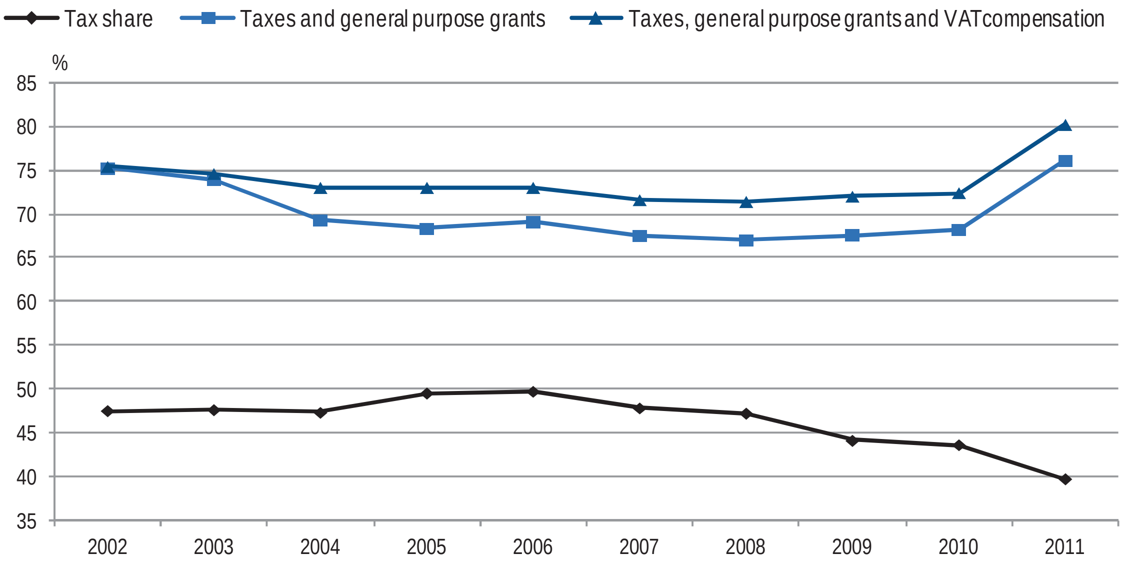
A general VAT compensation for local governments was introduced in 2004. The background was the introduction of VAT on services in 2001, which for local governments drove a wedge between the costs of producing services in-house and the costs of purchasing the same services from private providers. Only purchases from private providers were subject to VAT, and the purpose of the VAT compensation scheme was to restore neutrality. The classification of VAT compensation as an earmarked grant can be questioned since the purpose of the grant is not to stimulate the provision of a particular local government service. In that sense it is similar to a non-earmarked grant. The main difference is that the VAT compensation will be related to the local government's total spending. The higher the spending, the higher the VAT compensation will tend to be. A type of grant with a similar feature is a tax equalisation grant related to own tax effort where a higher tax rate will increase the amount received by the local government. This type of grant is classified by Bergvall *et al.* (2006) as a general purpose grant. In my view, a general VAT compensation scheme could also be classified as a general purpose grant using the same reasoning.

Indicators of revenue decentralisation and local autonomy

Some key indicators of revenue decentralisation and local autonomy are displayed in Figure 7.3. Revenue decentralisation is measured by the share of taxes in local government revenue, and includes local taxes on income, wealth, immovable property and power production as described in section 3. It appears that the tax share was stable around 47% until 2006. Since then it has been steadily reduced, and is estimated to be around 40% in 2011. It has been a stated policy of the red-green government that came into office in 2005 to reduce the tax share. The main argument has been to reduce the variation in revenues across local governments.

Figure 7.3. **Local tax revenues, general purpose grants and VAT compensation**

Per cent of total revenues (ordinary budget), 2010-11



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

Subject to legal regulations, both taxes and general purpose grants can freely be allocated across services. In the Norwegian context, the share of taxes and general purpose grants in total revenue is an important indicator of local discretion in the use of revenues. Until 2008 it was a downward trend in the share of taxes and general purpose grants. This development was mainly driven by the child care reform, of which increased capacity to achieve full coverage and lower user charges were financed by earmarked grants. Starting in 2011, child care will be included in the general purpose grant scheme, and consequently the share of taxes and general purpose grants in total revenue will increase sharply.

Figure 7.3 also reports an alternative indicator of discretion in use of revenues (used by the Committee for the Assessment of Local Government Economy) that includes VAT compensation in addition to taxes and general purpose grants. It appears that the handling of VAT compensation is of great importance. First, the reduction in discretion over revenues from 2003 to 2004 as indicated by the share of taxes and general purpose grants mainly reflects the introduction of VAT compensation. At the introduction the revenue increase associated with VAT compensation was neutralised by a reduction in the general purpose grant. This pops up as reduced local discretion in the use of revenues when VAT compensation is classified as an earmarked grant. Second, how is local discretion in use of revenues in 2011 compared to 2002? The discretion is about the same if VAT compensation is classified as an earmarked grant, but has increased substantially if VAT compensation is classified as a general purpose grant.

Incentive effects: The interplay between taxes and grants

Revenue decentralisation through a high tax share is considered to be an important element of fiscal federalism that underscores the autonomy and accountability of local governments. Moreover, tax financing creates a link between the local economy and local government revenues that provides incentives for local development policy. Everything else equal, the link and thereby the incentives are stronger the higher the share of taxes in local revenues. The point I want to make in the following is that the tax share may not be a precise indicator of the incentive effects, and that additional indicators may be useful if one, for instance, wants to study the impact of decentralisation on economic growth. The development of more precise indicators requires more detailed information on the design of the tax equalisation schemes.

Consider a stylised case where local governments receive revenue from a single tax base:

$$TR^j = t^j TB^j \tag{1}$$

In equation (1) TB^j is the per capita tax base for local government j, t^j its tax rate, and TR^j per capita tax revenues. A tax equalisation scheme is in place to reduce fiscal disparities. For simplicity, symmetric tax equalisation related to own tax effort is assumed:

$$TE^j = a(t^j TB - t^j TB^j) \quad 0 \le a \le 1 \tag{2}$$

In equation (2) TB is the national tax base per capita, a is the rate of compensation, and TE^j the tax equalisation grant received by local government j. It is sum of taxes and tax equalisation that is of relevance for the local government:

$$TR^j + TE^j = t^j[(1-a)TB^j + aTB] \tag{3}$$

The incentive effect can be measured as the relationship between revenues and tax base:

$$\frac{\partial(TR^j + TE^j)}{\partial TB^j} = t^j(1-a) \tag{4}$$

It is evident that the incentive effect depends on both the tax rate and the rate of compensation in the tax equalisation scheme. The incentive effect is stronger the higher the tax rate and the lower the rate of compensation. An immediate implication of this result is that systems with very different degree of revenue decentralisation may have similar incentive effects. A country with a low tax share[17] and a low rate of compensation can have the same incentive effect as a country with a high tax rate and a high rate of compensation. Sweden is an example of the latter. It is one of the OECD countries with the highest share of taxes in local government revenue, but because of a very ambitious tax equalisation scheme the incentive effect as captured by equation (4) is rather low.

Blöchliger and Vammalle (2010) investigate the relationship between taxes and tax equalisation in 12 OECD countries. Their results indicate that tax equalisation transfers (as share of GDP) are positively correlated with the share of total taxes received by sub-national governments. This finding may indicate that countries with substantial tax financing also have more ambitious tax equalisation and the variation in tax shares overstates the variation in incentive effects.

Conclusions

The chapter has discussed the Norwegian taxonomy of taxes and grants and how it compares with that of the OECD. A main issue is whether the major local tax, the personal income tax, should be classified as a tax with local discretion or a tax sharing arrangement. Although local governments formally can set tax rates below the upper limit, the system resembles a tax sharing arrangement. During the last three decades not a single local government has deviated from the upper limit, there is no local discussion on the income tax rate, and the central government uses the local tax rates as important distributional tools. It would give a more correct picture of the Norwegian system if the local income tax (and also the minor wealth tax) was reclassified as a tax sharing arrangement by the OECD.

The taxonomy of grants is less problematic. The general purpose grants scheme can safely be classified as general purpose grants and most earmarked grants are earmarked in the sense that they must be used for specific purposes or activities. Some earmarked grants constitute a grey zone as they may resemble non-earmarked grants, and this grey zone is not necessarily captured by the distinction between matching and non-matching earmarked grants. A VAT compensation scheme was introduced in 2004 to restore neutrality between in-house production of services and purchases from private providers. Although the purpose is not to stimulate the provision of a particular service, the VAT compensation is classified as an earmarked grant in the Norwegian taxonomy. It is argued that it should rather be considered as a non-earmarked grant similar to tax equalisation grants related to own tax effort. The classification of the VAT compensation is of great importance for the assessment of the development of discretion in the use of revenues during the last decade.

Finally, the chapter looks at the interplay between tax financing and grants and the incentives for local governments to develop the local tax base. It is argued that a more precise indicator, that also takes account of the rate of compensation in the tax equalisation scheme, may be useful in studies of the impact of decentralisation on, for instance, economic growth.

Notes

1. The descriptive parts of these sections are largely based on Borge (2010a).
2. The capital Oslo is both a municipality and a county.
3. In the tax system there is a second income tax base, personal income, which is a gross income tax base comprising labour income, income from self-employment and fringe benefits. The tax on personal income is highly progressive and is received by the central government.

4. In the most northern part of Norway the central government tax rate is 10.55% and the total tax on general income is 24.5%.
5. Since 2004, there is no minimum tax rate.
6. The law does not provide a definition of 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 property in urban areas.
7. An empirical investigation of the extension of the property tax can be found in Carlsen (2010).
8. The grant system included a large number of matching grants where the matching rates were differentiated between local governments. The differentiation was partly based on judgment and the matching rates were reduced for local governments with low tax rates.
9. See Borge and Rattsø (1998, pp. 34-35) for a more detailed discussion on the need for balanced growth in taxes and block grants.
10. Moreover, Blöchliger and Rabesona (2009, p. 5) seem to classify the Norwegian income and wealth taxes as taxes with full local discretion over tax rates. Since there are upper limits, tax discretion is restricted even when the classification is based on formal rules.
11. For these taxes all municipalities use the same rate (see section 3) so there is no need to distinguish between tax revenues and the tax base.
12. Notice that the regional policy grants are general purpose grants that are not earmarked for economic development. The grants are supposed to promote economic development by improving local public services.
13. Expenditure needs equalisation is still based on analyses of and criteria for specific service sectors. It is not clear to me whether Bergvall *et al.* (2006) would still classify it as a block grant. But if so, it is hard to think of any spending needs equalisation grant that could be classified as a general purpose grant.
14. A similar grant is also in place for churches.
15. OECD (2002) use the term specific.
16. In Borge (2010b) I labelled such grants narrow categorical block grants.
17. For given responsibilities a low tax rate will be associated with a low tax share.

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