Chapter 7

General grants and earmarked grants in Norway

Lars-Erik Borge and Grete Lilleschulstad

7A.Growth and design of earmarked grants: the Norwegian experience by Lars-Erik Borge[66]

Abstract

The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivation for the reform was to establish a simpler and more transparent grant system and a fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency. Ever since its introduction, the block grant system has been under pressure, and the level of earmarking has steadily increased. The purpose of this paper is to tell a story of how the design of earmarked grants has evolved over the last 25 years. There has been a trend towards more targeted earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of prioritized services without leaking into other services. The new schemes have reduced political frustration at the central level by increasing the correspondence between intentions and results, but have led to a more complicated system that in the longer term may lead to less local innovation and initiative. [67]

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7A.1. Introduction

The introduction of the block grant system in 1986 was a major reform in the financing of the local public sector in Norway. Around 50 earmarked grants were replaced by block grants based on objective criteria. The main motivation for the reform was to establish a simpler and more transparent grant system and fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency by giving local governments more discretion in the allocation of resources across services.

The block grant reform was considered a first step to further reduce earmarking. The main idea was to abolish many of the remaining earmarked grants and to increase the amount of resources distributed through the block grant system. Local government priorities should, if necessary, be regulated through legislation. In a larger picture, the block grant reform was one of several attempts of decentralization. The Local Government Act was revised in 1992 to give local governments more freedom to organize their decision-making and production. The liberalization of the credit market during the 1980s meant that the control of local public investments through public banks was reduced.

The intention to further reduce the level of earmarking after 1986 has not been realized. Conversely, there has been a strong trend in the opposite direction. The purpose of this part of the chapter is to tell a story of the growth and design of earmarking since the introduction of the block grant system in 1986. Section 7A.2 presents the empirical background and demonstrates that the block grant system has been under pressure ever since it was introduced. The increased reliance on earmarked grants can be understood as the outcome of a blame game between the central and the local governments. Sections 7A.3-7.A.5 are devoted to describing how the design of earmarked grants has changed over time; from ineffective earmarking, through earmarking with leakages, and finally to earmarking without leakages. Finally, section 7A.6 contains some concluding remarks.

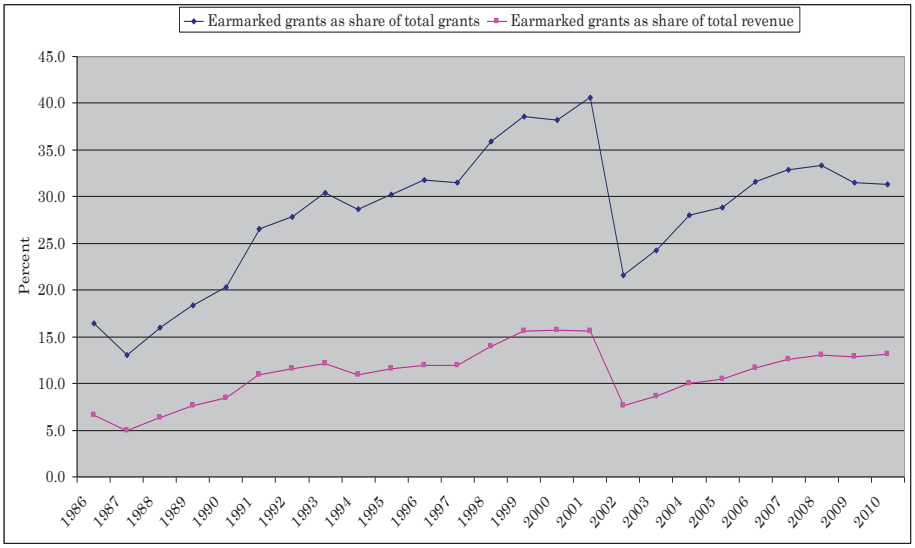
7A.2. Empirical background

In Norway, as in the other Nordic countries, local governments[68] are the main providers of welfare services, i.e. education, health and social services. Norwegian local governments have substantial discretion in the allocation of resources across service sectors, but are heavily regulated on the revenue side. The main revenue sources are local taxes and block grants from the central government, and total local government revenue amounts to 16-17% of mainland GDP (excluding the petroleum sector). Most taxes are of the revenue-sharing type, where effective limits on tax rates have been in place for the last 30 years. The main elements of the block grant system are tax equalization, spending needs equalization, and a discretionary grant (to take account of specific local conditions not captured by the objective criteria). A more detailed description of local government financing in Norway is provided in part B of this chapter.

In the Norwegian context, all grants that are not included in the block grant systems are labeled earmarked grants, and the same definition is applied here. All earmarked grants are conditional in the sense that they must be spent on a specific program or for a specific purpose. Most of them are either of the matching type or categorical block grants. This corresponds to the definition of earmarked grants suggested by Smart and Bird (2010). Compared to the OECD terminology (Blöchliger and Vammalle 2010), I make no distinction between block grants and general-purpose grants. I use the term general block grant (or simply block grant) for the grants included in the block grant system.

[68] The local public sector consists of two tiers, municipalities and counties. In the following the term local government covers both municipal and county governments.

Figure 1. The development of earmarking, 1986-2010



Note: Earmarked grants related to refugees and labor market policies are excluded as they vary substantially from year to year. VAT compensation (introduced in 2003) is treated as a block grant.

Figure 1 illustrates the development of earmarking since 1986. Two indicators are reported, i.e. earmarked grants as a share of total grants and earmarked grants as a share of total revenue. It appears that earmarked grants as a share of total grants have nearly doubled since the introduction of the block grant system, from 17% in 1986 to 31% in 2010. An increase in earmarked grants as a share of total grants does not necessarily mean more earmarked financing of local public services. It could rather reflect a shift from block grants to tax financing. However, this has not been the case in Norway during the period under study. Earmarked grants have nearly doubled also when measured as a share of total revenue.

The year 2002 represents a main exception to the trend towards more earmarking. That year, earmarked grants increased sharply both as a share of block grants and as a share of total revenue. However, the shift does not reflect less earmarking of particular services, but is rather the result of a shift in the division of labor between the counties and central government. The central government took over the responsibility for hospitals, a service

where the level of earmarking was relatively high.

In 2003, the Parliament adopted a major childcare reform the main goals of which were lower user charges and an increased capacity to achieve full coverage. The reform is financed by earmarked grants, and these grants account for much of the increase in the level of earmarking in recent years. Starting in 2011, childcare will be included in the block grant system, and consequently the level of earmarking will be substantially reduced. Based on data for 2010, earmarked grants would be reduced from 17% to 5% as share of total revenue.[69] In other words, the inclusion of child care in the block grant system will bring the level of earmarking back to the 1987 level. The purpose of this paper however, is to discuss how the design of earmarked grants has evolved since the introduction of the block grant system and until 2010.

The standard theory[70] of fiscal federalism argues that earmarked grants should be used in situations with positive spillovers across jurisdictions. However, it is hard to argue that spillovers may account for the steady growth of earmarking in Norway over the last 25 years. The responsibilities of local governments have not changed much and consist for a large part of welfare services where spillovers are of little relevance. Smart and Bird (2010) draw the same conclusion and argue that imperfect information, incentives, and political considerations are important to understand the widespread use of earmarked grants. In the following discussion, I will focus on political considerations.

The steady increase in the level of earmarking means that the block grant system, and its underlying logic, has been under constant pressure. In the Norwegian context with limited local tax discretion, the logic of the block grant system is that central government is responsible for the total revenues of the local public sector (correspondence between revenues and responsibilities), while the local governments are responsible for the allocation of resources between different services. In practice the leads to

[69] More updated calculations from the Ministry of Local Government and Regional Development indicates that the level off earmarking (measured as share of total revenue) will be further reduced to 4% in 2011, see also part B of this chapter.
[70] The standard theory corresponds to "the first generation theory of fiscal federalism" in the terminology of Oates (2005).

unclear responsibilities. When local politicians are confronted with a "crisis" in service provision, they immediately blame the central government which sets the financial constraints. On the other hand, central government will try to shift responsibility back to local governments, arguing that they should get more value for their money or give higher priority to the service concerned. If the "crisis" grows large and include a large number of local governments, it may be difficult to avoid supplementary grant increases. From the point of view of central government, earmarking can be seen as a way to limit the blame game as well as supplementary grant increases. A formal analysis of this argument can be found in Carlsen (1998).

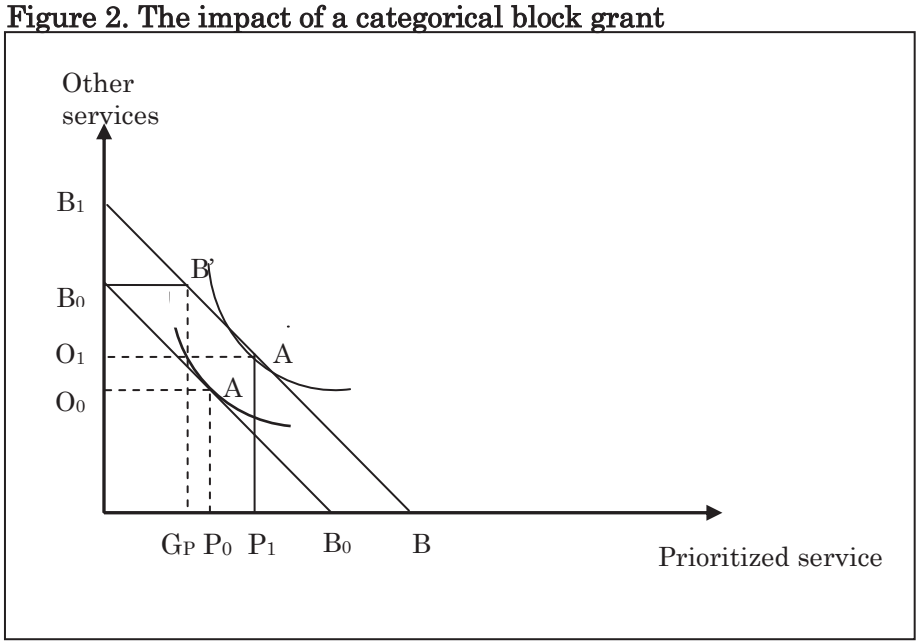
7A.3. Ineffective earmarking: Sectoral block grants and categorical block grants

Until 1994 the spending needs equalization in the block grant system consisted of sectoral block grants, i.e. one grant for each major service sector (education, healthcare, etc). Central government used these sectoral grants to signal its priorities. If it wanted higher spending on education, the sectoral grant for education was increased by more than were other sectoral grants. However, indications from central government did not impose any formal restrictions on the use of the grants. As part of the block grant system, the sectoral block grants were unconditional. Since local governments were free to spend the grants as they liked, it is no surprise that the indications made through sectoral block grants turned out to be ineffective. At best the sectoral grants gave the central government a short-term political gain when the budget was proposed, but this backfired during the fiscal year if local governments did not give priority to the sectors with the highest growth in grants.

At a later stage the central government introduced categorical block grants. These grants are allocated according to objective criteria (like a block grant), but are earmarked in the sense that the money has to be spent on a particular service or activity. The purpose of figure 2 is to illustrate that also categorical block grants tend to be ineffective. The local government provides two services;

the prioritized service (P) and other services (O).[71] Initially there is no earmarking, and the budget constraint is B_0B_0. The actual allocation is in point A_0 with spending P_0 on the prioritized service and O_0 on other services. Then the central government introduces a categorical block grant of size G_P. Since the amount G_P has to be spent on the prioritized services, the budget constraint shifts to $B_0B'B_1$. The optimal response for the local government is to increase provision of both services, to P_1 and O_1 respectively. However, this is exactly the same response it would have made if the amount G_P was given as a general block grant (with no strings attached), in which case the budget constraint would be B_1B_1.

Figure 2. The impact of a categorical block grant



The key point is that categorical block grants are likely to work as a general block grant as long as the amount (G_P) is smaller than the amount the local government would have spent on the prioritized service anyway (P_1). The local government is then able to neutralize the effect of earmarking by reallocating non-

[71] In the Norwegian setting with limited local tax discretion it is reasonable to interpret O as other services provided by the local government. In a more general setup with local tax discretion, other services would also include private consumption.

earmarked revenues (general block grants and taxes) from the prioritized service to other services. An implication of this result is that categorical block grants are likely to work as general block grants when they are wide (in the sense that the earmarking applies to large service sectors such as education and care for the elderly), but may be effective when they are narrow (school books, cultural activities for the elderly, etc).

Moreover, it should be noticed that sectoral block grants and categorical block grants may have some short-term impact on local priorities even if they are wide. In the short term, the reallocation of non-earmarked revenues from the prioritized service to other services may be too visible. In the longer term, however, it is difficult for the central authorities to detect the counterfactual allocation.

Sectoral block grants and categorical block grants must be understood in a political context, and more precisely as a response to a general "crisis" description in the media. Borge and Rattsø (1998, p. 35) argue that ministers can gain positive publicity in the press by granting a relatively small amount to solve problems raised in the tabloid press. In the short term, the ministers appear energetic, vigorous, and able to solve problems. In the longer term, however, the ministers (if still in office) may have a hard time explaining why the policy does not result in better services. It is my understanding that sectoral block grants and categorical block grants lead to much political frustration at the central level. Because of this frustration, ministers started looking for more effective (or targeted) grant schemes.

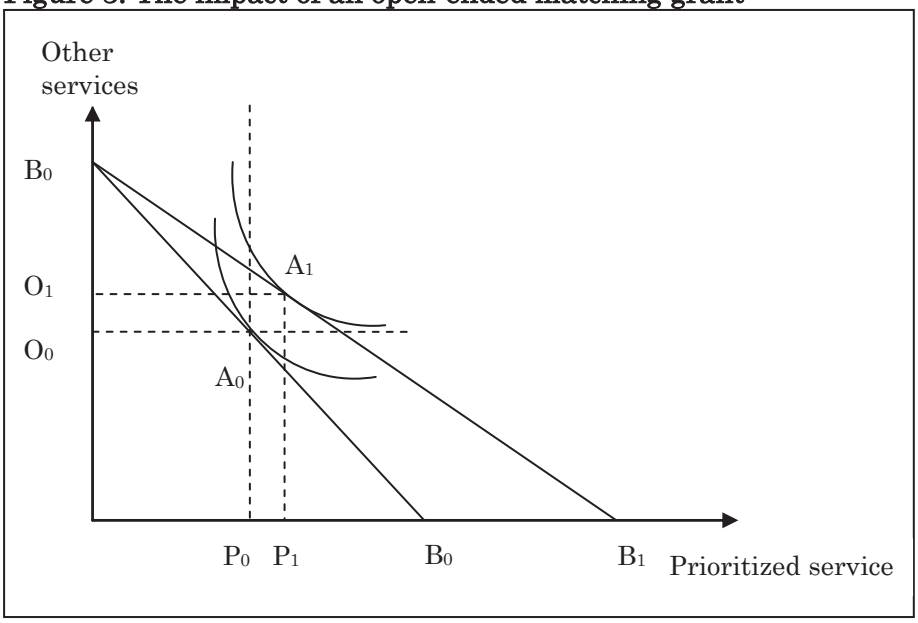
7A.4. Effective earmarking with leakages: Open-ended matching grants

In the economics literature on intergovernmental grants (e.g. Rubinfeld 1987, section 6.2) it is emphasized that effective earmarking should affect relative prices, i.e. they should be of the matching type. The impact of an open-ended matching grant is illustrated in figure 3. The initial budget constraint is B_0B_0, and the actual allocation is in point A_0. The introduction of an open-ended matching grant reduces the relative price of the prioritized service and shifts the budget line to B_0B_1. The matching grant has

a price effect that reduces the cost of providing the prioritized service, and a positive income effect because total revenue increases (given the initial allocation). Both the substitution effect and the income effect leads to increased provision of the prioritized service. Because of the substitution effect, the matching grant is more stimulative than sectoral and categorical block grants. The matching grant is therefore more effective in terms of affecting local priorities.

The effect on other services is more unclear, and depends on how much the prioritized service is expanded. If the expansion is large (the new allocation is southeast of the crossing between O_0 and B_0B_1), the impact on other services is negative. But if the expansion is small (the new allocation is between the crossing P_0-B_0B_1 and the crossing O_0-B_0B_1), other services are expanded as well. It can be demonstrated that provision of other services will increase (decrease) if the demand for the prioritized service is inelastic (elastic) with respect to price. Much empirical literature (summarized by Oates 1996) documents that demand for local public services tends to be inelastic with respect to price. Consequently, the typical outcome will be that an open-ended matching grant to some extent will leak out to other services. This is the case in figure 3, where the new allocation A_1 implies increased provision of both services.

Figure 3. The impact of an open-ended matching grant



For the local government the leakage to other services is an optimal response, but for central government the leakage may be problematic politically.[72] In the budget process, central government specifies the (expected) amount of money to be distributed through the matching grant, and the minister must argue that this amount of money is needed to improve the prioritized service. But if it turns out that the local spending increase on the prioritized service is lower than the grant increase, it becomes the minister's job to explain why. He can to some extent blame the local governments for not being loyal to the intentions of the grant program, but it is difficult to evade responsibility for an improper grant design that explains the lack of correspondence between intentions and outcomes.

The matching grant for childcare, which has been in place for several decades, is a prime example. In the late 1990s, the matching rate was increased to enhance coverage and to lower user

[72] A conflict of interest between the two tiers of government is a premise of the discussion, but I do not take a stand on whether a social optimum should be guided by local or central preferences. That (highly interesting) issue is beyond the scope of this chapter.

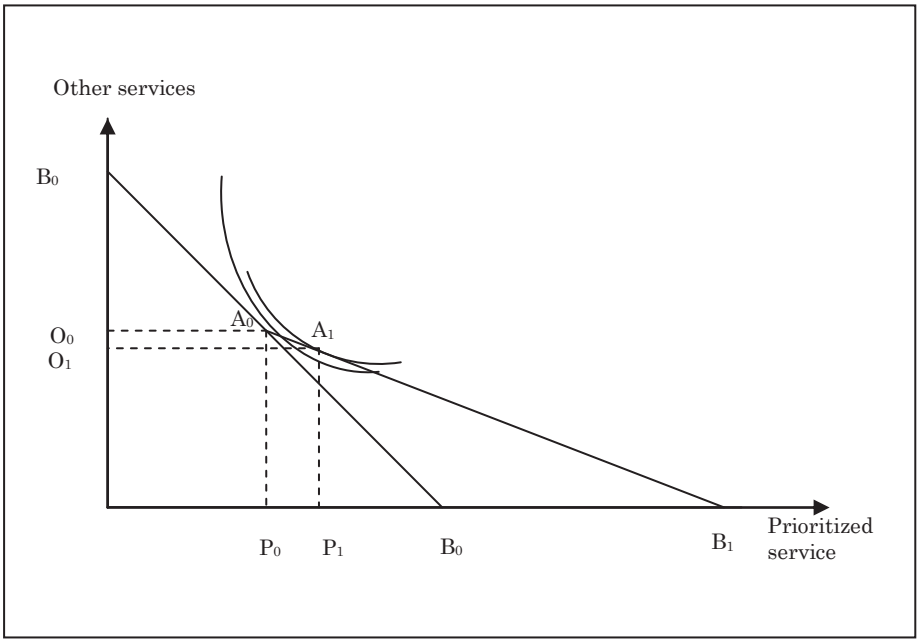
charges. It turned out that the impact on coverage and user charges was modest, and that the increased spending on childcare was much lower than the grant increase. The discrepancy between intentions and actual policy change received much media attention. This resulted in a blame game between central government and local governments. The local governments argued that they had obeyed the rules, since total spending on childcare amply exceeded grants received for childcare, while central government emphasized that the spending increase was lower than the grant increase. Again the frustration led to a search for more effective ways of affecting local priorities.

7A.5. Effective earmarking without leakages: Matching grants related to expansion of services

In recent years the central government has used so-called action plans to stimulate provision of particular services. Action plans are explicitly announced to be in place for a limited number of years, and they include temporary, earmarked grants as financial means. In order to reduce the probability of leakages, many of the grants are related to expansion of services or investment in new capacity. Action plans have been used in e.g. elderly care, education, and childcare.

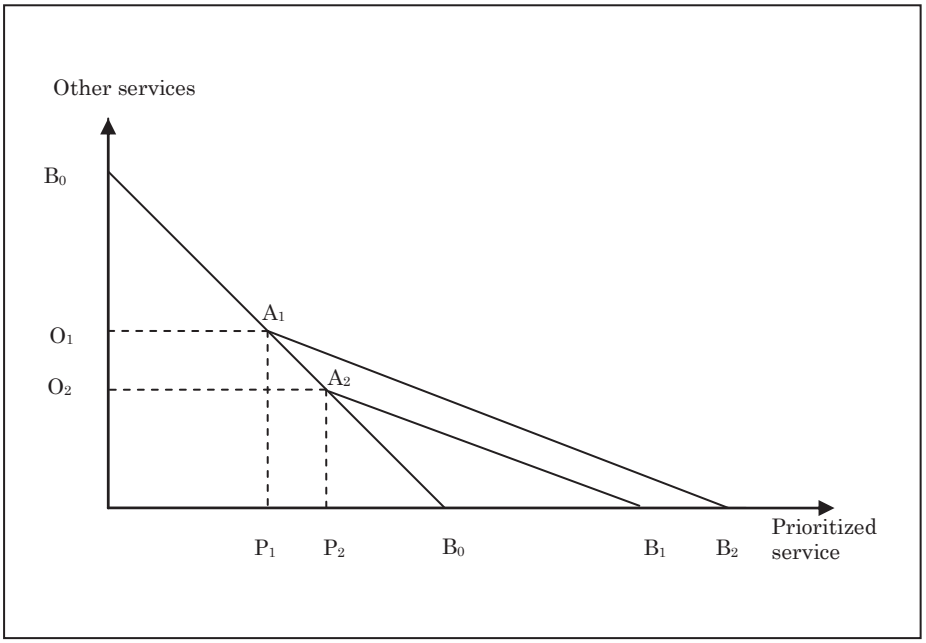
Figure 4 illustrates the case of a matching grant related to expansion of services. This could be either an investment grant or a grant for current expenditures related to increased spending. Again the initial budget line is B_0B_0 and the initial allocation is in A_0. The matching grant related to expansion of service P shifts the budget line to $B_0A_0B_1$, and the new allocation is in A_1. Since the new allocation has to be on the segment A_0B_1 of the new budget line, it is obvious that the matching grant increases the provision of the prioritized service and reduces the provision of other services. The leakage is eliminated. The outcome is rather the opposite, i.e. a reallocation of non-earmarked revenues from other services to the prioritized service. The larger the expansion of the prioritized service, the larger is the cutback of other services.

Figure 4. The impact of a matching grant related to expansion of services



The amount of grants received will vary across local governments depending on the initial service provision level. This is illustrated in figure 5, where I consider two local governments (1 and 2). The two local governments have the same initial budget constraint B_0B_0, but different initial allocations (A_1 and A_2 respectively). Because of the different initial allocations, the new budget constraint will also differ. The new budget constraint is $B_0A_1B_1$ for local government 1 and $B_0A_2B_2$ for local government 2. It is clear that the outward shift in the budget constraint is largest for local government 1, with lowest spending on the prioritized service. This is an attractive feature of the grant program since more resources are allocated towards local governments that are lagging behind in the provision of the prioritized service. However, local governments that have given high priority to the prioritized service will be "punished" since they are less able to take advantage of the new grant program. This is likely to have severe negative consequences in the longer term. Local governments will be reluctant to develop the services if they fear to lose out when the next central government action plan is implemented.

Figure 5. A matching grant for "new" service provision with different initial allocations



Borge and Rattsø (2008) present a more formal theoretical analysis of action plans and temporary matching grant programs. The intertemporal model distinguishes between three periods – before, during and after a matching grant program. Given a benchmark of block grant financing, three types of matching grants are analyzed – a matching grant for current expenditure, an announced investment grant, and an unexpected investment grant. A matching grant for current expenditure is the conventional way of handling matching grants and includes the standard price and income effects. Investments to expand capacity are largely neglected in the standard grant analysis, but matching grants to stimulate investments are important in practice. The inclusion of the investment decision also highlights the possibilities that local governments have of shifting resource use over time and the importance of expectations.

The analysis shows how an announced investment grant, due to an expectation effect, leads local governments to reduce their investments before the implementation of the grant program. This is avoided by introducing unexpected investment programs, which

will, however, have the effect that local governments giving priority to the relevant service will be "punished" since they are less able to take advantage of the grant (as in figure 5 above). Investment grants imply large changes in service provision, while matching of current expenditure offers more stability.

Borge and Haraldsvik (2008) provide an empirical analysis of the action plan for elderly care that was implemented in 1997 to increase capacity and improve service standards within the elderly-care sector. The main financial element in the action plan for elderly care was a temporary investment grant for nursing homes. Consistent with figure 4, Borge and Haraldsvik find that the elderly-care sector is expanded at the expense of other services, and particularly childcare. For the local government with the largest utilization of the action plan, the predicted increase in childcare coverage (during 1997-2005) is 7-8 percentage points lower than for a local government that did not implement the action plan.

Given the temporary nature of action plans, it is interesting to analyze whether they have any impact on the budgetary balance. It may be assumed that a temporary grant program leads to a "spend now" attitude that may reduce fiscal discipline. Consistent with this view, Borge and Haraldsvik (2008) find that high implementation of the action plan for elderly care is associated with a reduction in the operating surplus.

7A.6. Concluding remarks

The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivations for the reform were to establish a simpler and more transparent grant system and a fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency. Ever since its introduction, the block grant system has been under pressure, and earmarking has steadily increased. Also the design of earmarked grants has changed. There has been a trend towards more effective or targeted earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of the prioritized service without creating leakages towards other services. The new schemes have

reduced the political frustration at the central level by increasing the correspondence between central intentions and local outcomes, but have led to a more complicated system that in the longer term may lead to less local innovation and initiative.

7B. Financing municipalities and counties in Norway - Specific grants vs. block grants[73] by Grete Lilleschulstad [74]

Introduction

In 1986 the so-called General Purpose Grant Scheme for municipalities and counties was introduced in Norway. The new block grants replaced a financing system based on several different earmarked grants, even though a tax equalisation system already existed. In the new General Purpose Grant Scheme, both grants and tax equalisation are parts of the same system. The intention of the reform was to ensure a transparent, fair, rational and consistent distribution of income. Considerable differences existed between municipalities and between counties with respect to both level of income and level of expenditure needs. A high level of redistribution was therefore necessary, and this was achieved by the new grant scheme. The large number of earmarked grants had also been an administrative burden, both at the local and the central level.

Today the main sources of revenue for municipalities and counties are taxes, block grants, specific grants, charges and fees. Their free income consists of block grants and tax revenues. The free income is still being distributed by the General Purpose Grant Scheme. The general grants are calculated on the basis of objective criteria, and in addition the income taxes are equalized. The free income share of the total income of municipalities and counties is approximately 68 percent. Some of the responsibilities of the municipalities and counties are still being financed by earmarked grants, supplemented by financial contributions from the municipality itself and charges paid by the inhabitants. In 2009

[73] This is a revised version of a paper presented at the Copenhagen Workshop on Intergovernmental Grants on 17-18 September 2009.
[74]The Department of Local Government, Ministry of Local Government and Regional Development