

Decentralisation of education, health and social protection: issues and challenges

The Copenhagen Workshop 2015



Editors: Junghun Kim and Niels Jørgen Mau

Publishers: The Korea Institute of Public Finance and the
Danish Ministry for Economic Affairs and the Interior

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i.

Foreword Hyung-Soo Park

Foreword

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

In this spirit, the Korea Institute of Public Finance (KIPF) and the Danish Ministry of Economic Affairs and the Interior have been holding jointly-organized biennial workshops since 2007. These workshops have been quite successful in creating a rare opportunity for both renowned academics and experienced practitioners to gather and exchange views on major policy issues relating to intergovernmental fiscal relations. The papers presented at the past four workshops in 2007, 2009, 2011, and 2013 were later published as books titled "Measuring Local Gov-

ernment Expenditure Needs”, “General Grants versus Earmarked Grants: Theory and Practice”, “Balance between Decentralization and Merit”, and “Interaction between Local Expenditure Responsibilities and Local Tax Policy”. In 2015, the fifth biennial workshop was held on the theme of “Decentralization of Education, Health and Social Protection: Issues and Challenges”. This book is based on the papers presented at that workshop. We expect this volume, as was the case of the previous four volumes, to offer policy guidelines for practitioners and stimulating research topics for academics.

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

President
Hyung-Soo Park
Korea Institute of Public Finance

ii.

Opening address Niels Jørgen Mau

This seminar is the fifth seminar in Copenhagen about local government and public sector issues – arranged by Korea Institute of Public Finance and the Danish Ministry of Economic Affairs and the Interior.

From the beginning, the seminars were inspired by the work in OECD in the Network on Fiscal Relations Across Levels of Government – and this seminar is no exception. In this field the OECD Network has contributed to academic and policy-related issues since around 2005, and the Copenhagen workshops have, from 2007 on a biannual basis, discussed selected items already touched upon in this Network. As I see it, the Copenhagen workshops have hereby complemented and extended the analysis that have been on the table in the OECD Network. This time the headline is decentralisation on the expenditure side, which has also been on the Network agenda, although on a more limited basis. Hopefully, we also will be able to make extensions here.

However, the workshops are of course not only a forum for discussions to complement the OECD Network activities. In my view, the seminars also constitute an independent series of discussions on local government economic issues with a strong interrelationship.

We first investigated back in 2007 an important aspect of the equalisation system – the calculation of expenditure needs. Then we turned in 2009 to designing grants – involving the classical choice between earmarked and general grants. In 2011, we moved on to looking into the balance between merit wants and decentralisation, including different kinds of regulation. In 2013, we discussed local taxation in relation to

expenditures. Now in 2015, the autonomy and control of core local expenditures on the most important economic functions are in focus.

Taking an overview of the whole series of workshops, the main issues become apparent. It is evident that the revenue side of local governments, especially the system of grants and equalisation, has been given a great deal of attention in the workshops. This is natural taking into account the importance of a well-functioning revenue system as a prerequisite of a viable local government sector. However, the need for such a system originates from the idea of decentralisation of expenditures and local autonomy, which is also addressed in the workshops, and in continuation of this, the embedded problems of balancing local autonomy and local authority with merit wants and public interests. This year's agenda focuses on autonomy and central government control of local government expenditures, and it investigates the separate expenditure areas such as education, health and – not least of all – social protection.

Even though the main issue this time is local expenditures the revenue side and finance issues creep in now and then. Moreover, institutional characteristics are especially interesting but sometimes also with confusing discrepancies between countries. Against this background, it becomes even more satisfying to reveal common challenges across borders, hopefully inspiring one another and perhaps – in the end – promoting solutions. Then it is real fun to study policy problems across borders!

Niels Jørgen Mau
Project Director

iii.

Introduction

Junghun Kim and Niels Jørgen Mau

The main issue in this volume concerns the structure of public expenditures: Why, how, and for what purposes do different countries decentralise – or centralise for that matter – social expenditures such as education, healthcare, and social protection?¹ Which dilemmas have to be addressed before taking the necessary decisions?

The picture often is flickering when looking at the structure of public expenditures and the role of subnational governments. It is seldom possible in a very strict manner to follow the recommendation of the classical fiscal federalism literature to let the central government take care of tasks of stabilisation and redistribution while having the local governments to solve allocative tasks.² Especially it is difficult in reality to sort out redistribution from allocation.

This leads to the recognition that the fiscal relations across levels of government may vary widely from central and local units existing in their own right with significant autonomy to local governments carrying out tasks more or less on behalf of the central government in a principal-agent relationship. In the latter case the central government may be the principal responsible for aspects of redistribution and merit wants of a given task with subnational authorities serving as the implementing agents. Here central government management tools consisting of economic incentives and regulation play an important role.

¹ The main economic functions of governments expenditures, COFOG, are education, social protection, general services, health, and economic affairs. See OECD National Accounts (2016).

² Musgrave (1959).

Another dilemma in the assignment of expenditure responsibilities is how to set the scene – or create the potential - for effectiveness and harvesting of scale economies in big production units while still preserving the values of relatively small local authorities. These values include the ability to mirror local preferences and engage in innovation and competition to minimize costs.

Normally, the answers to these questions of organising public spending depend on which economic expenditure function we are looking at. The historical factors also must be taken into account - the choice of organisation becomes ‘path dependent’ so to speak. This implies that earlier decisions about structure and institutions of the public sector have significant effects on the current situation and future development.

Moreover, public expenditures cannot be seen in isolation of the revenue system. An earlier volume of the Copenhagen workshops discussed the so-called Wicksellian connection (Bird and Slack, 2015), which stresses the linkage between expenditure and revenue decisions. The analysis, also relevant in connection with this volume, touched upon problems such as how to charge local services, how to establish a system with tax sharing or autonomy of local taxes and how to arrange a suitable system of intergovernmental grants.

The scope of the first-mentioned “why, how and what” questions of decentralisation of public expenditures is far-reaching and multifaceted. The chapters of this volume present some answers and suggestions to questions of task assignment, central-local financial arrangements, effectiveness and efficiency, taking the country/national experiences as a starting point.

In a case study of Norway, *Lars Erik Borge* asks the fundamental question whether decentralisation in Norway has come to an end and the development reverses to gradual (re-)centralisation. The background of the Norwegian welfare system where local governments produce about the half of public goods and services. The Norwegian organisation and financing of the local public sector attempts at combining local democracy with an agency role of local governments for the provision of welfare services.

The evolution in Norway is put into its historical context with different phases from the 1970s until today. The development for three main sectors - health, education and social expenditures - emerges with no clear signs of convergence. Equal access to these public services for all citizens was a priority in the 1970s to 1980s, where matching grants and central government regulation were used as tools to achieve that objective. Later in the 1980s and 1990s decentralisation was promoted by a new local government act and more weight was given to general grants than matching grants – a development with similarities to the other Nordic countries. However, renewed centralistic forces in recent years manifest themselves by the central government's take-over from the counties of the hospital sector in 2002, and the child welfare institutions and foster homes in 2004. Likewise, with the so-called NAV-reform labour market services saw tendencies of increased central government responsibilities including former municipal services aiming at having “one door”-solution for the users. As discussed in Bergvall et al. (2006), risk-sharing seems to be one of the factors of choosing centralised solution.

There are also some examples of decentralisation in Norway such as childcare financing with general grants instead of earmarked grants from 2011. However, the examples of centralisation are remarkable. Lars Erik Borge foresees a continuation of centralisation, including more earmarked grants and regulation – with one important reservation: amalgamation of municipalities may prepare the municipalities for handling more tasks with high quality – and for the central government to delegate such tasks to them. But the current voluntary process of mergers may imply some skepticism regarding the success of the final outcome of amalgamation.

The nature of decentralised public sector is highly dependent on country-specific institutional and structural factors. This is what the Norwegian amalgamation discussion illustrates, and that is also evident from several of the other contributions. As discussed above, it often reflects the path dependency of a decentralisation process.

The conditionality of history in fiscal federalism is also highlighted in *Ludwig Strohner's* evaluation of decentralisation in Austria. The policy rigidity plays an important role – the more rigid the structure, the less scope for theoretical considerations about an optimal division of respon-

sibilities across levels of government. In some periods of Austrian history, other factors than traditional fiscal federalism considerations played an important role - such as the need to use centralism to bind together the Astro-Hungarian Empire ('Österreichisch-Ungarische Monarchie') of the 19th century. A centralist social insurance system was thought to calm down the strong centrifugal forces in this multi-ethnic state – different from the development in Germany where the welfare state was seen as a remedy for knitting together the various parts of the future Germany.

When Austria transformed into a democratic federal state after World War I there still existed a strong tendency towards centralisation, but the development hereafter must be seen in connection with the specific sector to be evaluated. As a characteristic, possible also observed in other countries, in some areas, e.g. education and health, the population seems to have stronger preferences for uniform standards than in other areas, e.g. social services. In Austria, the school system is centralistic in the sense that, even though communities and provinces are responsible for the construction and maintenance of compulsory schools, the school governing authorities of the state assign teachers to the schools. Moreover, the federal level refunds the financial outlays of the provinces for schools. Overall, this system might have led to a rather inefficient provision of educational services since Austria has the lowest efficiency of educational production in 15 OECD countries as discussed in Bogetoft et al (2015).

Contrary to the case of education, the data from the Eurobarometer (2007) points out that for social care and social welfare preferences are rather divergent. From this point of view, decentralisation of social care can be justified. In Austria the social insurance pools do not take this into account, but for social care and social assistance the provinces and the local authorities can be sensitive to divergent preferences. As Strohner notes that agencies close to the recipients of social welfare programmes are able to meet different preferences for redistribution and an effective screening of persons receiving transfers, like the verification of job activities.

Maja Frandsen and Niels Jørgen Mau investigate the conditions of social security with special attention to the public labour market sector. The core of the discussion is the significance of local governments being

close to the clients/customers and the incentive effects of financing means. The analysis and descriptions in their study concern the extent to which public services are assigned to local governments in Denmark - in particular the task of paying out labour market transfers in combination with more active labour market activities. The situation in Denmark indicates that preferences differ when it comes to social welfare, not only within countries but also across countries. At least it is evident that there is a great variation in the degree of decentralisation from country to country in the field of social security. In this regard, Denmark is an outlier in the sense that the measured level of decentralisation in this field is remarkably high.³

Since the content of decentralisation is not a given thing, the observed differing stance of decentralisation across countries should be taken with a pinch of salt. For instance, in Denmark four dimensions of decentralisation are identified concerning the task of handling a subset of social welfare, namely social benefits (e.g. unemployment benefits, social allowances, sickness benefits or early retirement benefits). First, it has to be taken into account which level of the public sector has the responsibility of paying out the transfers and being in charge of budgeting and accounting. Second, which level determines the size and rates of different benefit-schemes? Third, who determines the number of recipients entitled to receive benefits? Finally, how are the expenditures financed?

For Denmark it is found that the very high level of decentralisation appearing in the cross country measures for social benefit schemes originally seems to hinge on the first dimension, not necessarily implying any significant or 'real' local autonomy. However, seen in a historical context the municipalities gradually have gained more competence and influence regarding the benefit schemes and alternative services that comes into play for a certain person. Moreover, the financing method has changed step-by-step from mostly matching grants to general grants, changing incentives and making municipalities more financially responsible at the margin. Still, the central government in aspects such as size of benefits and eligibility criteria is to be regarded as the 'principal' and municipalities as the 'agents'.

³ As an example of measuring level of decentralisation across countries, see Ivanyna & Shah (2014).

As shown by Frandsen and Mau, the labour market benefit system in Denmark now has become rather decentralised, demanding a refined equalisation system and block grant compensation for cyclical swings in the economy. One of the purposes of the new Danish system was to establish a “one door system” – a policy goal that was also mentioned in the case of Norway. However, as discussed by Borge, the Norwegian NAV reform ended up in a more centralistic system. This seems again to point to the relevance of the historic path and structures of the public sector in different countries. For example, the fact that Danish municipalities are in average much bigger in population numbers than Norwegian municipalities seems to be part of the reason for such difference.

The connection between size of local governments and the level and character of decentralisation is discussed thoroughly by *Grete Lilleschulstad*. This item has for several years been a disputed topic in relation to the organization of the public sector in Norway, implying also the assignment of tasks between the two political levels in the country: the central government and the municipalities.

The Norwegian unitary state has a local government sector with a relatively high level of local self-government and high degree of division of responsibilities between the levels. However, as also pointed out by Borge, decentralisation meets challenges, and Lilleschulstad focus inter alia on so-called state micromanagement causing more detailed regulations of welfare services, which weaken the municipalities' possibilities to prioritise and adapt welfare services to the needs of the inhabitants.

The strategy of the small governments to ensure the delivery of good services with sufficient capacity and expertise may be to engage in inter-municipal collaboration. However, there are both pros and cons of such inter-municipal collaboration arrangements. It can be a necessary instrument to solve important tasks for many municipalities, but may also weaken local democracy by reducing opportunities to look at multiple tasks as part of a whole and making it harder for the citizens to understand what decisions are taken where.

Wouter Vermeulen examines decentralisation in the Netherlands in relation to the social protection function, with particular reference to three social area functions: youth care, long-term care and income support. The Netherlands recently (in 2015) have embarked on a consider-

able decentralisation in these policy areas. This decentralisation process happened in an environment with municipalities already having economically significant importance, financed mainly by conditional and unconditional grants, but with a very low level of local tax financing. Looking at the above mentioned areas of social functions allows for analysing different aspects – including pros and cons – of decentralisation in the Netherlands.

One of the motivations behind the recent Dutch decentralisation is to enhance efficiency. The reforms of youth care and long-term home care involve concentrating several services at the same level – the municipalities. This reduces fragmentation and makes the responsibilities more clear-cut. In the case of youth care, for example, responsibilities were formerly highly diversified with municipalities being responsible for universal and preventive services, provinces for more specialised care, health-insurance companies for youth mental health care, and central government in charge of most specialised types of care. The recent decentralisation reform in the Netherlands involving 10 percent budget cuts relative to previous levels of expenditures, in a direct manner illustrates expectations of savings.

However, the reforms also illustrate the challenge of where to draw the precise lines of task assignment. For long-term care the responsibilities will still be split between home care – with health insurers and municipalities being principals – and institutional care – with central government being responsible; a situation reminding of the Norwegian centralisation of children's foster homes with local governments responsible for other services to socially exposed children. This split as well as other dividing lines in relation to responsibilities raise the question of externalities between single authorities as well as between levels of government, e.g. who gets the benefits of investing in prevention of disabilities.

Wouter Vermeulen addresses the dilemma of on the one hand encouraging cost-efficiency through decentralisation and unconditional grants while on the other hand facing the risk of underprovision of social services if externalities are not taken into account. He sees the redistributive nature of these services as a first source of externalities in case of a decentralised responsibility. As emphasized by the classical fiscal feder-

alism literature⁴, an incentive to underprovide redistributive services arises when beneficiaries tend to move to municipalities with the most generous provision. In the Dutch cases of decentralisations this risk appears more relevant for youth care than for long-term care since young families are generally more mobile than elderly persons.

The question of decentralised redistribution is a disputed question in many countries. Will it lead to underprovision via a ‘race to the bottom’ or will decentralisation go hand-in-hand with more redistribution? *Nobuki Mochida* analyzes this problem both theoretically and empirically on the basis of Japanese evidence. Japan has – contrary to Norway – been decentralising welfare policy to local governments for a long span of years.

As is well known, grasping the extent and the characteristics of decentralised redistribution is not an easy task. Mochida points out that the bulk of the local governments’ expenditures in Japan are quasi-private goods rather than pure local public goods. For those quasi-private goods the reason for public sector provision is the redistributive effects rather than certain market failures that are normally referred to when it comes to pure local public goods. In reality, the case for decentralisation stems from subnational governments’ ability to identify special needs of the local community and to monitor the behavior of local recipients. For Japan, Mochida (2012) in an earlier study showed that decentralised redistribution adds up to as much as 10.6 per cent of GDP.

The conflicting theories about the effect of decentralised redistribution may be thought of by considering two different scenarios. In the first scenario of welfare migration, service recipients move to municipalities offering better service levels, increasing the costs for service provision for those authorities and possibly inducing them to reduce the service level. In the other scenario of yardstick competition, the performance of neighboring municipalities may give voters information to evaluate their own municipality and possibly induce the municipality to produce a high level of public services. In both cases the proximity between the municipalities is relevant in terms of mobility of persons and households as well as the transmission of information across local government borders.

⁴ See for example Oates (1972) or Boadway and Shah (2009).

The empirical study by Mochida focuses on child care and elderly care in municipalities in the Kantō Region and makes use of the so-called Nikkei-index to measure the service levels. The study produces interesting results including the insignificance of fiscal capacity variables on service levels indicating an effective Japanese equalisation system. On the main question of spatial autocorrelation the econometric study finds statistically significant positive effect of the behavior of neighboring municipalities within identical prefectures (i.e. the seven sub-regions of the Kantō Region). The implication of this study of yardstick competition may be compared with the related studies of tax competition. As Mochida points out, an OECD study on tax competition (OECD, 2013) shows that local tax rates in the OECD countries have trended up rather than down over time.

The challenge of decentralised redistribution is also the subject of the German study by *Gisela Färber and Marco Salm*. The pioneering categorisation of Musgrave (1959), really with German roots, still is the natural starting point in the discussion of the responsibility assignment between the levels of government. The German authors, like other contributors to this book, recognize that the classical recommendation of central redistribution (uniform provision) often conflicts with the actual practice of the responsibility assignment in many countries. Therefore, in practice the assignment of functions to the levels of government involves considerable overlapping and inter-governmental coordination.

As in the case of many other countries, the historic background and heritage of the German system is part of the framework conditions for fiscal federalism reforms. It is worth noting that the German social security system – including public pensions, health care, social long-term care and unemployment insurance and social accident insurance – from 1870s⁵ still plays an important role in the society, with the responsibilities of a range of social services and other social transfers left to the government. Besides the social security system the complex organization of three levels of government -- the central government/federation (Bund), the states (Länder), and the local governments (municipalities and counties) -- shares the responsibilities for those tasks.

⁵ The Prussian Reich Chancellor Otto von Bismarck is often mentioned as the founding father. His old-age social insurance program in 1889 was the World's first of its kind.

The assignment of tasks in Germany must be seen against the background of a special kind of federalism, arising from the dismantling of Länder-competencies in favor of the Federation/Bund after World War II. It can be named 'executive' or 'administrative' federalism as the majority of legislation and regulation is centralised at the level of the Federation and execution/administration decentralised at the level of the Länder and the local governments. The Länder, however, also have legislative and regulatory powers. The local governments are responsible for the basic access to public services including social services, many of them being compulsory tasks.

Problems of particular interest in the German system seem to stem from the redistributive principle of equivalent living conditions stipulated in the basic law. The decisive questions are how to fulfil this equivalence principle and how simultaneously to encourage efficiency in production and allocation.

The achievement of equivalent living conditions meets challenges by the fact that the equalisation system across Länder is rather simplified, taking into account the number of residents in the Länder. However, it must be taken into account that the federal government equalises further by taking over some municipal expenditures, by centrally (re)financing the needs-based pension supplement and by different transfers and matching grants. Finally, at the state level the so-called principle of connectivity implies that the Länder must cover the costs if they decentralise additional administrative tasks to their communities.

Färber and Salm discuss the important aspects of efficiency and adequate allocation on the municipal level based on three selected examples from the existing system: assistance for housing and heating, pre-primary and primary education, and needs-based pension supplement. All of the examples illustrate difficulties with partly incongruent assignment of competences concerning task, expenditures, and revenues. Especially, financial tensions arise from upper tier regulations of the services. The solution could be inclusion of a number of financial needs indicators into the fiscal equalization system across the Länder and a general revision of the assignment of tasks. Färber and Salm foresee fundamental decisions on these issues when a reform of intergovern-

mental financial relations in Germany takes place from 2020 and a further reform soon after 2020.

One of the most important problems of the existing German fiscal federalism is the rule that the duty for cost covering for a certain public task follows the right of execution, not the right of legislation and regulation. In the case of Finland, the consequences of regulation and possible fiscal squeeze on local governments is discussed by *Antti Moisio*.

Moisio first - alongside with many of the contributions to this book – undertake his analysis with due reference to the historic background. The self-government of municipalities in Finland dates back to the first Finnish constitution in 1919. Intermunicipal cooperation, which is important especially in the Finnish context with no intermediate layer of governments between central government and municipalities, was added to legislation in 1932. The first rural municipalities were poor and worked only with simple tasks such as road maintenance, basic education and income support for the poor – rather parallel with the situation in other Nordic countries.⁶ In the years to come the role of the municipalities increased rapidly, often on a voluntary basis and using the intermunicipal cooperations and joint authorities to overcome the long distances, especially in the health sector. In parallel with most Scandinavian countries matching grants were originally an important financial source of municipalities in Finland. Moreover, the central government of Finland provided matching grants taking into account also the economic situation of the municipalities in question. Nowadays, however, the matching grant system has been replaced with a formula-based block grant system.

The main challenges of the local public sector in Finland has since the financial crisis around 2009 been how to contribute to the recovery of the sluggish Finnish economy, and maintain healthy public finances. Several reforms affecting local governments have been under preparation in this respect. One of the issues has been an amalgamation reform, but – unlike the comprehensive reform in Denmark in 2007 and with some resemblance to the more difficult situation in Norway – the

⁶ See Lotz (1998) and Lotz et al. (2015).

merger process has been slow and a large-scale merger reform has failed.⁷

What is also on the Finnish reform agenda is to look for the regulatory burden imposed on local governments. To make decisions and eventually change and ease this burden demands an empirical background, i.e. counting and describing the existing regulations. Moisio reports that there are currently over 500 municipal tasks regulated with nearly 1,000 norms. When considering which regulations may be unnecessary it must be taken into account that a majority of the tasks seems to have spillover effects or have redistributive purposes, which may lie behind some of the norms.

Like in Germany, i.e. the German principle of connectivity, there has been political awareness to compensate the local governments if the central level assigns new tasks or administrative burdens to the municipal level. Therefore, in Finland, together with on the one hand implementing more strict fiscal rules to municipalities it has on the other hand been decided that central government has to compensate new municipal tasks by 100 pct. at the macro level instead of formerly only 50 pct. This development contrasts the Dutch examples mentioned above of a 10 per cent prior cut in budgets when assigning new tasks to local governments.

One of the economic functions under the influence of regulations in many countries is education. The primary education function and care institutions in connection with schools are often assigned to municipal governments. *Paweł Swianiewicz* analyzes the situation in Poland, which possibly is on the route to a local welfare state resembling the Nordic model. Currently, Poland has experienced a considerable decentralisation of education and to a lesser extent of social care.

A main issue in *Paweł Swianiewicz*' contribution is school financing. Local schools are financed by the "education grant", which constitutes the major part of the general purpose grant for local governments. More precisely, it is a hybrid type of grant between a general grant and a spe-

⁷ A characteristic of the Finnish reform-policy was the idea of bundling several reforms together. This has due to Moisio not been a success despite positive experiences from other countries, see Blöchliger and Vammalle (2012).

cific grant since it is calculated based on the expenditure needs of schools and are spent on teachers' salaries and the like. However, the final amount of education grants is controlled by central government according to the actual use of the funds.⁸ There are several problems and discussions about the size and configuration of the education grant, especially how to take into account the extra cost of schools in areas with dispersed population. Adding "small schools" into the formula violates the principles of objectivity of equalisation including the principle of 'not subject to outside influence', a classical dilemma when measuring expenditure needs (Kim et al., 2007).

Apart from the financing issues, the Polish case demonstrates the clear tension between decentralisation, local discretion, and central regulation of services exemplified by the area of pre-schooling education. Unlike what might be the intuition Swianiewicz points out that discomfort related to overregulation by the central level is not an important issue for the majority of local governments, who may find that education and social care should be properly managed, but do not necessarily require local policy making. Instead, the local governments see the need for securing financial resources much more important than room for discretion in policy formulation and implementation.

This is in parallel with Swianiewicz' (2013) finding about local governments' attitude toward more local tax autonomy. In that study, he concluded that increased tax autonomy plays a marginal role in the national associations' lobbying of local governments, possibly explained by the political costs that a larger tax autonomy might require, i.e. difficult decisions painful for voters (tax-payers). It is difficult to gauge if this statement about local orientation regarding autonomy is a universal experience across countries, but it definitely adds an important element to the picture.

The optimal mix of central regulation, local autonomy, and school-based management (SBM) applied to the education function is an important issue in many countries. *Giorgio Brosio* analyzes the organizational matters in this area starting from Italian present-day considerations. He initially observes the increasing demands for high quality education

⁸ Swianiewicz sees this kind of grant as more and more common in several countries, see e.g. Boerboom and Huigsloot (2000).

services in Italy, mainly stemming from of the increased competition on global markets. He argues that good education, leading to the formation of human capital well expendable in the labour market, has become a growing concern of the families.

The Italian model of education follows the traditional continental European model of strong centralisation. This means that the central government is responsible – through its regional deconcentrated units – for the structure of the educational system, students’ qualifications, curricula, management and payment of salaries of teachers – all the relevant decisions of education policy. People defending the existing system may emphasize a level of cost per student below the OECD average. However, this comes with an unsatisfactory performance with low PISA scores compared to other countries. Relatively low wages of teachers partly explain low costs but also a rather low workload impacting on the quality of teachers and teachers’ services is a key explanatory factor. Moreover, perhaps contrary to expectations with a centralised system, there are clear gaps in outcomes between the North and the South of Italy, which in turn may be a source of opposition to the current education system in Italy.

In deriving the most relevant education system approach for Italy, Brosio identifies four models for decentralisation of the school function (cf. Barrera et al, 2009)⁹: 1) deconcentration to the school principal, 2) functional autonomy with teachers as decision-makers, 3) community control with the local government as decision-maker and 4) balanced control of decision-making between principals, teachers and parents. He also looks for inspiration in other countries, but end up with three stylised country-models: the Spanish, the Nordic and the English model.

The relevance of the country-models must take into account the institutional factors of the public sector in Italy, once again highlighting the relevance of structures and the history of the public sector pointed out in the outset of this chapter. In the case of Italy this implies that the Nordic model is less relevant since it involves rather large municipalities. In the case of Denmark, the size of local government is 56,000 in-

⁹ Papers from the OECD Fiscal Network, e.g. Blöchliger (2013) and Fredriksen (2013), support an assumption of a positive correlation between decentralisation and educational outcomes/PISA scores.

habitants on average, i.e. much larger than the average of 8,000 in Italy. Thus, the Italian municipalities may be too small for appropriate organising a school system within limiting borders. Here the Spanish regionalisation model seems more relevant, involving devolution of powers to the regions to become central players on education. The fears of increasing discrepancies between North and South in Italy are mitigated by the observation that the regional disparities seem smaller in the regionalised system of Spain compared to the existing centralised Italian model. The centralised English model on the other hand is seen to be more compatible with present centralisation of education in Italy, but would require more private sector involvement.

Finally, Brosio observes that substantial improvement in Italian school system requires a comprehensive national strategy. He mentions Korea and Japan among the most valuable examples in this context – the well-known top performers in the area of education sector.

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Chapter 1

Welfare services in Norwegian local governments: has decentralisation come to an end?

Lars-Erik Borge^{10 11}

Abstract

During the last three decades of the 20th century, local government consumption in Norway increased steadily as a share of GDP. Local responsibility for welfare services or social expenditures was an important driving force. The hospital reform in 2002 reduced the importance of the local public sector as a provider of welfare services, but the degree of decentralisation (measured as the ratio of local to central government consumption) has been on decline since the mid-1980s. Recent trends in earmarking, regulation, and service organisation point towards even more centralisation. This triggers the question of whether decentralisation has come to an end. It is argued that the ongoing process of municipal amalgamations is crucial in answering this question.

1.1. Introduction

The organisation and financing of the local public sector in Norway attempt at combining local democracy with an agency role in welfare services. Local governments are an integrated part of the welfare state and run about half of public service production. Since equalisation of ser-

¹⁰ Norwegian University of Science and Technology.

¹¹ I am grateful for comments from the participants, and in particular from my discussants Ludwig Strohner and Wouter Vermeulen.

vices is a central goal of the welfare state, service provision and financing are subject to central regulation. The local governments have been integrated in the welfare state by national laws, and the legal and financial framework established for the local public sector must be understood in this context.

With the establishment of the welfare state after World War II, a quite clear division of labour between central and local government emerged. The central government took over most municipal transfer schemes for the poor and the elderly and established a national social security system, while welfare services (education, health and social services) remained local responsibilities. Expansion and equal access to welfare services were cornerstones in the construction of the welfare state. It became a central government responsibility to provide sufficient funding, and the expansion of welfare services were largely financed by matching grants. Equalisation was achieved through fiscal equalisation and legal regulation of the services.

Major changes in financing and regulation were implemented in the 1980s and 1990s. First, in 1986 a major grant reform was implemented. Most matching grants were consolidated into a general purpose grant scheme where fiscal equalisation is achieved through tax and spending needs equalisation. In 1992 a new Local Government Act was implemented and gave local governments more freedom with respect to organisation of the political system and service production. The purpose of these reforms was to promote local democracy, local accountability and efficiency.

This paper discusses the current responsibilities of municipal and county governments in Norway (Section 2), the development of the degree of decentralisation (section 3), and some recent experiences of earmarking and central government regulation (Section 4). The paper ends (Section 5) with a brief discussion of whether the era of decentralisation has come to an end.

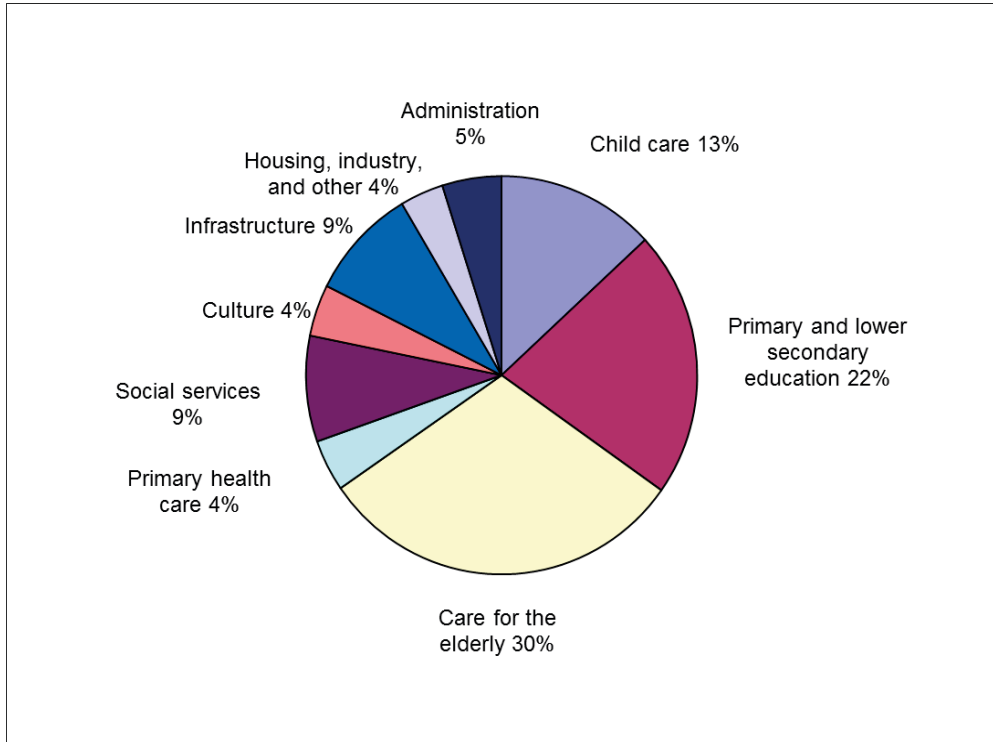
1.2. Current local government responsibilities

Norway is quite large in terms of area, but small in terms of population. By January 2015, the population size was 5.2 million. The public sector is divided into three tiers; the central government, the county governments and the municipal governments. The 18 counties and the 428

municipalities constitute the local public sector.¹² More than half of the municipalities have less than 5000 inhabitants. 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 percent of government consumption and their revenues make up nearly 20 percent of (mainland) GDP. Close to 20 percent of the workforce is employed in the local public sector.

¹² The capital, Oslo, is a municipality that also has county responsibilities.

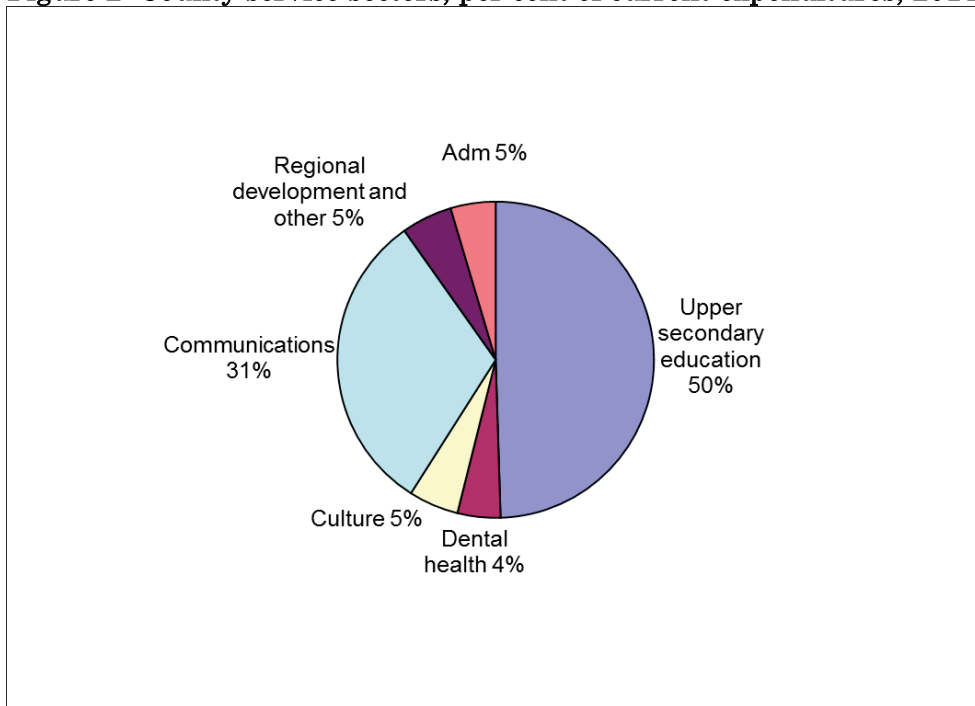
Figure 1: Municipal service sectors, percent of current expenditures, 2014



Source: Local Government Accounts, Statistics Norway

The main responsibilities of the counties are shown in Figure 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 communications (roads and public transport), which accounts for $\frac{1}{4}$ 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 health make up around 55 percent of county expenditures. However, if we consider county transport as part of a national infrastructure, this share increases to 85 percent.

Figure 2: County service sectors, per cent of current expenditures, 2014

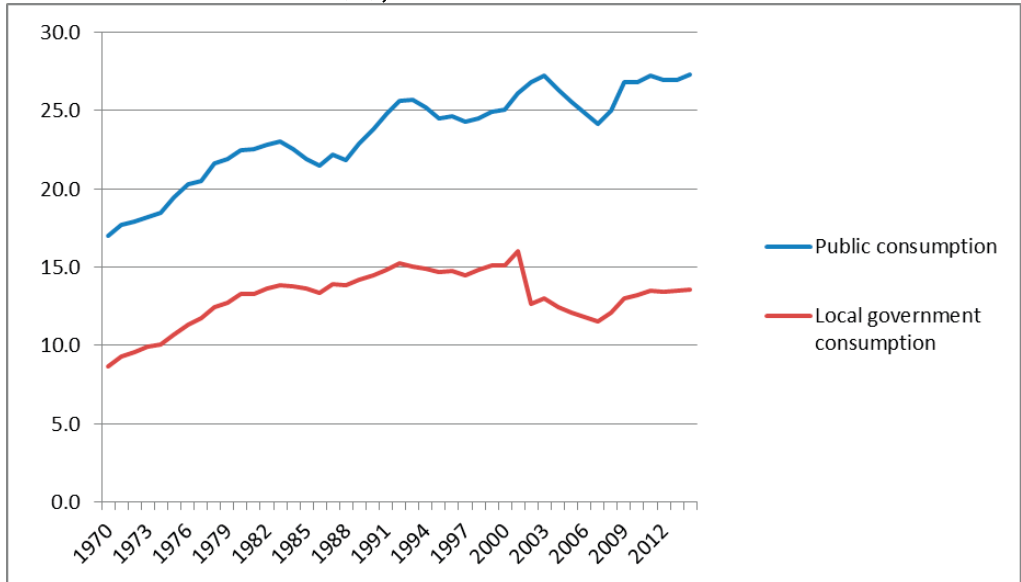


Source: Local Government Accounts, Statistics Norway

1.3. The development of public consumption since 1970

In the Norwegian welfare state, local governments (municipalities and counties) are important providers of public welfare services within education, health and social services. Figure 3 shows the development of public consumption (local and central) and local government consumption as share of Mainland GDP for the period 1970-2014. Until 2001 both public consumption and local government consumption increased steadily as a share of GDP. However, the growth was higher for local government consumption than for public consumption in total. While local government consumption amounted to around 50 percent of public consumption in 1970, it increased to around 60 percent by the turn of the century. On average, the real annual growth rates from 1970 to 2001 were 4.1 percent for local public consumption and 3.3 percent for central government consumption.

Figure 3: Public consumption and local government consumption as share of Mainland GDP (%), 1970-2014

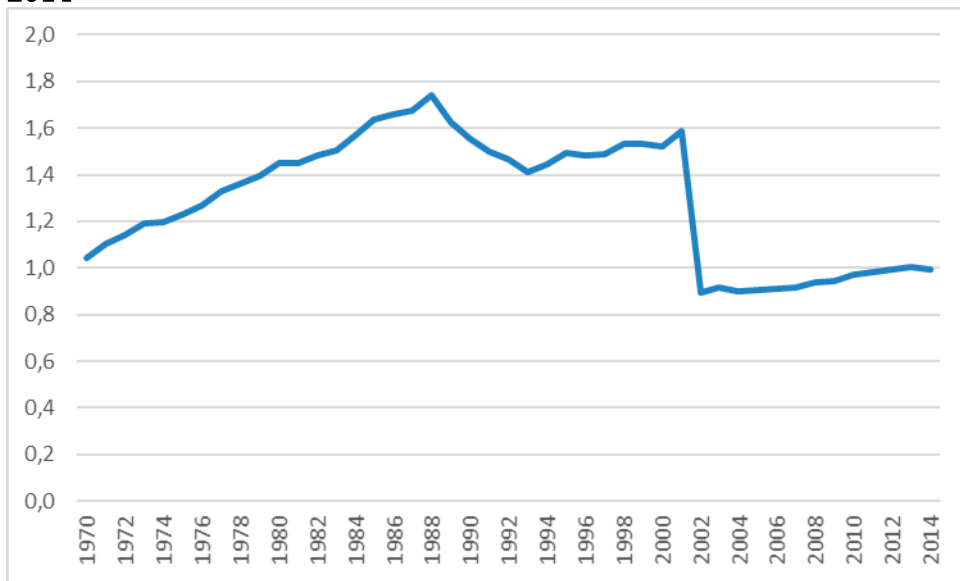


Source: National accounts, Statistics Norway

From 2001 to 2002 local government consumption was sharply reduced, from 16 percent of GDP to less than 13 percent of GDP. This reflects that the central government took over the responsibility for hospitals, and as a consequence, the share of local public consumption in total public consumption dropped from 61 to 47 percent. Since 2002 local public consumption has again grown faster than central government consumption and has since 2011 made up around 50 percent of total government consumption.¹³

¹³ The average annual growth rates were respectively 2.2 and 1.8 percent.

Figure 4: The ratio of local to central government consumption, 1970-2014



Source: National accounts, Statistics Norway

The ratio of local to central government consumption, displayed in Figure 4, can be interpreted as an indicator of the degree of decentralisation of public services. It appears that the degree of decentralisation increased steadily during the 1970s and most of the 1980s, but has been on decline since then. The hospital reform in 2002 was a substantial contributor to increased centralisation, but the process started already in the late 1980s.

Table 1 shows the breakdown of local government consumption by COFOG functions for 5-year intervals from 1970 to 2010. The COFOG classification separates between (i) education, (ii) social protection, (iii) health, (iv) housing, (v) economic, (vi) general, and (vii) other. To better understand the figures in Table 1, it is necessary to clarify the link between the COFOG functions and the actual services provided by municipalities and counties. The service sectors in the COFOG function education is primary and lower secondary education (municipalities) and upper secondary education (counties). Nearly 90 percent of the COFOG social protection function is home-based elderly care (municipalities) and child care (municipalities). Finally, the COFOG health function in-

cludes nursing homes (municipalities), primary health care (municipalities) and dental health (counties). Before the central government takeover in 2002, it also included hospitals (counties). It is interesting to notice that the care for the elderly sector is split between social protection (home based care) and health (nursing homes).

Table 1: Local government consumption by COFOG functions 1970-2010, percent

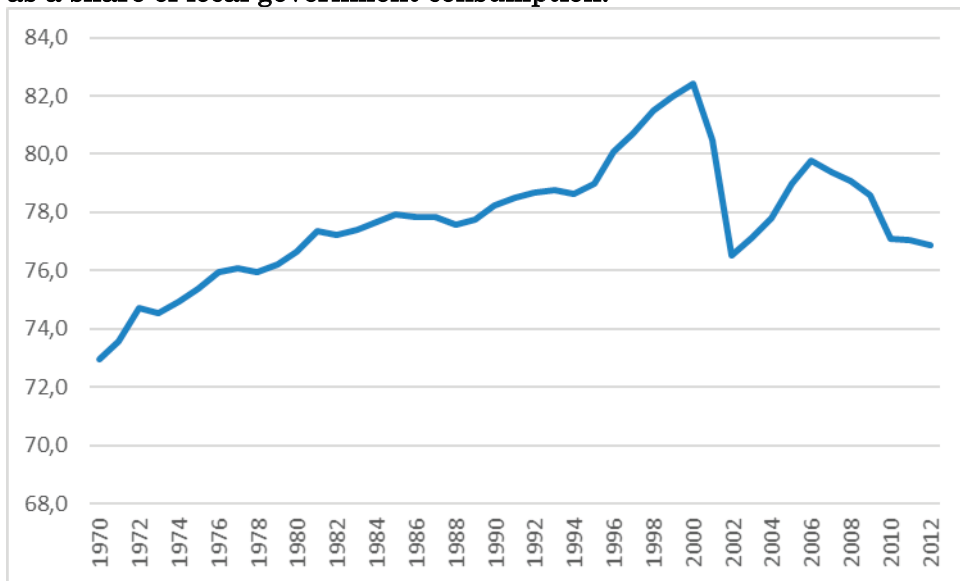
Year	Education	Social protection	Health	Housing	Economic	General	Other	Sum
1970	44.2	11.8	17.0	3.9	8.2	8.5	6.4	100.0
1975	37.4	16.6	21.4	3.5	7.3	7.7	6.1	100.0
1980	33.9	19.4	23.4	3.1	6.2	7.6	6.4	100.0
1985	32.0	21.1	24.9	2.7	5.3	8.1	6.0	100.1
1990	30.8	23.6	23.9	2.6	4.2	9.2	5.7	100.0
1991	29.8	15.1	33.6	1.6	3.7	8.7	7.5	100.0
1995	27.7	17.3	33.9	2.4	3.5	8.1	7.0	99.9
2000	28.0	17.3	37.0	1.3	2.7	7.2	6.4	99.9
2002	35.3	24.7	16.6	0.8	3.2	13.3	6.2	100.1
2005	35.5	27.6	15.9	0.2	3.1	11.8	5.9	100.0
2010	32.0	30.6	14.4	0.5	4.2	11.7	6.6	100.0

Note: There are breaks in the series for 1991 and 2002 reflecting accounting standards (nursing homes classified as health from 1991) and the hospital reform in 2002.

Source: National accounts, Statistics Norway

Social expenditures may be defined as education, health and social protection. These are services where the central government imposes national standards to secure that services are of a reasonable standard and to limit the variation across local governments. In Norway the spending needs equalisation system for local governments includes so called welfare services, a term that roughly corresponds to social expenditures. Social expenditures is the main local government responsibility in terms consumption, and its importance has increased over time (see Figure 5). The share of social expenditures in local government consumption increased from 73 percent in 1970 to 82 percent in 2000. After the central government became responsible for hospitals, the share of social expenditures has been 78 percent on average.

Figure 5: Social expenditures (education, health and social protection) as a share of local government consumption.



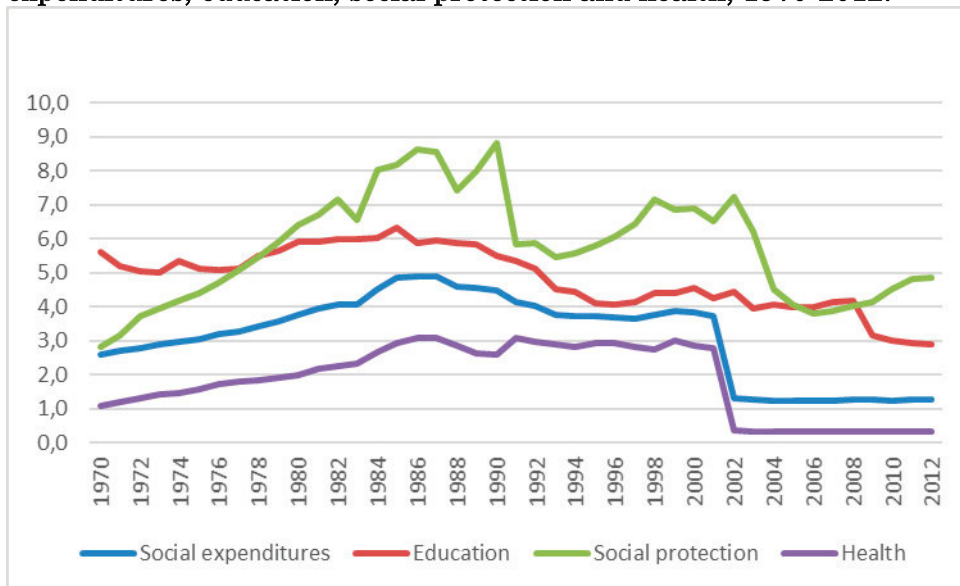
Source: National accounts, Statistics Norway

Among social expenditures, the expansion has been largest for social protection. Its share of local government consumption more than doubled from 1970 to 1990. In 1991 there is a break in the series, reflecting that institutions for the elderly became classified as health instead of social protection. Then the share of social protection increased during the 1990s, jumped in 2002 because of the hospital reform and increased again during the 2000s. The growth reflects expansion of (home-based) care for the elderly, and in recent years, a sharp increase of younger users (below 67 years of age) in home-based care and the child care reform. The aims of the child care reform were to increase the number of child care places to achieve full coverage and to impose a maximum limit on user charges. Full coverage was achieved in 2010.

On the other hand, education has been on the decline despite a number of reforms like expansion of before and after care, right to upper secondary education (1994) and school start for 6-year-old students (1997). However, in absolute terms, education has not been declining. On average the real annual growth has been around 2 percent. The relative decline of education reflects even higher growth in social protection and

health (until 2001). This fits well with the low expenditure elasticities for education, as estimated by Borge and Rattsø (1994) and Aaberge and Langørgeren (2003), among others.

Figure 6: The ratio of local to central government consumption for social expenditures, education, social protection and health, 1970-2012.



Source: National accounts, Statistics Norway

The ratio between local and central government consumptions is an indicator of the degree of decentralisation of service provision. Figure 6 shows the development of the local-central ratio for social expenditures as well as the individual components education, social protection and health. It appears that the local-central ratios increased steadily during the 1970s and the first half of the 1980s. For social expenditures, the local-central ratio peaked at nearly 5 in the mid-1980s, i.e. local government consumption for social expenditures were nearly 5 times as large as central government consumption. Since the mid-1980s there has been a gradual decline in the local-central ratios, and after the hospital reform, the local-central ratio for social expenditures has been stable at 1.3. By this measure there has been a sharp decline in the degree of decentralisation over the last three decades.

The reduction in the degree of decentralisation is mainly driven by the hospital reform in 2002, but the same trend is observed for education and social protection. In social protection a major shift occurred in 2004 when the central government took over responsibility for child welfare institutions and foster homes from the counties. For education the trend is not driven by shifts in responsibilities between government tiers, but rather by a huge expansion of higher education (universities and regional colleges), which is a central government responsibility.

1.4. Financing and regulation of welfare services: Some recent experiences

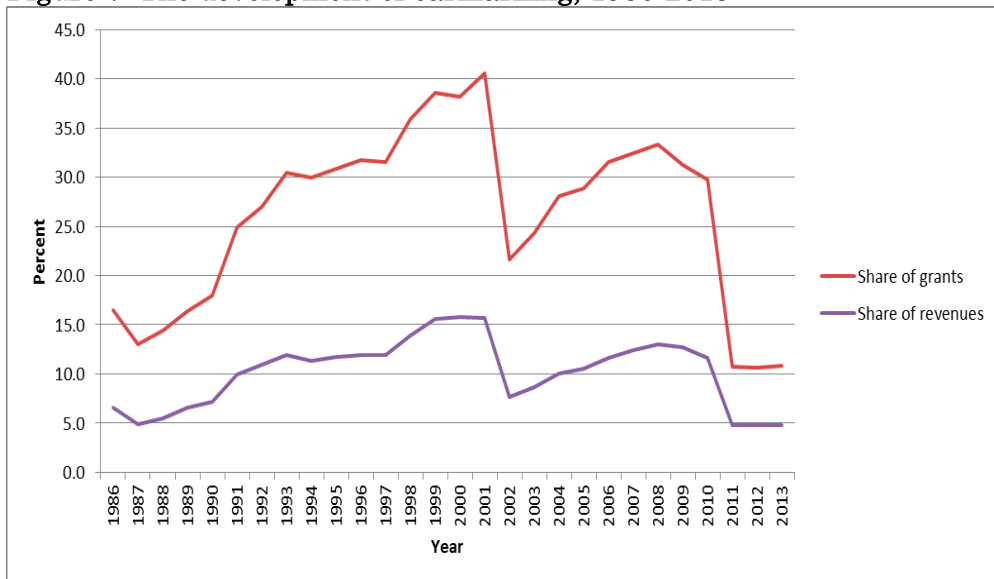
With the responsibility for welfare services, Norwegian local governments have an important role in society, and the performance of the local public sector is subject to intense public debate. International knowledge tests (PISA and TIMMS) have demonstrated that student achievement in primary and lower secondary education is below the OECD-average despite high resource use per student compared to other countries. In upper secondary education (high schools) the dropout rate is around 1/3 on average and with huge variation across counties. Care for the elderly has expanded in recent years, but with an increased number of elderly, the coverage rates have not increased much. And individual cases of insufficient care receive substantial media attention. In many small municipalities, specialised services like educational-psychological service and child welfare suffer from a too tiny specialist environment to develop high-quality services. Maintenance backlog and buildings (schools and nursing homes) in decay is also a concern (Borge and Hopland 2016). These concerns tend to raise demands for earmarking, regulation, central government takeover of services and also increased grants from an (until now) oil rich central government. In the following I provide some recent examples of earmarking, regulation and central governments takeover of services.

Earmarking

The general purpose grant scheme has been under constant pressure since it was introduced in 1986, see Figure 7 and the discussions by Carlsen (1995) and Borge (2010). The degree of earmarking increased steadily from 1987 to the hospital reform in 2001, despite an ambition to further reduce it after 1986. The drop in 2002 reflects that hospitals, to a larger extent than other services, were financed by earmarked grants. After 2002, the degree of earmarking increased again, mainly

due to the child care reform that was financed by earmarked grants. After child care was included in the general purpose grant system in 2011, the degree of earmarking has returned to the lowest level in 30 years. A likely interpretation of this development is that the central government often meets the demand for more earmarking, but also that it is able to phase out most of them.

Figure 7: The development of earmarking, 1986-2013



The child care reform is a prime example of how earmarked grants are applied. They are used temporarily to expand a service, and after the service is built up they are phased out. However, it is important to notice that in the case of child care, earmarking was replaced by an individual right to child care for children above 1 years of age.

Individual rights may be more difficult to impose for other services like child welfare and care for the elderly, where earmarked grants are also in place. Child welfare has been expanded in recent years financed by an earmarked grant amounting NOK 0.5 billion (USD 62 million) in 2015. It will be hard to design an individual right to child welfare in the same fashion as for child care as decisions to some extent must be based on judgement. A phase out of the child welfare grant will probably be more difficult than the phase out of the child care grant.

Care for the elderly is largely financed by taxes and general purpose grants, but two types of earmarked grants have to some extent become a permanent feature. The first type is an earmarked grant that compensates municipalities for “resource-demanding” users. More specifically, the grant is of the matching type and equals 80 percent of the local costs above a specific threshold for individual users. The justification for this grant scheme is that many Norwegian local governments are too small for the “law of large numbers” to apply. There is huge variation across municipalities, in both the number of resource-demanding users (per capita) and the change in the number of resource-demanding users over time, in particular for municipalities with less than 10,000 inhabitants. This variation is a source of a financial risk, and the grant works to reduce the risk borne by the municipalities. The risk is shifted over to the national government, which is in a better position to bear the risk because of a larger insurance pool. The risk sharing aspect is also emphasised by Bergvall et al (2006) in their discussion of the theory and practice of intergovernmental transfers. However, there is a concern that the grant weakens the municipalities’ incentives to keep costs down for users above the threshold. The grant for resource-demanding users has had a sharp increase in recent years, and in 2015 it amounted to 8 percent of total spending on elderly care.

The other type is a grant for nursing homes consisting of two parts. The first part is an investment grant of the matching type to cover parts of the projected building costs. The remaining costs are supposed to be financed by borrowing, and the second part is an annual grant to cover interest and instalments. The total amount is NOK 2.6 billion (USD 325 million) in 2015. These earmarked grants date back to the late 1990s as part of the Action Plan for the Elderly. Although the action plan ended in 2003, the earmarked grants have remained.¹⁴ The effects of this action plan is analysed by Borge and Haraldsvik (2016). They find that the action plan worked as intended to increase expenditures and the share of single rooms in nursing homes, but it had unintended consequences in terms of lower spending on education, reduced child care coverage and increased budget deficit.

¹⁴ The compensation for interest and instalments would last longer than the action plan, but that was not the case for the investment grant that makes up nearly 2/3 of the total amount.

The current conservative government has announced that the state should take more responsibility for quality and investments in the care for the elderly sector. Starting in May 2016 an experiment with central financing of elderly care will be rolled out in 20 municipalities. The municipalities can choose between two models (A and B). In model A, services for individual users are assigned based on criteria set by the central government. Municipal employees assign services and the costs are covered by the state. There will be some budgetary risk for the state because of uncertainty with respect to the number of users and the services provided for each user. Cost control (per unit of service) is achieved by a centrally determined price model. The model assumes that municipalities and private providers are willing to provide the service for the fixed price. Model A can be understood as a Prospective Payments System (PPS). Model B is more similar to the present system. The difference is that the municipal budget for elderly care is effectively determined by the central government through a sectoral block grant and there is no budgetary risk for the central government.¹⁵

In model A, the municipalities are almost totally put on the sideline for elderly care. They have little or no responsibility for financing and no discretion in assignment of services. They mainly supply services along with private providers. In model B, the municipalities have discretion in assignment, but little responsibility for financing. Both models are in conflict with the principle that the government tier responsible for a service should also be responsible for financing. Model A is probably not a long term solution and is best understood as a first step towards a central government takeover of elderly care.

Regulation

The new Local Government Act of 1992 gave municipalities and counties more freedom with respect to the organisation of the political system and service production. As pointed out by Lilleschulstad (2016), the new act was a framework act and later the laws for the specific services were changed to be in line with the new Local Government Act. It is fair to say that the legal regulations of the specific services leave municipalities and counties with substantial flexibility in how to run the services. An example of reduced formal regulation is the elimination of the

¹⁵ A similar model was originally proposed for the child care reform, but in the end a more traditional model of financing was chosen.

maximum class size rule in 2003, which was replaced by a requirement of a proper pedagogical group size.

However, sectoral interests do not have faith that all local governments are able to decide on a proper number of teachers per student or more generally a proper number of employees per user. They argue that the central government should impose stricter minimum standards and regulate the number of teachers per student and the number of employees per user in nursing homes. The previous government proposed to impose a maximum group size in primary and lower secondary education. Borge, Falch and Strøm (2012) showed that affected municipalities (higher group size than the proposed maximum) on average had better student performance than municipalities that would not be affected (lower group size than the proposed maximum). They argued that a maximum group size would force municipalities with well-functioning schools (in terms of student achievement) to increase spending on education and reduce spending for other services. This would most likely reduce allocative efficiency. In the end the proposal was downscaled and ended up as a minor earmarked grant for lower group size, targeted towards municipalities with poor student performance and few teachers per student.

Central government takeover

As discussed in Sections 2 and 3, the division of labour between the government tiers has shifted from the county governments to central government in recent years by the state takeovers of hospitals and child welfare institutions. A small step in the opposite direction was increased county responsibilities for roads and regional development in 2010. The responsibilities of the municipalities are largely unaffected, but there are also some tendencies of increased central government involvement in municipal services.

The clearest example is the establishment of the Norwegian Labour and Welfare Administration (NAV). The so called NAV reform was carried out from 2006 to 2011. The reform was mainly a merger between two central government agencies, the social security administration and the directorate of labour, but local NAV-offices also include municipal activities related to social assistance. The idea is to have “one door” for the users, but behind this door is a complicated organisation with both central governments and municipal employees. In many cases, the municipi-

palties have contributed to even more complication by including social services like child welfare and substance abuse treatment in the NAV offices. One of the main aims by the NAV reform was to reduce unemployment by coordinating the forces of the former director of labour (responsible for individuals that are registered as unemployed) and the municipal social assistance department (responsible for recipients of social assistance with a looser attachment to the labour market). The NAV reform is evaluated by Fevang, Markussen, and Røed (2014) who utilised that the timing of reform implementation varied across the country. Their main finding is that the establishment of NAV-offices increased the unemployment spell for both registered unemployed and recipients of social assistance. But since the negative effects seem to be reduced over time, it cannot be concluded that the old model was better than the new one.

Over time, the municipal welfare services are getting more complicated and require more specialised skills. This is clearly the case for specialised services like child welfare, educational-psychological service and substance abuse treatment, but also for larger services like education, care for the elderly and primary health care. Education used to be mostly about the building and location of schools, but nowadays there is more emphasis on student learning – a much more complicated task. In the care for the elderly sector, welfare technology must be developed and applied to meet the wave of the elderly. There is an increasing concern that most municipalities are far too small to handle these challenges, and in 2014, the current central government appointed an expert group to propose criteria for a new size structure for the municipalities. The expert group concluded that municipalities should have at least 15.000-20.000 inhabitants in order provide good services, given their present responsibilities. Municipalities of that size could also take on a more coherent responsibility for specialised welfare services. The central government has initiated a voluntary reform process, but without any explicit minimum size. Based on the experiences from Finland (e.g. Moisio 2016), it is unlikely that a voluntary process will result in a coherent municipal structure in all parts of the country.

1.5. Has decentralisation come to an end?

During the last three decades of the 20th century local government consumption in Norway increased steadily as a share of GDP. The hospital reform in 2002 reduced the importance of the local public sector as a

provider of welfare services. However, the degree of decentralisation (measured as the ratio of local to central government consumption) has been on decline since the mid-1980s, and central government has become more involved in provision of public services. Recent trends in earmarking, regulation and service organisation point towards even more centralisation. This triggers the question of whether decentralisation has come to an end.

In my view the ongoing process of municipal amalgamations is crucial in this respect. A successful amalgamation reform will make the municipalities capable of carrying the current services and take on new tasks. As a consequence, the trend of increased centralisation may be reversed. The argument is that the central government will be more willing to delegate service responsibility to larger municipalities that are capable of providing high quality services. Moreover, the need for earmarking and regulation will be reduced as larger municipalities can handle financial risks and will have more competence to provide specialised services and to improve service quality for larger services such as education and elderly care.

With an unsuccessful amalgamation reform (which seems to be the case), many municipalities will be too small to carry the current responsibilities. As a consequence, the central government may be reluctant to give the municipalities new tasks and their responsibility for specialised welfare services may be reduced. Central regulation and earmarking is likely to remain, and may even increase as detailed regulation is necessary to compensate for the lack of competence in the smaller municipalities. Reduced responsibilities for the municipalities would not necessarily lead to an increased degree of centralisation, measured as the ratio of local to central government consumption. That depends on whether the responsibilities are shifted to the counties or the national government.

However, even with an unsuccessful amalgamation reform, it is unlikely that the responsibilities of the municipalities will be much reduced in the short term. Currently the central government has little appetite to take over more local services since the NAV reform has been messy and the hospital reform expensive (Tjerbo and Hagen 2009). In the nearest future we will probably see a continuation of recent trends, i.e. somewhat increased centralisation and more earmarking and regulation.

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Chapter 2

Is decentralisation in Austria effective? A view on Health, Education and Social Welfare

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Abstract

Regional and local governments in Austria play an important role in providing public services with a redistributive component, such as health, education or social welfare. The federal government is responsible for legislation in these fields to a large extent. The division of responsibilities is mainly a consequence of historical developments. Nevertheless, the centralisation of legislation is also supported by preferences of the population. Economic arguments for decentralisation are a higher degree of innovation and possible efficiency gains. However, the federal system in Austria does not provide incentives to realise these gains. The most important reasons for this result are overlapping competences between different layers of government, the inexistence of tax autonomy at the sub-central levels and non-transparent transfer relations between different levels of government. To make federalism work in these important public fields, an unambiguous distribution of competences and responsibility for financing are necessary.

2.1. Introduction

The theoretical literature about federalism suggests that the role of redistribution should be assigned to the federal level. Redistribution at decentral-

¹⁶ EcoAustria.

¹⁷ I am grateful for comments from the participants of the workshop, especially Giorgio Brosio and Antti Moisio.

ised levels can lead to a decline of the tax base as a result of tax competition between communities or provinces. However, in many countries public services with a redistributive component are provided at a sub-central level, like health, education or social welfare. In this paper, I discuss the extent of decentralisation in these policy fields in Austria. Although Austria is a comparably small country, with 8.5 million inhabitants, federalism plays an important role in the administration and the political process. The country is composed of 9 provinces, 99 districts and about 2.100 local communities. Compared to other countries like Germany, with only 16 provinces, Austria is divided into very small entities. The size of administration units within Austria varies a lot. The population in the provinces ranges from about 290,000 to about 1.8 million inhabitants. The importance of federalism is less a result of the legislative power of state parliaments. It is rather a consequence of the large political power of the governors of the state. The federal system can be characterised by a considerable responsibility for public expenditures at the sub-central level but nearly no responsibility for revenues.¹⁸

In this paper, I will first provide a short overview on the health, education and social welfare system in Austria from a federal perspective and its historical development as an important root of today's system (Section 2). In Section 3, the share of expenditures for these systems at the sub-central level is presented to give an overview of the importance of sub-central levels in providing these public services. In Section 4, I discuss reasons for decentralisation of public services with a distributional impact and whether these reasons are valid in Austria. A special focus lies on the impact of decentralisation on the efficiency of the provision of the discussed public services. Conclusions will be provided in Section 5.

2.2. Overview on the historical development and today's system in health, education and social welfare in Austria

In this chapter the distribution of competences in the policy fields of health, education and social welfare is discussed. To understand how the political system works, it is necessary to take a look at the historical development and its influence on the allocation of competencies in a federal state. For example, it took France 30 years to move from a high-

¹⁸ See Strohner et al. (2015).

ly centralised country to a fairly decentralised one nowadays.¹⁹ For this reason, the following discussion presents an overview of the historical context and the main aspects of the systems in the considered policy fields.

2.2.1. Historical Development²⁰

Comparable with the development in Germany, the expansion of the welfare state started already under the Habsburg monarchy in the 19th century and followed a top-down approach. The reforms were initiated by the conservative elite to avoid conflicts with the workers' movement and to protect small companies and craftsmen. It was also seen as an opportunity to calm the strong centrifugal forces in the multi-ethnic state. From this point of view there is a difference compared to the development in Germany. The introduction of a broad welfare state should preserve the economic and social order whereas in Germany the reform was rather future oriented.

The introduction of accident insurance (1887), health insurance (1888) and old-age pension insurance for white collar workers (1906) represented the major steps towards the welfare state. The social insurance system was organised along professions and focused on industrial workers. Agricultural and forestry workers as well as farmers and self-employed remained without social insurance. There was a strong opposition from the authority in the provinces due to agrarian feudal interests. The administration of the accident insurance was initially based on a territorial principle established in seven provinces and possessed federal characteristics. Due to the exclusion of different types of workers, the social insurance system had a low degree of coverage.

In contrast to social insurance, poverty assistance regulation was enacted by provinces and municipalities, and social assistance was under the responsibility of municipalities. The place of birth was crucial for the ability to assert claims. Provinces were authorised to implement partially and supplementary measures, and they made use of this right. The local jurisdictions led to considerable regional disparities with respect to organisation, funding and benefit provision.

¹⁹ See Prud'homme (2006).

²⁰ This section is based to a large extent on the work of Obinger (2005).

Austria is a country with a strong political transformation after the First World War, from a multi-ethnic superpower ('Österreichisch-Ungarische Monarchie') to a small democracy. The new constitution was a compromise between the two important political parties, the Christian Social Party (CSP) and the Social Democratic Workers' Party (SDWP). The first one strongly supported a federalist system, whereas the Social Democrats favoured a centralist constitution. Although Austria was constituted as a federal state, there was a strong tendency towards centralisation. This can be seen in the strong centralisation in legislation in spite of the principle of subsidiarity, a weak power of the second chamber of parliament and a centralist fiscal constitution.

The formation of unemployment insurance in 1920 and the extension of the health insurance system, e.g. towards civil servants, extended the welfare state. The federal constitution of 1920 assigned the social insurance system to the federal level, with the exception of the insurance of agricultural and forestry workers. Social insurance was self-governed by the employers and employees. In addition, the federal level had the right to enact framework legislation on certain social policy issues like general welfare, hospitals and welfare for blue and white collar workers in agriculture and forestry. By 1925, the federal level had enacted such laws in almost all social security issues, with the exception of social assistance.

The basic principles of today's social insurance system were laid out 1956 by the General Social Security Act. It merged the different insurance branches for blue and white collar workers. The Federal Association of Austrian Social Security, founded in 1948 as umbrella organisation for pension, health and accident insurance, was responsible for the administration. Further extensions of the welfare state were also largely centralised. Family allowances, introduced in 1948, and the long-term care allowance (1993), in addition to the expansion of the social insurance system, increased federal responsibility. Altogether, the centralised welfare state expansion was also in the interest of provinces and municipalities. It reduces regional disparities and stabilises demand in regions with high unemployment or structural problems. In the last years, further steps towards centralisation have been undertaken. A minimum provision in social assistance and the devolution of the care allowance of the provinces to the central level are important examples of this.

A strong centralisation is also identifiable in the educational system, which has historical and political reasons. Before 1868, the Catholic Church was in charge of education. The constitution of 1867 led to a new competence distribution with a central level of responsibility for framework legislation. Provinces were responsible for implementation of legislation. The central level was also in charge of the execution of legislation, even provincial legislation. After the First World War, both political parties, CSP and SDWP, were not able to reach an agreement about a new distribution of competences and thus the system of the monarchy was in power until 1929. The constitutional reform of 1929 led to the result that the whole legislation and execution was shifted to the central level. The state and district education authorities were responsible for execution, both of which were federal authorities, but not bound by directives and responsible only to the constitutional court.

After the Second World War until 1962, the educational system was dominated by the provinces as a consequence of administrative differences. The reform of 1962 led to the central system which still prevails in the educational system. It introduced the requirement of a qualified majority and the 'inverse subsidiarity' rule for legislation in the educational system. Although this reform was a strong setback of the provincial influence it was a result of a compromise between the different layers of government. Erk (2004) states, that the provinces were engaged actively in the nationalisation of education. Since 1971, it has been possible to perform pilot projects. Given that reforms in the educational system require a qualified majority in parliament and that the political system was dominated for a long time by two political parties with opposed views on organisation and competence, far-reaching reforms in the compulsory education system did not happen.

A discussion about a reform of the system was initiated by sobering PISA results of Austrian pupils. This led to the appointment of the so-called 'commission for the future' in 2001. However, important reform proposals, like increased autonomy of individual schools, were not implemented. Recently, a reform has been launched providing more autonomy on school level.

2.2.2. Description of today's systems

Competences in the public Austrian health system are highly fragmented.²¹ Compulsory insurance is organised according to regional and occupational criteria. Currently there exist 36 different social insurance institutions ('Krankenkassen' and 'Krankenfürsorgeanstalten') that form the basis for the organisation and funding of the public health system. The most important field of the provinces in the health care system is hospital care. The regional level is responsible for legislation on hospital organisation and financing, but has to take account of the framework legislation of the federal level. Provinces determine the access to the hospital market and run most of the acute-care hospitals, directly or indirectly through publicly owned companies. Financing is organised by provincial health funds ('Landesgesundheitsfonds'). The administrative body of the health funds is the health platform ('Gesundheitsplattform'), generally staffed by representatives of the provinces, the federal level, the social health insurance (SHI), the association of the Austrian cities as well as municipalities and the Austrian chamber of physicians. The platform discusses all matters related to the health system in the province. The provinces have the majority of votes related to hospitals, and the SHI with respect to outpatient care. Coordination between these two pillars of the health system should be improved by the introduction of reform pools, but it was not successful. Sanitary matters and sanitary supervision of hospitals are settled at the district level (99 in Austria). Municipalities are responsible for some sanitary matters and a few are owners of hospitals. The number of hospitals belonging to municipalities is declining.²² They are also involved in hospital financing of provincial hospitals.

Social welfare was dominated by the provinces in legislation as well as in administration for a long time. The federal level was responsible for framework legislation with respect to social welfare and nursing homes. Originally, provinces were responsible for the legislation and the provision of benefits and services in social care. Some benefits were also provided by the SHIs. However, social welfare is more and more influenced

²¹ The overview about the health system and social welfare is largely based on the work of Trukeschitz et al. (2013).

²² A transfer of the management of hospitals to the regional level can also be observed in Scandinavian countries, see Ahmad and Brosio (2009). Reasons for the shift to the provincial level are economies of scale and positive externalities to other communities.

by the federal level. This tendency towards centralisation arises in social care as well as in social assistance.

The 1993 legislation in social care was a major step to decrease the fragmentation and differentiation in benefits and support between provinces. It introduced a framework regulation for the social care system and the federal care allowance²³. In the last years, additional benefits were introduced at the federal level to support family members who support people in need of social care²⁴ (e.g. benefits supporting 24-hour care²⁵). A reform of social welfare benefits took place in 2010. Differences in the benefits in the provinces led to the introduction of a minimum level of social welfare benefits, the so-called ‘Bedarfsorientierte Mindestsicherung’. These steps led to a harmonisation of the generosity of the provincial allowances.

Social welfare services are provided by different layers of the federation, i.e. the provinces, the municipalities, districts and public associations of welfare agencies (‘Sozialhilfverbände’). Regions as well as municipalities are responsible for financing social welfare services.

Table 1: Distribution of legislative authority for social provision as between state and central government

	Australia	Austria	Canada	Germany	Switzerland	USA	Sum
Old age, survivors and disability	1	1	0.5	1	1	1	5.5
Health	1	1	0.5	1	1	0.5	5
Work injury	0	1	0	1	1	0	3
Unemployment	1	1	1	1	1	0.5	5.5
Family allowance	1	1	0.5	1	1	0.5	5
Social assistance	1	0.5	0	1	0	0.5	3
Sum	5	5.5	2.5	6	5	3	27

Legend: 1 = federal jurisdiction, 0 = state or provincial jurisdiction, 0.5 = shared jurisdiction

Source: Obinger et al. (2005).

²³ Until 2011, provinces also granted a care-allowance for persons not eligible for the federal allowance. Since 2011 the provincial care allowance was included in the federal allowance.

²⁴ Informal care plays an important role in Austria. About 70% to 80% of dependent older persons rely on help provided by family members.

²⁵ Financing is split between the federal level (60%) and provinces (40%).

The strong centralisation of legislative authority in social issues in Austria is summarised in Table 1. It shows the responsible legislative authority in several federal countries for different aspects of social policy. In Austria, with the exception of social assistance, the legislative authority is the federal jurisdiction. Higher centralisation with respect to legislation can be found only in Germany, where each social issue is settled at the federal level. In Switzerland and Australia legislation is also rather centralised. A strong responsibility at the decentralised level arises only in Canada and the United States.

Education policy in Austria is a controversial topic with intense political discussions. This led to a complex distribution of competences between the central level and the provinces. In a wide range of areas, a qualified majority in the parliament is necessary for reforms. In contrast to the general subsidiarity rule, for education an ‘inverse subsidiarity’ rule is applied.²⁶ In the Austrian educational system, one finds four different types of competence distribution, which are presented in Table 2.

²⁶ See Fallend (2012), p. 80.

Table 2: Types of competence distribution in the school system in Austria

<p>I: Federal Government: Legislation and Executive Administration</p>	<p>Secondary Academic Schools (Upper and Lower Secondary). Vocational Education and Training Schools (Upper Secondary). Public Services Law and Employee Representation Legislation for teachers teaching at schools listed above.</p>
<p>II: Federal Government: Legislation Provincial Government: Executive Administration</p>	<p>Public Services Law and Employee Representation Legislation for teachers teaching at Public Compulsory Schools, i.e. Primary Schools, Regular Secondary Schools (Lower Secondary), Special Schools, Pre-Vocational Schools ('Politechnische Schulen') and Vocational Schools for Apprentices.</p>
<p>III: Federal Government: Framework Legislation Provincial Government: Implementation Legislation and Executive Administration</p>	<p>Formation and organisation of school governing authorities of the Central State in the Federal States ('Landesschulräte'). Allocation and organisation of Public Compulsory Schools (see listing above): Location and maintenance of infrastructure and facilities, regulation of maximum class size, teaching time and closing of locations.</p>
<p>IV: Provincial Government: Legislation and Executive Administration</p>	<p>Public Services Prerogative over teachers on Public Compulsory Schools (see listing above) in cooperation with Central States school governing authorities ('Landesschulräte') as regards the appointment of teachers, nomination and disciplinary proceedings. Kindergarten and after-school-care institutions.</p>

Source: Fallend (2012).

The central level is responsible for the education of teachers, curricula and a list of textbooks for the lessons. In the year 2009, national education standards for the fourth and eighth grades were introduced. As

Table 2 shows, the federal level is also responsible for the secondary academic schools and vocational education and training schools, whereas provinces are responsible for allocation and organisation of public compulsory schools (primary schools and lower secondary schools as well as special schools). Teachers of the secondary academic schools are employed at the federal level, teachers of public compulsory schools at the provincial level. However, the federal level refunds wage costs of the latter ones to provinces after approving the staff appointment scheme provided by the provinces. This rule is heavily criticised as the autonomy in personal matters and the responsibility for financing teachers diverge. There exists some autonomy²⁷ in the Austrian schooling system through the possibility of pilot projects. However, the number of pilot projects is restricted as a qualified majority of parents and teachers have to agree and at most 10% of all classes are allowed to participate in a pilot project. In 2012/13, pilot projects took place in about 50% of all schools. The high share is a consequence of missing or inflexible legal provisions.²⁸

The federal administration at the provincial level is organised by state school governing authorities which are responsible to the federal minister. Interestingly, the governors of the states are head of these authorities. This system leads to a balance of the interests of the federal level and the state level but also to fragmented and parallel competences and missing use of these competences.^{29,30}

2.2.3. Historical path dependency in federalism

The system of federalism in Austria is to a large extent determined by historical developments. Especially the continuity of the constitution of the year 1920/25, as amended in the year 1929, plays an important role

²⁷ Pilot projects increase rather the autonomy of schools than of provinces.

²⁸ See Schmid (2015).

²⁹ See Schmid (2015).

³⁰ In September 2014 the government decided to install a reform commission, which presented their results in November 2015. According to the proposal, the state school governing authorities should be replaced by education boards ('Bildungsdirektionen'), which is a common authority of the federal and provincial level such that parallel competences will continue to be an outstanding feature of the educational system. In addition, the autonomy of schools should be strengthened by e.g. more flexible resource management and co-determination of employment of teachers.

for the distribution of competences between the federal state and provinces. Organisational models can partly even be traced back to the monarchy.³¹ Attempts to reform the distribution of competences failed as a consequence of divergent interests. First, interests differed between the two main political parties, the Social Democratic Party favouring a centralised view of federalism and the Peoples Party favouring a more decentralised form of federalism. In addition, there are also opposing interests between the federal and the provincial level, especially the provincial governors and the federal government. The strong political position of provincial governors led to very restricted reforms in the distribution of competences. Important attempts to prepare constitutional reforms in 1994 and 2004 failed due to opposing interests of the involved negotiators.

The current form of federalism in Austria is therefore a result of the historical development and very rigid. It is not based on theoretical considerations about an optimal structure and division of responsibilities within the federal structure. In addition, the rigidity of the system does not even lead to gradual adjustments to increase the efficiency of the system as a result of the divergent interests and political power of the groups involved. The political responsibility of provincial and local governments for revenues is very low in Austria (see discussion below) as transfers from the revenue sharing agreement are the dominant source of revenue of decentralised governments. For this reason, it is in the interest of state governors to claim additional tasks and to refrain from handing over responsibilities to other levels of the federation.

2.3. Expenditures at the provincial and local level

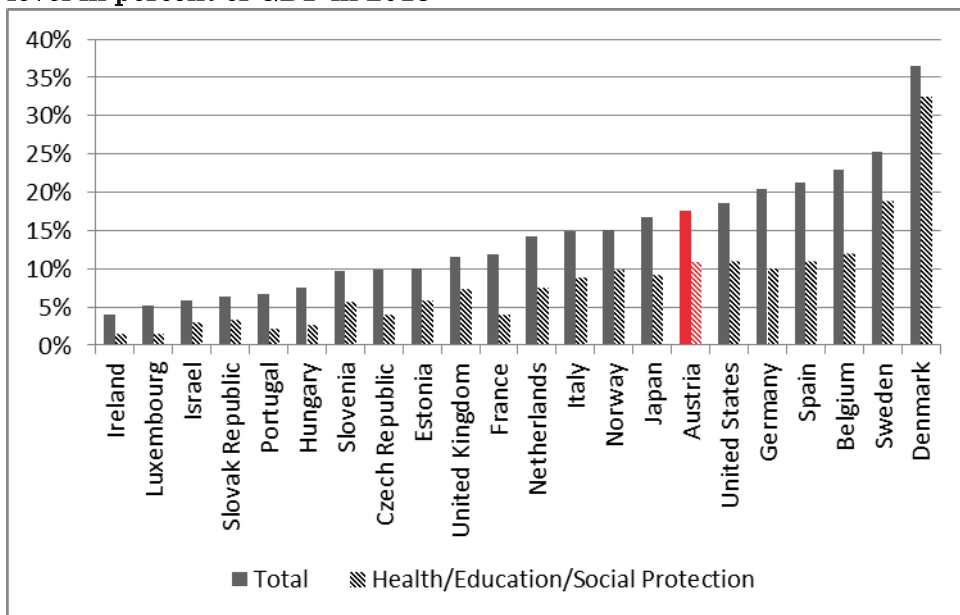
In contrast to the highly centralised legislation in the fields of health, education and social protection, execution in Austria is decentralised to a large extent. Provinces and municipalities are responsible for a considerable share of overall public expenditures and also in these policy fields. To provide an overview of the share of expenditures at different levels of government for the different fields of public policy, information based on COFOG is presented.³² Figure 1 shows the sum of unconsoli-

³¹ See Konrath (2005).

³² One has to keep in mind that information about expenditures for different levels of government is unconsolidated, i.e. intragovernmental transfers are counted twice and

dated total expenditures as percent of GDP at the regional and local level (left column) and expenditures for health, education and social protection (right column). These two figures show that expenditures on the regional and local level play an important role in Austria compared to many other countries, although decentralisation of expenditures is considerably lower than in Denmark. Higher expenditures in the fields of interest can be found in Spain, the United States, Belgium, Sweden and Denmark. Germany exhibits a comparable level of decentralised expenditures.

Figure 1: Total expenditures (left column) and expenditures for health, education and social protection (right column) at the regional and local level in percent of GDP in 2013



Source: OECD database, own calculations.

The shares of regional and local expenditures relative to total expenditures across all levels of government for the surveyed expenditure fields are shown in Table 3. In Austria in all three fields, the share of decentralised expenditures is higher than the median of the presented countries. The highest share can be found for education (47%), followed by

not deducted. This may distort the result in case of countries in which co-financing of different levels of government takes place.

health expenditures (41%) and expenditures for social protection (14%). Considering federal countries³³ (Austria, Belgium, Germany, Italy, Spain and the United States) in comparison to centralised countries, decentralised expenditure shares are higher for health (42% vs. 15%) and education (73% vs. 41%). With respect to social protection, one cannot conclude that the share of decentralised expenditures in federal countries is higher. Also in Unitarian countries local expenditures can play an important role, like in Denmark or Sweden.

Table 3: Expenditures for health, education and social protection at the regional and local level as share of total public expenditures in these fields in 2013

	Health	Education	Social Protection
Austria	41.2%	46.7%	13.6%
Belgium	2.4%	83.3%	22.4%
Czech Republic	3.5%	43.7%	4.2%
Denmark	64.0%	43.5%	53.8%
Estonia	21.1%	57.6%	5.7%
France	1.1%	30.7%	8.5%
Germany	6.6%	96.0%	21.4%
Hungary	3.0%	22.9%	6.2%
Ireland	0.0%	10.5%	5.9%
Israel	0.3%	26.9%	6.1%
Italy	67.3%	23.6%	2.7%
Japan	13.1%	73.9%	20.4%
Luxembourg	0.3%	15.8%	1.7%
Netherlands	3.0%	47.6%	14.1%
Norway	28.4%	72.2%	22.8%
Portugal	7.5%	15.9%	2.6%
Slovak Republic	0.3%	41.5%	2.7%
Slovenia	9.8%	40.8%	4.7%
Spain	93.3%	96.4%	8.6%
Sweden	84.4%	74.0%	26.4%
United Kingdom	1.7%	43.1%	20.6%
United States	41.9%	90.4%	11.1%
Median	7.1%	43.6%	8.6%

Source: OECD database, own calculations.

³³ According to the definition of the OECD.

2.4. Decentralisation from a theoretical and practical view

From a theoretical perspective, there are several reasons for decentralisation of public functions with a distributional focus or equity considerations.³⁴ First, different preferences for redistribution or equity perceptions may call for some decentralisation of government functions with a strong redistributive effect. Preferences may not only differ with respect to other jurisdictions, but could also be very different from the view of the federal government. Second, screening and/or continual monitoring of persons receiving transfers, like the verification of job search activities, requires agencies to be close to recipients of social welfare programmes. This could be achieved by decentralisation. The vicinity to customers is also important for preventive and public health services.³⁵ Third, decentralisation can lead to improvements and innovations in programme design and programme delivery. The more regions or communities are involved, the more opportunities for innovation can arise. These innovations can be imitated by other jurisdictions. Yardsticks for delivery costs will be available and increase the efficiency of the system. Competition will induce decentralised governments to provide services in an efficient way.

However, there are several risks related to decentralisation of public functions, like health, education or social welfare. Decentralisation runs the risk of distorted internal markets and of tax and expenditure competition between different jurisdictions. It can also distort national redistributive objectives. Another argument against decentralisation referred to in literature is the loss of economies of scale. For this reason, several public service programmes are assigned to the state level and not to the local level. A possible loss of macroeconomic control, given the multiplicity of decentralised bureaucracies together with a shortage of skilled administrators, can be a third reason for a centralised provision.

Another important point is related to the way decentralised expenditures are financed. Ahmad et al. (1997) point out that this aspect is more important for the level of expenditures rather than the extent of decentralisation. Financing decentralised expenditures by federal transfers, like a revenue sharing agreement, can have a stimulating effect on expenditures leading to a higher level than optimal. According to the

³⁴ For an overview see for example Ahmad, Hewitt and Ruggiero (1997).

³⁵ See Ahmad, Hewitt and Ruggiero (1997), p. 44.

authors, examples of such an increase in expenditures can be found in Italy, Latin America or China. Revenue sharing grants do not crowd out local revenue collection but lead to increased expenditures of decentralised governments.³⁶

Which of the above-mentioned reasons for decentralisation can be applied to Austria for the discussed public services? In general, we find a strong centralisation of legislation and partly also administration. This result is in line with available information on preferences of Austrian citizens. According to Bußjäger and Seeber (2010), more than 70% of respondents of a survey prefer comparable living conditions at the federal level and 13% at the level of provinces and local communities. In addition, there is a strong preference for cooperative federalism. Only a quarter of respondents prefer competition in health and social policy and about one third in education. This result is also confirmed by a survey in three Austrian provinces.³⁷ About 70% of respondents prefer a centralised responsibility of provision of public educational services. Only 20% prefer a decentralised provision. The strong preference for uniform standards in the population does not support decentralisation of these services.

In Austria, social welfare is provided to a very large extent by the public social insurance, covering the most important social risks. The social insurance pools these risks across the whole country and provides distribution between regions with different economic conditions. Social assistance and social care are provided at the provincial and local level to take account of divergent preferences on the one hand and the information available at the decentralised level on the other hand. Data from the Eurobarometer 2007³⁸ point out that there are quite pronounced differences in the preferences for care arrangements between provinces (the share of persons preferring home care by family members ranges between 29% and 77%, for domiciliary care services or personal carers

³⁶ Gramlich (1979) finds an elasticity of expenditures with respect to revenue sharing grants of approximately 1.

³⁷ See Fallend (2012), p. 88.

³⁸ See Special Eurobarometer 283 (2007), http://ec.europa.eu/public_opinion/archives/ebs/ebs_283_en.pdf.

between 22% and 55%, and for care homes between 0% and 21%).³⁹ From this point of view, a decentralisation of social care can be justified.

Efficiency gains via competition and innovation are important reasons for decentralisation. For example, decentralisation in Italy and France was at least partly motivated by the objective to boost efficiency in these countries.⁴⁰ Competition between bureaucracies allows the imitation of the policy of other bureaucracies and leads to a spill-over of innovation. However, to be able to benefit from decentralisation, some requirements must be met. First, the population must be aware about the efficiency in comparison to other local or provincial units to react either by relocation of residency (voting by feet in the sense of Tiebout) or by changing voting preferences (yardstick competition). This requires, for example, publicly available efficiency comparisons or a decentralisation of revenue-raising responsibilities, which allows the comparison of tax rates of different territorial entities. Learning from other entities requires comparable information about the costs and quality of public services, and accordingly a well-functioning cost accounting and result accounts to allow for benchmark comparisons.

In Austria, there exist several problems to realise efficiency gains from decentralisation. One obstacle is that accounting practices between different entities differ significantly, such that comparisons are often problematic. A harmonised catalogue of services for cost and result accounting for the regional and local levels is still missing, and thus benchmark comparisons between the different entities are not possible in general. This reduces the potential of administrations to learn from each other, especially with respect to cost reductions of public services. Nevertheless, one important exemption refers to the hospital sector in Austria. Public hospitals are obliged to prepare cost and results accounts and provide information about specific indicators, like average costs for different services. This allows for comparisons, to foster innovation and to reduce costs. These data are also publicly available and provided by the federal ministry of health, but provide little information about the quality of health care services.

³⁹ See Trukeschitz et al. (2013), p. 179.

⁴⁰ See Ahmad and Brosio (2009).

In the last 15 years a number of new public management instruments for the management of the public administration were introduced, but mainly at the federal level. Currently, the federal government strives for a reform of the accounting system of provinces and communities which should lead to a stronger harmonisation of accounting practices.

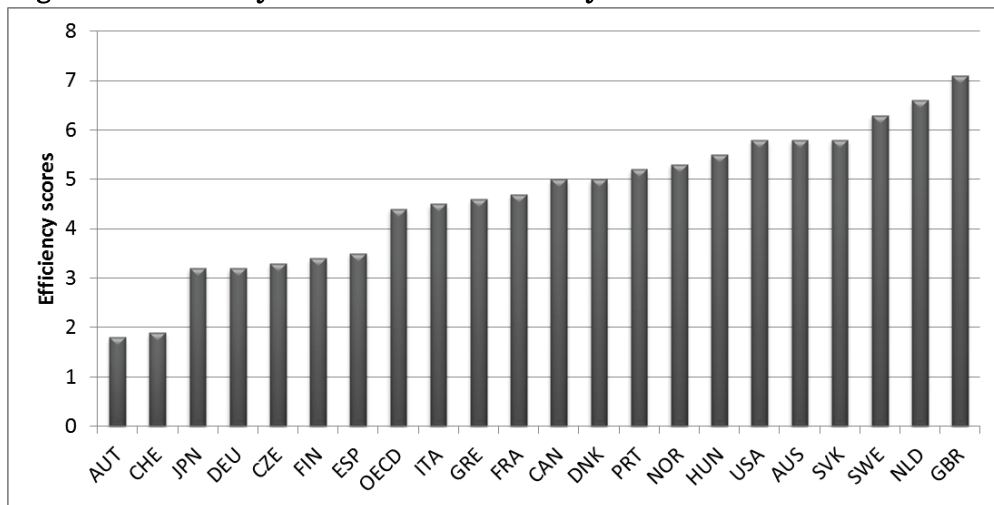
A second line of argument for inefficiencies is a low degree of accountability due to overlapping competences and responsibilities for financing in all three policy fields, health, education and social policy. In the educational system, all three levels of territorial units are involved. Communities as well as provinces are responsible for the construction and maintenance of compulsory schools. The provincial government has to approve the construction of compulsory schools and can close them. Communities are responsible for most compulsory schools (nearly 99.5%). The federal level is responsible for lower and upper secondary academic schools. The state school governing authorities assign teachers to schools which are financed by the provinces but refunded by the federal level, in case of compulsory schools, or by the federal level directly in case of secondary academic schools. The federal ministry has to approve the staff appointment scheme provided by the state governing authorities. The strong divergence of competences and accountability leads to small-scale schools and to a large share of long-term employed teachers at the same school.⁴¹ In most countries, especially in top performing countries, schools select teachers autonomously. In addition, evaluations at the federal level about the quality of services do not lead to significant consequences. Overall, this system leads to a rather inefficient provision of educational services. This is also confirmed by Gonand et al. (2007). They derive efficiency scores for different education systems in OECD countries. Based on these results the most inefficient⁴² education systems by far can be found in Austria and Switzerland, see Figure 2.

⁴¹ See Schmid (2015). The possibility of shared infrastructure between different types of schools is not used. This is of special importance as a considerable share of schools has only a few classes. In Austria 67% of teachers are employed in a school for more than 10 years, in Europe the share amounts to 40%.

⁴² Efficiency scores are based on composite indicators of the institutional and policy characteristics of primary and secondary education systems. The indicators reflect institutional characteristics which have been identified as most important for technical and cost efficiency of public spending.

Studies using Data Envelopment Analysis (DEA) confirm this picture. Sutherland et al. (2009) perform a DEA with two inputs (cumulative expenditure per pupil and pupils' socio-economic background) and one output (PISA scores 2003). Cost efficiency analysis shows that Austria ranks in the middle of all considered countries (rank 16 of 29 countries) with an input saving potential of about 15 percent of total expenditures. Adams et al. (2014) carry out an analysis for OECD countries between 1970 and 2000. For the period 1990 to 1999 and the year 2000, Austria ranks in 14th place of 18 countries with respect to the efficiency score. Bogetoft et al. (2015) compares efficiency in the educational production for 15 OECD countries. In this study, Austria ranks in 12th place taking into account primary and secondary education.

Figure 2: Efficiency scores of educational-systems



Source: Gonand et al. (2007).

The main problems of public health care in Austria are the small size of some provinces, the distribution of responsibilities between inpatient and outpatient treatment and the fragmentation of healthcare financing. With respect to the size of provinces and possible differences in preferences, the following can be concluded. The Austrian population is quite homogenous according to socio-demographic indicators, and the population size in some provinces is too small to provide higher-tier

health care.⁴³ The large number of small hospitals is a source of potential efficiency gains. Scale effects arise for hospitals with less than 200 to 300 acute-care beds.⁴⁴ About 40% of all public hospitals have less than 200 acute-care beds available and 60% have less than 300 beds. There also exist sizeable external effects in terms of guest patients. They are of sizable magnitude in some provinces, e.g. in Vienna 21% of medical treatments concern guest patients.⁴⁵ However, costs are not reimbursed by other provincial health funds at the time of consumption of medical services. Instead they influence the result of the next revenue sharing agreement.

The distribution of responsibilities between inpatient and outpatient treatment is a very important source of inefficiency. The social health insurance pays for outpatient care but only a lump sum and no marginal contribution for hospital care. In addition, they also have no influence on any aspect of hospital care as provinces have the majority of votes in provincial health platforms.⁴⁶ The lump sum payment for hospital care provides an incentive to SHIs to make people use hospital care. This is also reflected in the share of total inpatient expenditures as a percent of total health expenditures, which amounts to approximately 40% in Austria. In the EU, the share is higher only in Italy and the Netherlands.⁴⁷ Furthermore, infrastructure provided and demand are also considerably high. In comparison to other EU-countries the number of hospital beds and acute care hospital discharges are significantly higher, see Table 4. Average length of stay in acute care hospitals is very similar to the EU-average.

All in all, this system leads to quite pronounced inefficiencies. Based on results of a DEA, Czypionka et al. (2012) find considerable room for improvement of technical and scale efficiency. Dutu and Sicari (2016) estimate a savings potential of more than 50 percent for Austria (nearly 40 percent on average over all 34 countries analysed). Following Medei-

⁴³ See Trukeschitz et al. (2013).

⁴⁴ See Austrian Court of Audit (2010).

⁴⁵ See BMG (2014).

⁴⁶ See Trukeschitz et al. (2013).

⁴⁷ Based on European health for all database for 2011. For seven countries information is not available.

ros and Schwierz (2015) Austria ranks in 16th place of 28 EU-countries, Adam et al. (2014) assign Austria to the 18th place (of 21 countries).

Table 4: Indicators for hospitals in selected countries and the EU in 2010

	Austria	Denmark	Germany	Nether-lands	Switzer-land	EU
Hospital beds per 1,000 inhabitants	7.7	3.5	8.2	-	5.0	5.5
Acute care hospital beds per 1,000 in-habitants	5.5	2.9	5.3	3.3	3.1	3.9
Acute care hospital discharges per 100 inhabitants	26.2	12.8	22.0	11.5	15.1	15.9
Average length of stay in acute care hospitals	6.6	-	8.1	5.6	6.6	6.5

Source: European health for all database (HFA-DB).

Another important aspect of the federal system in Austria is the absence of tax autonomy at sub-central levels. The federal government has the authority over most taxes, especially taxes with high revenues. Tax revenues are distributed between the different levels of government by a revenue sharing agreement⁴⁸, with negotiations between the governments every 4 to 5 years.

⁴⁸ Provinces and communities receive a negotiated share of revenues from federal taxes.

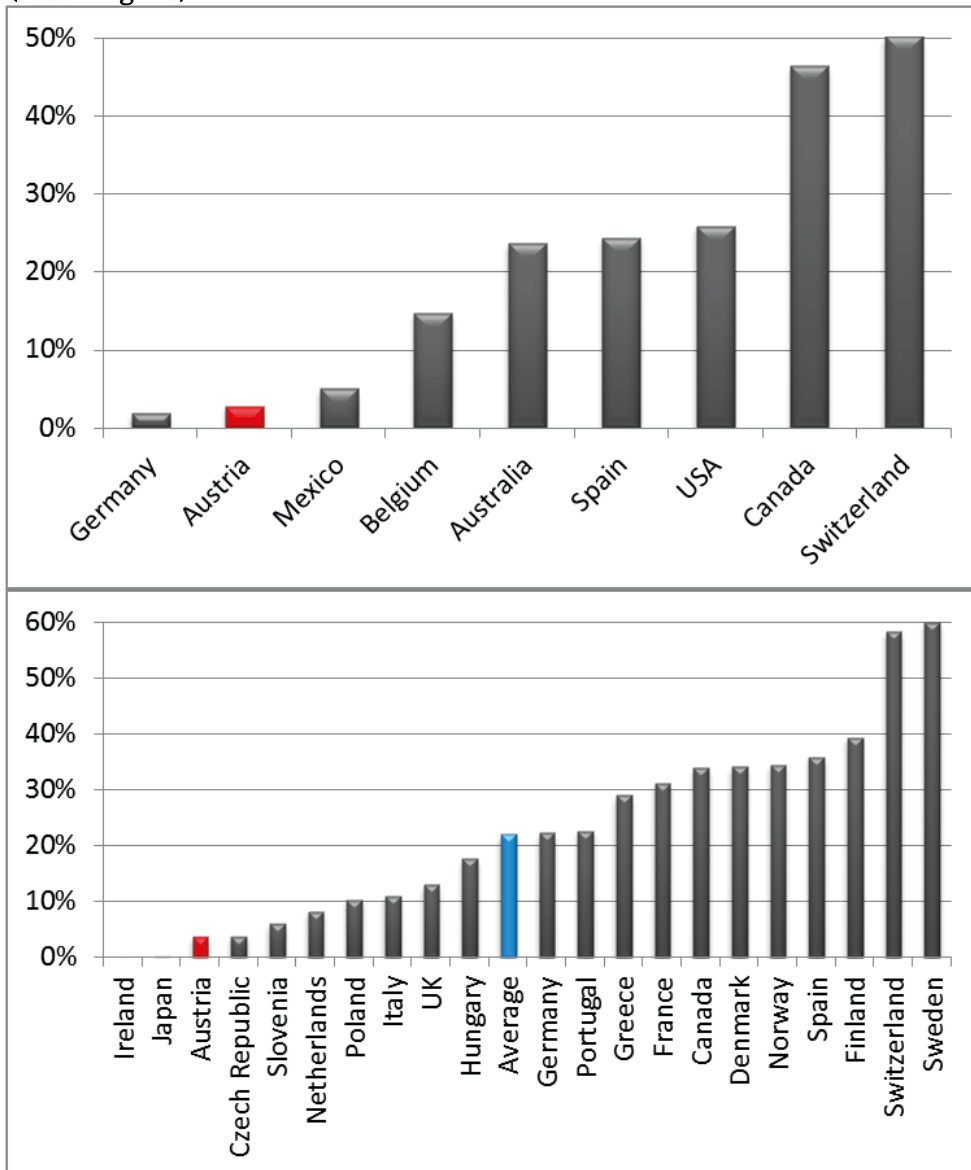
Figure 3 provides an overview about tax autonomy⁴⁹ at the provincial (upper figure) and local level (lower figure) in OECD countries. One can observe significant differences between the countries. At the provincial level countries with quite pronounced tax autonomy are Canada and Switzerland, with a share of autonomous revenues of nearly 50% of expenditures. In Germany, Austria and Mexico tax autonomy is of no importance. At the local level there is also a strong divergence between the countries. Again the autonomy indicator for Austria is very low. This reveals that in Austria there exists almost no responsibility of sub-central governments for tax revenues.

Aside from the low fiscal federalism on the revenue side, a hard budget constraint of sub-central governments is absent. It is possible to claim additional funds in the revenue sharing negotiations every four to five years. Given asymmetric information concerning the development of costs of the provision of decentralised public services, sub-central governments are in a better situation in negotiations. This may be an important reason why for example the number of acute-care hospitals in Austria is one of the highest in Europe.⁵⁰ The political benefit of a new hospital is earned by the state governor, but the tax burden is shifted upon all Austrian tax payers. The role of tax autonomy for Italian communities was recently shown by Boetti et al. (2012). The authors find a positive impact of tax autonomy on the efficiency of public spending as well as a positive impact of fiscal rules like a domestic stability pact.

⁴⁹ Tax autonomy is derived as the share of autonomous tax revenues on unconsolidated expenditures. Autonomous tax revenues consist of categories a-c of the OECD tax autonomy indicator. In these cases, the sub-central government can either set the tax rate and/or influence the tax base.

⁵⁰ See Trukeschitz et al. (2013).

Figure 3: Tax autonomy at the provincial (upper figure) and local level (lower figure)



Source: OECD Fiscal Decentralisation database, General Government Accounts, own calculations.

In addition to the low level of tax autonomy in Austria, there exists a non-transparent network of transfers between the different layers of

government. The volume of intra-governmental transfers⁵¹ in 2011 amounted to 18% of overall tax revenues. Given the complexity of transfers it is nearly impossible to determine allocative and distributive effects of these complex relationships. Transfers play an important role not only in the relationship between the federal and provincial level, but also between the provincial and local level. Communities in most provinces are obliged to contribute to the financing of provincial service provisions. The extent is determined by provincial law. In case of social care, the contribution of communities lies between 35% and 50%; in case of hospitals it lies between 10% and 40%.⁵²

These examples show that in Austria possible efficiency gains from federalism are not raised. In contrast to that, the federal system with shared responsibilities with respect to legislation and especially administration and financing leads to an inefficient system with comparably high expenditures and average outcomes at most (see for example poor PISA results and high costs for public education services). In principle, the responsibility for expenditures in absence of revenue responsibility favours decentralised governments. This observation holds especially for the provincial level.

2.5. Conclusions

The distribution of competences between different levels of government for health, education and social welfare in Austria is to a large extent a consequence of historical path dependency and the rigidity of the political system. It was already established after the First World War, and opposite interests of both the political parties as well as federal and provincial governments led to a strong continuity of this distribution. In general, the federal government has a considerable weight with respect to legislation, but sub-central governments are responsible for a large share of expenditures in an international context.

The importance of the federal level is supported by preferences of the population. Surveys show that Austrians prefer very similar standards in these policy fields and a low level of competition between provinces or communities. Only in the field of social care do preferences differ be-

⁵¹ Without transfers to social insurance.

⁵² See Bauer et al. (2012).

tween provinces. Possible efficiency gains through decentralisation are not realised. Contrary to that, decentralisation is rather a source of inefficiency in Austria. The reasons for that inefficiency are insufficient data quality and the resulting lack of benchmarking between sub-central governments, overlapping competences between different layers of government, the inexistence of tax autonomy on the provincial level as well as on the community level, and non-transparent transfer relations between the different levels of government.

This system is in the interest of state governors as they benefit politically from providing public services to the population without responsibility for financing these expenditures. Financial resources are provided to sub-central governments by revenue-sharing of federal taxes. The financial requirements are shifted upon all Austrian taxpayers, such that the federal government is blamed for the high tax burden. Given the opposed interests in politics, reforms happen only incrementally as can be seen from failed constitutional reform initiatives in the past. The rigidity of the system is also a consequence of the perpetual prosperity and good labour market performance in the country in the past. However, in the last years, the Austrian economy fell behind in comparison to other European countries leading to a more intense discussion about the existing inefficiencies in federalism. Also an increase of the tax autonomy of the provinces is discussed at the political level. To make federalism work efficiently further reforms are necessary, like an unambiguous distribution of competences within the federation.

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Chapter 3

Decentralisation at sectoral level: developing the role of local government on labour market oriented benefits in Denmark

Maja Frydkjær Frandsen and Niels Jørgen Mau^{53 54}

Abstract

Danish local governments' share of public expenditures has been gradually increasing, especially the share towards social protection expenditures, which is now very high compared to other countries. An increasing part of social benefit expenditures, i.e. redistributive income transfers, counted as local in official statistics explains this development. This contributes to the fact that Denmark scores very high on international indexes of the most decentralised countries. An analysis shows, however, that decentralisation in this area is not only a matter of what level incurs the expenditures but also what level of government determines the size of and entitlement to benefits. Moreover, it matters what level provides the funding. It shows that for more than half of the so-called decentralised income transfers there is virtually no local autonomy. For the rest, i.e. the labour market oriented benefits, local autonomy is limited but developing over time when it comes to entitlement and

⁵³ a) Ministry of Economic Affairs and the Interior and b) Danish Institute for Local and Regional Government Research (KORA). The opinions in the paper are solely those of the authors. The Ministry of Economic Affairs and the Interior and KORA have not been involved and are not responsible for the paper.

⁵⁴ We thank Kasper Strandvig Jørgensen, Jørgen Lotz and Marius Ibsen for very helpful contributions and comments to an earlier draft of this paper. We are also grateful for comments from Marco Salm and Grete Lilleschulstad.

financial responsibility. We identify four characteristic stages of development starting from the 1970s and ending up with the latest and comprehensive employment reform of 2015. The reform supports local competencies and streamlines central government reimbursement systems, which also implies the challenging task of solving equalisation needs without jeopardising the incentives for efficiency being a main motive of decentralisation and recent reform.

3.1. Introduction and purpose

A motivation for this article has been to get a nuanced picture of the process and content of decentralisation of labour market oriented social benefits in Denmark. Our method is comparative, i.e. to characterise the Danish situation seen against other countries and especially to identify and compare different stages of development over time.

Labour market oriented benefits – as part of social benefits – may or may not be seen as suitable for decentralisation. On the one hand, we usually assign social benefits to the redistribution branch of the public sector⁵⁵, emphasising the national, legal rights to receive benefits in certain well-defined situations and taking into accordance the mobility of recipients between local governments. On the other hand, social benefits may be seen in close connection with other social expenditures on e.g. job creation, rehabilitation, continuing education /re-training, social arrangements etc., where local governments used to have a more important role, stressing factors such as cost-minimisation, effectiveness and taking into account local preferences and conditions.

In Denmark those last-mentioned factors seem to have been attached importance since – according to Statistics Denmark – the major part of social benefits, including the labour market oriented benefits, are assigned to the local government sector. We observe that this may be one of the reasons why a World Bank paper lists Denmark – out of 182 countries – as number 1 according to the degree of decentralisation.⁵⁶ In this paper, we will investigate how the time-series figures of public expenditures on sectoral/functional level mirrors decentralisation and make some simple cross-country comparisons (section 3.2).

⁵⁵ Musgrave (1959) and Oates (1972).

⁵⁶ Ivanyna & Shah (2014).

The international data and key figures on decentralisation is only crude indicators of the central-local relationship, and is only a first step for a more comprehensive picture of the situation. To get a more detailed understanding, we therefore discuss decentralisation, focusing on social benefits/income transfers, where Denmark seems to deviate from most other countries (section 3.3).

To get deeper into this issue about decentralising labour market oriented social benefits in a Danish context, we will study the decentralisation process of local governments in Denmark seen over a longer period of years. In this historical view (section 3.4), we will try to sort out different periods of decentralisation which mark progressive steps in the process. We are curious to find out how decentralisation has developed, having in mind that decentralisation of income transfers may have another character than decentralisation in other expenditure areas, i.e. areas dominated by local consumption. We expect to disclose some dilemmas or challenges in this connection. Especially, we note that cost-minimisation seems to be an important motive behind decentralisation of labour market oriented social benefits, but alongside those benefits also play an important role in Denmark in national redistribution policy.

Next we discuss the most recent financial reform of labour market oriented social benefits (section 3.5), including some of the motives and perspectives of the reform – and their implications on the need for improving the equalisation system.

Finally, we conclude in section 3.6.

3.2. Decentralisation at the sectoral level – development and international comparison

Table 1 illustrates for the local governments in Denmark the development of expenditures by economic functions (sectors) in a period covering the last 25 years.

Table 1: Danish local governments' (=municipalities and regions) expenditures by economic functions, local governments' share of total general government expenditures for each function.

Pct. Economic function	1989	1996	1999	2003	2007	2013
1. General public services	28	30	29	30	20	16
2. Defence	1	-	-	-	1	1
3. Public order and safety	12	11	12	12	9	10
4. Health	93	98	98	98	99	99
5. Education	54	51	52	54	45	41
6. Social protection	72	71	74	74	79	80(90)
Total¹	52	54	56	59	62	62(66)

¹ Including other functions, i.e. economic affairs, environmental protection, housing and community amenities, recreation, culture and religion.

Note: 1989, 1996, 1999, 2003: economic functions and modified COFOC-classification, 2007, 2013: COFOC-classification. Note for 2013 that the recent major revision of national accounts may itself have changed distribution marginally.

Source: Jørgensen et al (1992), Knudsen et al (1998), Larsen et al (2015).

It is in accordance with the standard model of allocation of tasks that the central government is the primary responsible level for *General public services*, *Defence* and *Public order and safety*. In Denmark, the *Health* sector is predominantly a regional and partly a municipal responsibility, while municipal primary schools, central government secondary schools, higher education institutions, etc. carry out *Education*.

The transfer in 2007 of secondary schools from regions/counties to independent institutions controlled by the central government explains the local governments' decreasing share of Education. In the opposite direction for *Social protection*, the importance of local governments seems to increase gradually, i.e. to around 4/5 of total expenditures in this area in 2013. Taking into account that the unemployment funds (social security funds) pay out 10 pct. of government expenditure, but are partly financed by the local governments, it may even be argued that local governments' share is up to 90 pct.⁵⁷

⁵⁷ In the official guide to national account systems, an 'alternative method' of sub sectoring the general government sector is mentioned, where social security funds are included in the other subsectors of general government (central government, state governments and local government), European Commission et al (2008, 80).

From *table 2*, it becomes more evident that tasks in connection with *Social protection* especially characterise the Danish local government sector. Denmark allocates 56 pct. of expenditures to this function with only 12 pct. and 20 pct. for OECD- and EU-countries in general. No. two on the list is Germany (33 pct.) and then UK (30 pct.), Norway (27 pct.) and Sweden (27). It seems to indicate that Denmark deviates in accordance to (measured) decentralisation of the social protection sector.

Table 2: For local governments (=municipalities): share of local governments' expenditures for each economic function, Denmark, OECD and EU, 2012

Pct.	Denmark	OECD27	EU28
1. General public services	4	15	17
2. Economic affairs	4	13	12
3. Health	22	18	13
4. Education	10	26	20
5. Social protection	56	12	20
6. Other	4	16	18
Total	100	100	100

Source: OECD (2015).

The economic function of *Social protection* includes social services, i.e. public consumption expenditures such as kindergartens, elderly homes, care for disabled persons etc., and social benefits, i.e. mainly income transfers to households.

For *Social protection*, the main explanation for the economic significance for Danish local governments compared to the central government seems to be the expenditures for social benefits/transfers to households. That is what the figures from Denmark and some neighbouring countries clearly indicate, cf. *table.3*.

Table 3: Social benefit expenditures by level of government, 2012

Pct. of GDP	Denmark	Netherlands	Germany	Korea	Norway	Sweden	Switzerland	Finland
1. Central government ¹	5.2	22.2	20.3	6.6	14.3	14.0	9.0	19.5
2. Local and other levels of government ²	13.1	1.8	3.8	0.0	1.1	4.2	2.3	2.1
Total	18.3	24.0	24.1	6.6	15.4	18.2	11.3	21.6

¹ Including social security systems, agencies etc.

² Calculated residually

Source: IMF (2015), table W09.

3.3. The character and degree of decentralisation of social benefits

3.3.1. General considerations

As mentioned in the introduction in international comparisons, Denmark appears as one of the most decentralised countries. A recent study from the World Bank ranked Denmark as number 1 according to an aggregate decentralisation index – with Sweden and Switzerland as number 2 and 3. Other studies/indexes also rank Denmark among the most decentralised countries.⁵⁸ The studies try to cover several aspects of decentralisation, but one of the findings is that Denmark deviates from most other countries by having a large share of public expenditures allocated to subnational governments, and especially social benefits expenditures, cf. section 2.

However, decentralisation can take many forms. When OECD and the World Bank (Ivanyna and Shah, 2014) focus on which level of the public sector is accountable for the expenditures, i.e. incur expenditures vis-a-vis the citizens, it is only a crude measure of decentralisation, which in practice is not necessarily congruent with autonomy or freedom to prioritise these expenditures. The World Bank is fully aware of this, cf. remarks from Ivanyna and Shah about measuring the relative importance of local governments by the share of local government expenditures in consolidated general government expenditures. Ivanyna and Shah

⁵⁸ Ivanyna & Shah (2014) and Rodden (2014). Moreover, Strohner (2016), figure 1.

(2014, 10): “This is obviously an imperfect measure of relative importance of local governments as a significant part of local government expenditures may simply be in response to higher level government mandates with little local discretion. However, data on autonomous local government expenditures are simply not available”.⁵⁹

It *is* a complex task to estimate the degree/substance of decentralisation. According to common standards, the essence of a decentralised community is that each municipality can match the local needs and preferences with the local expenditures and services. In line with this, a high degree of decentralisation means municipalities have a degree of freedom to decide the level of service and expenditures. For instance, a variation in the use of resources across municipalities suggests that the municipality has autonomy in prioritising the resources.⁶⁰

In Denmark (and other countries), the degree of decentralisation varies from one area to another. For instance, primary schools have been subject to closer regulation than day care for small children, while regulation of care for the elderly has been in-between.⁶¹

The central government control of the local governments can take many forms and involve varying degrees of control and management tools, ranging from regulation by law of standards and production processes to establishing economic incentives for motivating certain desired local behaviour. In addition, more soft instruments may come into play, like proposing local governments to compare results and learn from each other. In the next section, we discuss decentralisation and control instruments in relation to social benefits.

3.3.2. Decentralisation of social benefits

As mentioned, the expenditure area of social benefits in the form of income transfers to households serves as an instrument of redistribution. Redistribution according to the classical view should be a central government task, cf. section 1. Nevertheless, in Denmark these expenditures appear as decentralised, municipal expenditures. However, can we get closer to what we really mean by decentralisation here? Moreover,

⁵⁹ See also OECD/KIPF (2013), chp. 2 about Denmark.

⁶⁰ Grønnegård Christensen, Munk Christiansen, Ibsen (2011)

⁶¹ Grønnegård Christensen, Munk Christiansen, Ibsen (2011)

what indications about the degree of decentralisation do we get from the financial system?

For this use, we identify four factors/ dimensions characterising centralisation/decentralisation of social benefits.

First, as a starting point, it is relevant to observe if the central government or local government level incurs the expenditures. This is the piece of information that we track down from the national accounts, and the various indexes mentioned in section 2 make use of this. It tells us which level pays out the expenses to the citizens and has the responsibility of budgeting and accounting the expenditures. However, it does not necessarily imply autonomy or degrees of freedom in the decision-making about those expenditures.

Second, we ask which level determines the size of the benefits to entitled recipients. As an example: is it the central government or the local government that decides the level of social pension or cash allowance when the person in question has been entitled to these transfers?

Third, what is the relevant authority for entitlement of social benefits? The criteria for awarding benefits may be defined by a central government law or be a matter of local government discretion. Alternatively, it may be somewhere in-between, where the municipality might be able to affect the number of persons entitled to the benefits through preventive policies in other fields.

In addition, as the *fourth* factor: is it the central or local level of government that has the financial responsibility – or are the responsibilities shared in some kind of co-finance system?

Box 1 summarises the above-mentioned relevant factors or dimensions characterising decentralisation of social benefits.

Box 1: Dimensions of decentralisation of social benefits (income transfers)

- 1) What level incurs the expenditures?
 - Local government (1b)
- 2) What level determines the size of the benefit to entitled recipients?
 - The size of payment is centrally regulated (2a)
 - The size of payment is not regulated, i.e. depends on local government discretion (2b)
- 3) What level determines who is entitled to receive benefits?
 - Entitlement is centrally regulated and local governments cannot influence the potential number of recipients (3a)
 - Entitlement is centrally regulated but local governments are able to influence the potential number of recipients (3b)
 - Entitlement is not regulated, i.e. depends on local government discretion (3c)
- 4) How is the net expenditure financed (indirect measure of autonomy)?
 - Full reimbursement from central government (4a)
 - Co-financing by earmarked reimbursement from central government (<100 pct.) and partly by general grants and/or local taxes (4b)
 - Solely by general grants and or local taxes (4c)

According to the above dimensions, we identify four combinations characterising Danish social benefits, cf. *table 4*.

Table 4: Four combinations of dimensions of decentralisation

	1 Expenditures	2 The size of payment	3 Influence on entitlements	4 Finance
A	Local	Centrally regulated	No local influence	Full reimbursement
B	Central	Centrally regulated	Local influence	Co-financed local/central
C	Local	Centrally regulated	Local influence	Co-financed local/central
D	Local	Centrally regulated	No local influence	Co-financed local/central

Table 4 joins *table 5*, which categorises the different Danish social benefit schemes according to the combinations. Moreover, the table shows the economic significance of the single schemes.

Table 5: Municipal/partly municipal financed social benefit expenditures (income transfers), 2013, by scheme

Scheme	Bn. DKK	'Local autonomy'
Old-age pensions	112.6	A
Early retirement pensions	42.8	C
Personal pension supplements	1.4	A
Unemployment benefits	19.7	B
Social assistance	20.4	C
Other cash benefits	5.1	C
Unemployment allowance	3.0	B
Working capacity allowance	0.1	C
Gross rehabilitation allowance	1.8	C
Sickness benefits	12.8	C
Maternity benefits	9.2	A
Holiday benefits	1.0	A
Child and youth allowance	0.1	A
Contribution to free places in day care institutions	2.7	C
Rent subsidies and rent allowance	13.3	D
Total bn. DKK	246.1	(A: 124,3/B: 22,7/ C: 85,7/D: 13,3)

Source: Danmarks Statistik (Statistics Denmark). DST, October 2014, OFF10, and own estimates.

From *table 4* it appears that it varies at what level the expenditures are incurred (dimension 1), what level has influence on entitlement (dimension 3) and what level has the financial responsibility (dimension 4). However, for the size of the benefits, it is clear that only the central government level has the decision power (dimension 2), which may – in a Danish context – support what was formerly called the classical view of assigning the task of redistribution policy to the central level.

Combination A (in 2013 124 bn. DKK = 7 pct. of GDP) consists of income transfers, such as old age pensions, maternity benefits and child and youth allowances, counted as municipal but with no discretion and underpinned by full reimbursement. These income transfers are genuine “agency functions”, i.e. the local governments are only paying-offices, so

to speak.⁶² It seems obvious to correct negatively for these expenditures when estimating the degree of decentralisation in Denmark.⁶³

Similarly, the local autonomy for *combination D-expenditures* (in 2013 13 bn. DKK = 1 pct. of GDP) is rather limited. Under this heading, we find rent subsidies and rent allowance. The municipalities after all have some channels of influencing the number of recipients. However, the municipalities can only carry out this influence in a very indirect manner, by encouraging the constructing of new social housing usually inhabited by relatively high numbers of people receiving rent subsidies and allowance.

Overall, we think it is fair to conclude that both category A and D payments should not be counted as local expenditures in e.g. a decentralisation index, since local autonomy does virtually not exist.⁶⁴

In the discussion about decentralisation, we find *combination B* and *combination C* as the most interesting categories. Category B expenditures are unemployment benefits (in 2013 23 bn. DKK = 1 pct. of GDP) counted as central government/social security funds expenditures, but partly and increasingly financed by local governments. Category “C” expenditures are primarily early retirement pensions, social assistance and sickness benefits (in 2013 86 bn. DKK = 5 pct. of GDP) counted as municipal/local government and partly financed by local governments.

For combination B and C, it is obvious that the local autonomy is limited but the designs assume some local influence on education, job training, employment agency functions, job creation and rehabilitation.

⁶² From 2013, “Udbetaling Danmark” administers all payments from those schemes. A board consisting of municipal representatives (majority) governs this relatively new organisation. In the national accounts, the organisation however is assigned to the central government; cf. Larsen et al (2015), p.77. Udbetaling Danmark also administers rent subsidies, rent allowance and early retirement payments.

⁶³ This will account for major revisions of statistics, see Lotz p. 43 in OECD/KIPF (2013).

⁶⁴ In the index mentioned in Ivanyna & Shah Denmark would then move from number 1 to number 2-4, of course assuming that other countries do not have similar relevant corrections.

Another aspect of decentralisation – not accounted for in the factors above – is the intensity of process regulation and use of performance management. This will also affect the autonomy of the local government, but it is very difficult to measure the intensity of e.g. process regulations.

In the rest of the paper, we will discuss how decentralisation has evolved for the most important category, B and C payments schemes, which mainly consist of the labour market oriented benefits. We will concentrate on benefits like early retirement pension, sickness benefit, unemployment benefit and social assistance.

3.4. A historical view on decentralisation of labour market oriented social benefits

This section gives a brief overview of the development in employment policies and the role of the municipalities. We give special attention to changes in competencies and especially the financial system for labour market oriented social benefits, and we touch upon some links to the broader social protection area.⁶⁵ To help distinguishing the factors of motivations and tendencies, we sort out different periods of decentralisation.

3.4.1. The 70s and 80s: a stronger municipal sector after 1970 structural reform – the municipalities as the main entrance for social services

Concerning the organisation and tasks of local governments, in a Danish context there are especially two important dates to be aware of. They are the local government reform of 1970 and the structural reform of 2007. These were the times of two major local government reforms that also involved labour market oriented social benefits.

The process of decentralisation began before the 1970 reform and was parallel to the development of the Danish welfare society in the 1960s. To begin with, the process spread out local responsibilities to public utilities, roads, schools, culture and care for elderly. In the years to follow – and with basis in the reform of 1970 – the local responsibilities were ex-

⁶⁵ Sources: Finansieringsudvalget (2004), chp. 7-8, Finansieringsudvalget (2012), chp. 3, and memorandum to Socialministeriet (1990).

tended continuously, not least of all in the social areas like day care, certain social benefits, etc.

The reform in 1970 was also background for a change in the financial system between the state and municipalities. Until then, state earmarked grants in the form of reimbursements primarily financed the tasks of the municipalities, and the central government reimbursed a certain part (e.g. 50 pct. or 100 pct.) of local government expenditures. The reform replaced a major part of the reimbursements schemes with a general grant, which was free of bindings to certain expenditures. At the same time, the central government expanded the financial equalisation scheme between municipalities.⁶⁶

In 1976, the Parliament passed the Social Assistance Act. The Act was based on the 1970 reform and decentralised social competences from central government to municipalities. The municipalities became the main “entrance” for applications for social assistance and most other social assistance schemes. The Act allocated the responsibility for awarding and payment of social assistance and sickness benefits for the needy without unemployment insurance to the municipalities. The rate of reimbursement for social assistance for uninsured unemployed was 50 percent. Persons who were members of the unemployment insurance remained the responsibility of the state and the unemployment insurance funds.

1987 saw new changes in the financing of local governments’ social benefits.⁶⁷ Social expenditures on wages and services, which used to be financed partly through reimbursements, became fully financed by the municipalities. These changes covered the areas of care for elderly and day care institutions. Now, only social cash benefits (e.g. social assistance and sickness benefits) and some services in specialised social areas like services for handicapped, vulnerable families and children, drug addicts etc. applied to the “old” system of reimbursements.

It also was under consideration to change the financing of early retirement pension towards more financial responsibility for the municipali-

⁶⁶ Grønnegård Christensen, Munk Christiansen, Ibsen (2011).

⁶⁷ Ministry of Social Affairs (1985): Bill number 262 6/6 1985.

ties, but there was yet no political will to do so.⁶⁸ The economic importance of early retirement was increasing, however, since in 1983 it became possible to receive early retirement pension based on a broad assessment of needs and not solely on the health situation.

The purpose of the change from reimbursement to general grants was to increase financial consequences for the municipalities failing to take steps to avoid the need for social help.⁶⁹ The intention was that the cost-consciousness of the responsible authorities would increase. Moreover, it was deemed important to insure economic neutrality between overlapping services so the most suitable service was carried out – without considering the financial “advantages”, a factor that would later be stressed even more, cf. below.

3.4.2. Decentralisation in the 90s: more local own finance of social benefits and macroeconomic protection of the municipal sector⁷⁰

In the aftermath of the change in 1987, there were ongoing discussions and considerations whether to change the “old” finance system regarding social benefits towards lower reimbursements and more general grants.

One of the discussions was the possible effect of the finance system regarding the amount of benefits. Would a change of the reimbursement system increase the local incentive to help an (uninsured) unemployed person to find a job quickly so that person would be able to support himself – instead of receiving social benefits? Following the economic argument advocated by the Ministry of Finance, it would contain the increasing amount of benefits when the local municipality financed a greater part of the benefits – instead of receiving 100 percent reimbursement. The municipalities would be more aware about the money spent on benefits, i.e. the costs for the society, and would have more focus on getting unemployed people a job quickly and thereby save money.⁷¹ If the options for the municipalities were over-estimated, the re-

⁶⁸ Ministry of Social Affairs (1990): Bill number 64 7/11 1990.

⁶⁹ The changes were prepared based on Finansieringsudvalget (1985).

⁷⁰ Sources: primarily Finansieringsudvalget (2012), Arbejdsmarkedskommissionen (2009), KL et al (2009) and memorandum to Socialministeriet (1990).

⁷¹ Cf. Christiansen (2000).

form would lead to inequalities between the spending need of the municipalities, so the changes implied serious challenges to the equalisation system.

At this stage, the discussions of the role of local governments relative to the unemployed solely concerned the uninsured persons, i.e. people eligible to social assistance. Later, the municipalities also played a role in relation to the insured unemployed, see below.

Another consideration was to uphold the classic principle in decentralisation: competences and finance should go hand in hand⁷². Decentralisation of competences should follow more direct financing by municipalities so that the municipality was also entitled to allocate benefits like early retirement pensions. The competency to award early retirement pension was at that time (around 1990) a county responsibility (county boards – “Revaliderings- og Pensionsnævn”)⁷³. The rationale was to make the municipalities acting responsible by increasing their autonomy in this field. In other words, to encourage them to be the entrance for a more coherent employment policy, including the autonomy to award and (co)finance benefits and to assist and help people get back to work.

Generally, the thinking of labour market policy was changing towards a more active approach and active employment policies aiming to qualify and motivate the individual person to seek and obtain employment. At the time the active employment measures were not very used, as only 1/5 of the total employment expenditures were spent on activating and rehabilitation schemes, education etc., while 4/5 were spent on passive benefits, i.e. income transfers.⁷⁴ The argument was that reduced reimbursement and more general grant financing would stimulate municipalities to prioritise the active employment policy. By prioritising the active employment policies, it would be possible for the forward-looking municipalities to reduce the amount of income transfer benefits in the end and thereby save money and improve employment in general.

⁷² The slogan – intensively used in this period – was in Danish: “Ansvar og kompetence bør følges ad!” which is translated to “Finance and competence should go together!”.

⁷³ The county boards/”Revaliderings- og Pensionsnævn”, were independent boards for awarding rehabilitation and pension, administered by county council personnel.

⁷⁴ Ministry of Social Affairs (1990): Bill number 64 7/11 1990.

It was not only an economic argument. Due to studies⁷⁵, income transfers were not a suitable solution for social problems, and social assistance or early retirement pension did not necessarily help persons with reduced working capacity. The studies argued⁷⁶ that even to receive social benefits in a limited period could involve a risk of making the unemployed person more passive and helpless than before. It was important that the municipality – quickly – assisted those people that needed help to find a job. It was serious that these active measures were carried out immediately so the period with passive benefits was as short as possible.

There were also talks about a uniform reimbursement across (some of) the different social benefits, i.e. the same rate of reimbursement would apply for different social benefits schemes. Uniform reimbursements should ensure a choice among the different benefits based upon the correct relative cost – expressed as “the principle of neutrality”⁷⁷. The size of the reimbursement rate and who should pay would not affect the choice. Instead, it was found that focus would be on the jobseeker and the measures needed in order to find a job.

All these considerations by subsequent governments led to the decision *first* to reduce the size of the reimbursements so the municipalities should finance more themselves, and *second* to uniform the co-financing system so municipalities would make a neutral, non-distorted comparison between the different benefits.

These changes placed much emphasis on the local ability to shape their own social landscape. However, the legislators would later face that the accompanying deepening of differences in objective local spending needs between municipalities would be very difficult to equalise between them.

In 1990, an agreement⁷⁸ reached by the central government and Local Government Denmark (LGDK) lowered and uniformed the size of the

⁷⁵ Ministry of Social Affairs (1990): Bill number 64 7/11 1990.

⁷⁶ Ministry of Social Affairs (1990): Bill number 64 7/11 1990.

⁷⁷ Pedersen (2007), p. 273 and Lotz (1998), p. 392f.

⁷⁸ Ministry of Social Affairs (1990): Bill number 64 7/11 1990.

reimbursement for social assistance, sickness benefits and early retirement pension. The Parliament passed the following law in 1991 and thereby implemented the principle of neutrality between different measures – as considered back in the 70s. Moreover, the parties agreed to increase the competence of the municipalities, so municipalities also had the competences to award early retirement pension and administering the national set of rules for eligibility. At first, in 1992, the county boards transferred the competence concerning certain kinds of early retirement pension to the municipalities. Later, in 1994, the municipalities could take over the full competency of awarding early retirement pensions if the individual municipality deliberately asked for it.

The future general level of reimbursement rates for these benefits should be 50 percent – assuming that with this lower rate it would be more attractive for the municipality to invest more money in the active measures. Formerly there had been 100 percent reimbursement on early retirement pension and 75 percent reimbursement on sickness benefits. The new 50 percent reimbursement rate did not apply fully, however. For early retirement pensions, it only applied to persons under the age of 60 and only for those pensions allocated by the municipality. For sickness benefits, it only applied after the first 13 weeks of illness.

Nevertheless, the reform changed economic conditions markedly. A person that got sick or was in another way hindered from working would now more directly affect the municipal economy. Conversely, by assisting this person in finding a job, the municipality could save money – and of course improve the welfare of the person. The government and municipalities agreed that this change would give the municipalities the right incentive to prioritise active measures instead of passive measures. Since then the side effects of this reform in terms of inequalities between the municipalities have become visible and has intensified the debate about the equalisation needs and especially the needs criteria.⁷⁹

In 1992, the so-called *budget guarantee scheme* was also implemented; its purpose was to compensate the municipalities for changes in cyclical activity-related expenditures, for instance social assistance for the unemployed, early retirement pensions, etc. The (co)finance social benefits

⁷⁹ Finansieringsudvalget (2004), chp. 7 in fine.

would expose the municipalities more to macroeconomic conditions. Therefore, it was deemed fair that central governments compensated these expenditures. The general grant system (the annual block grant) compensated the municipalities, and some new inequalities cropped up here as the general grants did not compensate those hit hardest by the cycle.⁸⁰

Further changes along the same lines followed the 1992 reform. The financial system was changed in 1997 where the 50 percent reimbursement on early retirement pension was expanded to pensions of persons over the age of 60, and for sickness benefits, the 50 percent reimbursement now began after 8 weeks of illness. Then, in 1999, the reimbursement to municipalities for early retirement pension expenditures for “new” persons was lowered from 50 pct. to 35 pct. Moreover, the changes abolished reimbursement for sickness benefits totally after one year of illness. Further, in 2001 the 50 percent reimbursement for sickness benefits started after 4 weeks of illness – instead of 8 weeks in 1997. *Table 6* shows the development of the reimbursement rate system in 80s and 90s.

Table 6: Reimbursement rates (pct.) for certain municipal/partly municipal financed labour market oriented social benefit schemes, 1985-1999

	1985	1992	1997	1999
Early retirement pension	100	50 ¹	50	35
Sickness benefit	75	100/50	100/50	100/50/0
Unemployment benefits	-	-	-	-
Social assistance	50	50	50	50

¹ For persons < 60 years of age.

Note: In some instances, the rates are lowered in relation to the length of the period an individual can receive benefits. The table shows these different rates.

In conclusion, during the 90s the municipalities undertook a greater share of the direct finance of early retirement pension and sickness benefits. Several times, we saw a reduction of the reimbursement rates. This development was parallel to a general tendency in the relationship between the central and the local government sectors to move away from detailed rules and towards economic management and economic incentives. Generally, it was a time for further devolving of competence to municipalities. All in all, these changes attempted a better correla-

⁸⁰ For a description of the budget guarantee, see AKF et al (2007), p.91.

tion between the decision competences and the financial responsibility of municipalities, but there have been costs in terms of horizontal equity among municipalities that were difficult to compensate. Further, the central government had to take over the macro responsibility to guard the municipal sector against unfavourable changes in cyclical income transfers.

1.4.3. The Structural Reform of 2007 and the following years: local responsibilities for nearly all labour market benefits and differentiated reimbursement to encourage active instead of passive activities⁸¹

The active employment measures continued to be in focus and the central government underlined that the municipalities had to make an active effort to help people get back to work.⁸² The central government deliberately started to distinguish between *active* measures and *passive* benefits. This was in order to further motivate the municipalities to activate.

A new initiative followed this policy to give a higher reimbursement when municipalities used active measures instead of passive benefits. By differentiating the reimbursement rates, the government wanted to affect the incentives and behaviour of the municipalities. If municipalities “only” assigned social benefits without presenting activation offers, training or education they would get less money reimbursed. From 2006, central government reimburses social benefits by 65 percent in periods with activation and education, while reimbursing the benefits by “only” 35 percent in periods with passive payments. Before, the reimbursement was 50 percent in both active and passive periods. *Table 7* shows the development of the reimbursement rate system from the 80s/90s to the first part of 00s.

⁸¹ Sources: primarily Finansieringsudvalget (2012).

⁸² Ministry of Social Affairs and the Interior (2004): Agreement on a Structural Reform.

Table 7: Reimbursement rates (pct.) for certain municipal/partly municipal financed labour market oriented social benefit schemes, 1985-2006

	1985	1992	1997	1999	2001	2006
Early retirement pension	100	50 ¹	50	35	35	35
Sickness benefit	75	100/50	100/50	100/50/0	100/50/0	100/50/0
Unemployment benefits	-	-	-	-	-	-
Social assistance	50	50	50	50	50	65/35

¹ For persons < 60 years of age.

Note: In some instances, the rates are lowered in relation to the length of the period an individual can receive benefits and these different rates are shown in the table. Rates also vary in accordance to “active” or “passive” measures, i.e. for social assistance in 2006.

The active measures of the municipalities were only reimbursed up to a maximum amount. Expenditures over the maximum would be financed 100 percent by the municipalities.⁸³The municipalities off course wanted to apply active measures on as many unemployed as possible within the ceiling, and the possible risk was that the municipalities used the cheapest activation – without focusing on the quality.

In order to avoid “doubtful” activation, the central government defined some legislative minimum demands regarding the active measures. This we see as an example that the differentiated rate of reimbursement had unintended consequences, as it led to further legislative demands. In addition, the central government introduced legislative rules defining that the municipality could lose the reimbursement from the state if the municipality did not fulfil different process steps.⁸⁴

On 1 January 2007, the Danish Structural Reform came into force. 98 municipalities replaced the previous 271. The reform transferred a number of new tasks to the municipalities. The reform strengthened the position of the municipalities as they undertook most of the citizen-related tasks.

The reform assigned new tasks to the municipalities, and employment-policy/employment service was one of them. 91 new so-called ‘job centres’ (there are 98 municipalities) were established and should act as the access point for all the citizens and companies needing help and ser-

⁸³ Ministry of Employment: Bill number 89 21/3 2006.

⁸⁴ Ministry of Employment: Bill number 89 21/3 2006.

vice regarding employment exchange. The government and the municipalities would enter binding partnerships to join their tasks (both local and central) in these centres. The aim was to create *one* access and insure that the decisions and measures were locally grounded. The focus of the job centre was the active labour market policies and to activate and motivate the unemployed – in dialogue with the individual – to seek and obtain employment. The unemployment insurance system (“A-kasser”) still had some competencies regarding the insured unemployed persons such as interviews and job guidance and were solely financed by the central government and membership fees.

In 2009, the central government transferred some of the measures towards insured unemployed persons to the municipalities. Reimbursements and a new special employment grant to soften the equalisation problems financed this change. The joined partnership at the job centres (between municipality and government) was cancelled as the municipalities took over the full responsibility. It was argued that it would be more efficient and assure a more coherent and focused employment policy.

An important part was the decision to make the municipalities co-finance the expenditures for insured unemployed, i.e. let the municipalities pay part of the central government bill to the social security funds (“A-kasser”).⁸⁵ It was argued that this would strengthen the incentive to help unemployed people find a job, regardless of whether the individual was insured or not. At the same time, the idea to distinguish between active and passive reimbursements was expanded to other benefits.

It finally became clear that it was necessary to consider the economic burden of the municipalities from these changes and to find ways to mitigate the distribution of those burdens. In this respect, the reform was – as said – comparable to earlier financial reforms but the challenges were added to the consequences of earlier reforms and were more difficult to solve. It was complicated because expenditures to insured

⁸⁵ Formerly, when local governments co-financed social assistance benefits but not unemployment benefits, local job creation would affect the economy in a very different way, e.g. an economic premium if the employed persons were uninsured – but negatively if they were insured. The case was named after the municipality to discover the problem, the Municipality of Nakskov (now merged into Lolland Municipality), cf. PLS-Rambøll (2000).

unemployed are to a high degree influenced by the economic conditions and general activity level of society, even more than for expenditures on social assistance. Therefore, the economics of the municipalities became more “vulnerable” because of the new competences. The solution was a special employment grant. This grant was distributed to municipalities considering the past number of insured unemployed persons – a measure that reflects the unemployment in past years.⁸⁶

In 2011, the central government (again) lowered the reimbursements to local governments in general. There was still a higher reimbursement on active measures than on passive measures, but from now on the central government harmonised the reimbursement on active measures. The system thereby got simpler and the municipalities were encouraged to decide the exact measures, which had the best-documented effect on how to get an unemployed person back to work. *Table 8* shows the development of the reimbursement rate system from the late 90s to 2011.

Table 8: Reimbursement rates (pct.) for certain municipal/partly municipal financed labour market oriented social benefit schemes, 1997-2011

	1997	1999	2001	2006	2011
Early retirement pension	50	35	35	35	35
Sickness benefit	100/50	100/50/0	100/50/0	100/50/0	100/50/30/0
Unemployment benefits	-	-	-	-	100/50/30
Social assistance	50	50	50	65/35	50/30

¹ For persons < 60 years of age.

Note: In some instances, the rates are lowered in relation to the length of the period an individual can receive benefits and these different rates are shown in the table. Rates also vary in accordance to “active” or “passive” measures, i.e. for unemployment benefits in 2011 and for social assistance in 2006 and 2011.

Finally, the system of punishing local governments economically if they did not make timely job-efforts was abolished from 2013.

⁸⁶ To avoid distortions from the financial system against efforts to reduce the number of unemployed, the employment grant was calculated on the basis of historical figures in combination with figures from functional regional areas (local labor markets/commuting areas), cf. Finansieringsudvalget (2012), chapter 19.

3.5. Reform of employment policies and reimbursements 2015⁸⁷

In 2014, the political parties reached a political agreement on a new employment policy. The Parliament passed the law in August 2015. The reform implements changes by 1 January, 2016.

3.5.1. The reform

The aim of the reform is to reduce the level of structural unemployment. The focus of the reform is to promote an individual approach to each unemployed person. This means greater freedom of choice and more personal influence on individual active measures. At the same time, the reimbursement system again is reformed – in a rather radical way.

The reform has implied several changes:⁸⁸

First, it implied some changes for the unemployed. The authorities should offer the unemployed support much earlier. The municipality will have greater flexibility in the efforts so that the measures will be individual and meaningful for the unemployed and not depend on “mechanical” steps. The first six months introduces an intensive job-seeking course with relevant and differentiated interviews and job seeking activities. The job centres and unemployment insurance funds must cooperate in organising this intensive job-seeking course. Unemployed persons have a right and duty to receive one activation offer instead of repeating offers – and the offers must relate to enterprises. Education and training must be targeted at unemployed persons who are motivated to learn and in need of a skills upgrade.

Second, focus on enterprises and the needs of enterprises increases. Assistance for enterprises must be a main priority for job centres, so the enterprises can receive the necessary labour. The job centres should lead a systematic and outreaching contact to enterprises based on knowledge of the labour market, assist in recruitment of unemployed workers as well as upgrade qualifications and maintenance of existing employees.

⁸⁷ Sources: Especially Ekspertgruppen (2014, 2015) and Regeringen et al (2014).

⁸⁸ Ministry of Social Affairs and the Interior (2015), bill number L1, and Ministry of Employment (2015), bill number L4. Both bills passed through Parliament on 26 August, 2015.

Thirdly, the municipalities get increased flexibility to organise relevant courses for each individual unemployed. The job centre can freely choose between all possible measures; however, there must be a focus on those offers relevant for enterprises. Additionally, the reform intended less regulation and more simplified and efficient processes. Local Government Denmark (LGDK) however did not find the reform that ambitious when it comes to less regulation and bureaucratisation.⁸⁹

Fourth, the reform involves some changes in the overall organisation of the tasks. The 94 Local Employment Councils and 4 Regional Employment Councils are merged into a number of cross-municipal employment councils that better corresponds to geographic ‘travel to work’-areas (commuting regions). The new councils shall support cooperation between municipalities, between municipalities and unemployment insurance funds and between the job centres, Adult Education Centres and Regional Growth Fora.

Fifth, thorough changes to the finance system is a part of the overall reform of the employment policy. From 2016, the rate of reimbursement rates of municipal expenditures on labour market oriented social benefits are be the same for all sorts of benefits. Similarly, they now only vary in accordance to the total length of the period of receiving labour market oriented social benefits – irrespective of the kind of transfer (i.e. sickness benefits as well as unemployment benefits as well as early retirement benefits etc.).⁹⁰ Consequently, the rate of reimbursement is no longer be dependent on the active/passive dimension. Over the length of the period of receiving income-transfer for the individual person, the reimbursement rate declines. The aim of these changes is to support the main purpose of a more flexible and individual approach in the employment policy and to encourage employment efforts from the beginning.

⁸⁹ KL (2014): A note from the Local Government Denmark regarding the reform of employment policy.

⁹⁰ Certain other labor market schemes outside income transfers, which count as subsidies and/or public consumption, are also covered by the reform e.g. fleksjobs (jobs on certain conditions and with local government financial support), wage-subsidies (subsidies to certain jobs in the private or public sector of extraordinary character), see Ministry of Employment (2015).

Until now, a complex set of rules as the rate of reimbursement varied from one measure to another and, dependent on the actual active measures in use, characterised the reimbursement system, cf. section 3.4. The system maybe also had too many objectives. Although this system also has had its underpinnings in such a system, there is a risk of opportunistic behaviour to optimise the highest rate of reimbursement instead of identifying the best measure for the unemployed person.⁹¹

Thus, the new reimbursement system aims to strengthen the result-oriented focus of the municipalities, i.e. a performance management viewpoint. The change implies an overall reduction of average reimbursement rates and correspondingly again more weight given to financing through general grants. To a higher degree, it gives the municipalities direct economic incentives to prevent long-term unemployment and carry out an effective effort to obtain permanent employment.

As indicated, the rate of reimbursement declines over time: From 80 percent the first 4 weeks of receiving income transfers, 40 percent in week 5-26, 30 percent in week 27-52 and 20 percent in week 52 and thereafter, cf. *table 9*.

Table 9: Reimbursement rates (pct.) for certain municipal/partly municipal financed labour market oriented social benefit schemes, 2001-2016

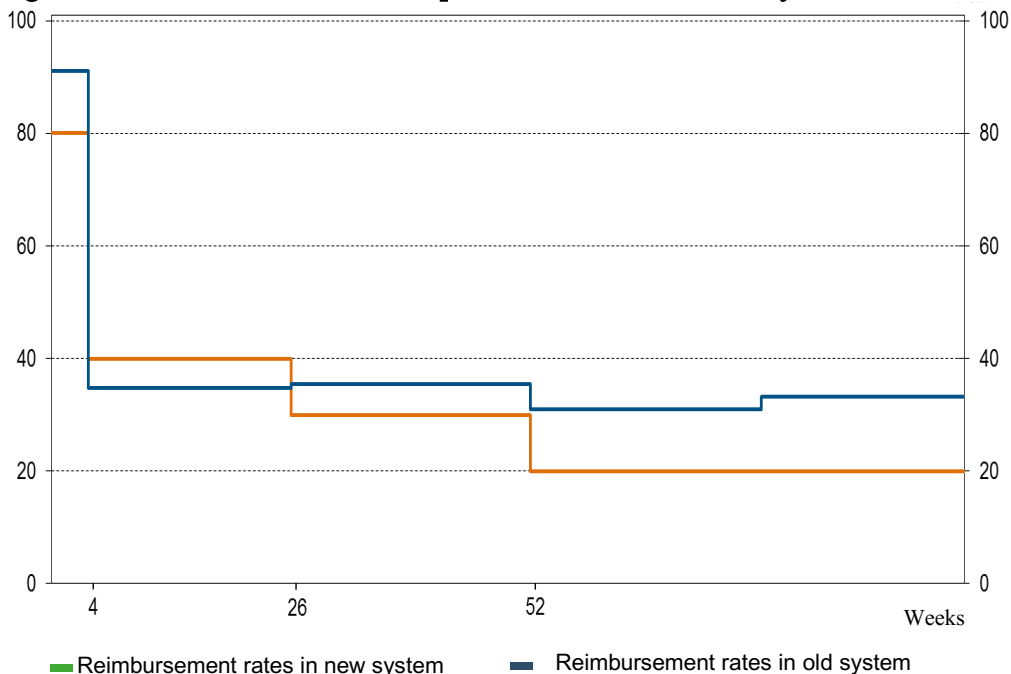
	2001	2006	2011	2016
Early retirement pension	35	35	35	80/40/30/20
Sickness benefit	100/50/0	100/50/0	100/50/30/0	80/40/30/20
Unemployment benefits	-	-	100/50/30	80/40/30/20
Social assistance	50	65/35	50/30	80/40/30/20

Note: In some instances, the rates are lowered in relation to the length of the period an individual can receive benefits and these different rates are shown in the table.

In *figure 1* the “old” and the “new” system are illustrated. The graph of the “old” system is however, an average of several different rates of reimbursement for the different schemes involved.

⁹¹ Cf. the political agreement behind the reform, Ministry of Economic Affairs and the Interior (2015).

Figure 1: Reimbursement rates (percent) in new and old system



Source: Ministry of Employment (2015).

Sixth, it is presumed that the changes in the finance system will not have unintended economic consequences for the municipalities and the economic balance between the municipalities. Therefore, an important part of the changes is a parallel adjustment in the equalisation system.

In short, so-called initial adjustments enhance the level of equalisation, which primarily will benefit the rural municipalities where the reform would otherwise tend to have a negative effect. Moreover, some temporary financial arrangements to limit some of the consequential losses and gains of the municipalities. As has been the case for the preceding reforms, it is a complicated task to repair the consequences for the municipal equity using objective criteria. Therefore, the Finance Committee (Finansieringsudvalget) of the Ministry conducts an analysis of a more permanent adjustment to the equalisation system.

3.5.2. Perspectives of the employment reform of 2015

The latest and most comprehensive reform of employment policies implies many changes with the purpose of generating an efficient system that permanently can raise the structural employment rate and limit the numbers of benefits. With the reform, the government takes an important step towards “actual” decentralisation.

The different changes are interdependent and must be seen as a whole as the increased economic responsibility follows increased autonomy and flexibility. The government gives up some control of the process and content, but instead, the economic incentives will ensure that the municipalities will make more and more effective efforts to get the unemployed in a job than before. Onward, more focus will be placed on the targeted help for each individual unemployed person, instead of measures with advantageous reimbursements. Further, it is hoped for that the changes will lead to a better political leadership locally and to professionalised policies of the municipalities.

The aim of the preliminary change of the equalisation scheme in 2016 and 2017, and the more long-sighted changes expected to come, is to ensure that the increased economic responsibility of the single municipalities will not lead to an unintended imbalance between the municipalities. It seems evident that the comprehensive changes of the reimbursement system would not have been possible if it was not for the parallel adjustments of the equalisation system. The consequences of lowering the rate of the reimbursements would have been tremendous, at least in the end, as it would have had a significant negative impact on the revenue, especially of some rural municipalities and some regions. On the other hand, it is important to base the equalisation system firmly on so-called objective criteria, which do not reduce the economic incentives to get the unemployed a job. If the equalisation system works against the intended economic incentives of the reform, the financial changes will have been all in vain. The legislators have to find a more reasonable balance between “economic equity” and “economic incentives”. This will be an important topic for further discussions and evaluations. One must also keep an eye on the temporary adjustment of the equalisation system and transitional arrangement so that it will not compensate the municipalities in a way that jeopardises the improvement of economic incentives, which is the aim of the reform.

The reform was implemented by 1 January, 2016, but the effects are of course “yet to be seen” over the following years.

3.6. Conclusions

Denmark has a very high score when it comes to comparing the GDP-share of expenditures assigned to local governments across countries. This is an explanation why investigations often rank Denmark at the top of decentralised nations. Nevertheless, we have to regard the ranking of Denmark at the top end in this respect with a pinch of salt. The reason that official statistics measure a high share of expenditures assigned to local governments stems primarily from the fact that the major part of expenditures, especially for social benefits/income transfers to households, are counted as local expenditures in Denmark.

More than half of the social benefits, i.e. old age pensions and child benefits, are “agent functions” and involve no local discretion nor local financing and consequently should not be counted as “local”.

For the rest of the social benefits, i.e. the labour market oriented social benefits, we find that decentralisation concerns the authority to award the benefits and the possibility to influence who is entitled to them, together with a degree of self-financing from local governments. The wish to improve structural employment and to contain expenditures seems to drive decentralisation.

The historical development shows that since the first local government reform back in 1970 – the several governments that have been in power have sought to decentralise labour market oriented benefits. However, the nature of that process has been different in comparison with other decentralised areas. Irrespective of the official assignment of these social benefits to the municipalities, for many years a high rate of reimbursement and bureaucratic process regulations has characterised the expenditures. Thus, the government maintained – contrary to what the official statistics may show – a high degree of regulation and inspection of the employment policies, and the degree of local autonomy was rather limited.

After all, seen over a long period of time the changes in the financial system, e.g. lowering reimbursements, have to a certain degree been going hand in hand with more competences for the local authorities

awarding the benefits. However, the central government has also used the finance system to influence the behaviour of the municipalities. We identify two partly conflicting objectives: first using the finance system to encourage certain measures and solutions, and second obtaining financial “neutrality” without distorting the process of the municipalities to make “free” decisions about the most effective measure. Legislators see changes to the reimbursement system as a possible way to affect the municipalities, however leaving a growing challenge to the equalisation system to compensate for resulting local inequalities.

In the recent 2015 reform, the reimbursement system was itself seen as a hindrance to an efficient employment policy and a more individually based employment policy. Parallel to this, the central government method of control via process regulation was criticised. Consequently, the reformed reimbursement system is clearly simplified and (some of) the process regulation has been abolished. The effects of the reform in the coming years are yet to be seen.

A condition for the municipalities to efficiently produce services is the ability to finance these services as independently as possible. In order to do so, there must be a certain level of equalisation between the municipalities so each municipality has the fiscal potential to deliver an “average” service at an “average” local tax rate. A successful decentralisation of social benefits is dependent on a solid equalisation system and “safety net” because the expenditures are vulnerable to macroeconomic fluctuations. It is also critical that the equalisation system rests on objective criteria so that it does not jeopardise the gains of improving incentives.

The solution to this is not a minor problem. In addition, to maintain the Danish system of local autonomy and responsibility intact, it should be kept in mind that this should be done without increasing – but rather reducing – the discretionary grants partly stemming from former reimbursement reforms.

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Chapter 4

Local Government in Norway - principles, guidelines and responsibilities

Grete Lilleschulstad⁹²

Foreword

Local democracy is historically strong in Norway, and the local government sector is a well-established institution. The degree of decentralisation is relatively high, and the relationship between the central and local government sector is based on a high degree of division of responsibilities. Norway is a unitary state, and the local self-government shall function within the framework of national goals and the decisions of the central government. The relationship between the two levels thus forms an exceedingly integrated system, with different degrees of municipal freedom on different areas of activity. Norwegian municipalities and county authorities are responsible for providing important welfare services: education, primary health care, care for elderly, kindergartens etc. Local government consumption amounts to about 14 % of GDP in continental Norway. Approximately 77 percent of the total income comes with no strings attached. One in five of all employees in Norway work in the local government sector.

This paper seeks to describe the distribution of responsibilities between the different levels of government in Norway and the policy for the local sector, focusing on the legal and financial tools. Three principals have been important guidelines for the management of the local sector: decentralisation, equalisation and economic independence. Additionally the paper will present a short historical resume as a basis to describe

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the drivers in the development, some current tendencies, the needs for reforms and new political goals. Towards the end of the paper the current government's new reforms concerned with merging municipalities and giving them new tasks will be discussed.

4.1. The Norwegian model

A unitary state, with two political levels.

In Norway, local democracy functions within the framework of the decisions of the central government. The parliament (Stortinget) passes the laws concerning decentralised government. Norway has a two tier-system of local government: the municipalities and the county authorities. There are 426 municipalities and 19 counties. The municipalities and the county authorities have the same administrative status, whereas central government has the overriding authority and supervision of municipal and county administration. The main representative of central supervising local authorities is the County Governor.

Levels of government in Norway:

- The central government
(including central government agencies at the regional and local level)
- The county authorities (19)
- The municipalities (426)

Both at the municipal and the county level there are elections to local government assemblies. The municipal council is the municipality's supreme body. More than half of the municipalities have less than 5000 inhabitants, eight have more than 50 000. Despite such differences, the distribution of responsibilities is based on the generalist municipal principle, which means that all the municipalities and all the counties are intended to fill the same functions and are given the same rights. The municipalities have different roles towards the inhabitants. We can separate between four different roles:

- deliver welfare services
- an arena for democracy
- decision-making authority
- societal development.

4.2. Short historical overview and current tendencies

Local democracy has a long tradition in Norway. The Alderman Act of 1837 first defined local authorities' rights and responsibilities. It also defined the geographic boundaries and ensured a high level of autonomy in local affairs through the 19th century. The period from the end of the 1800s until the 1920s and 30s was crucial in laying the foundations for the central place of the municipalities in the Norwegian welfare society. The municipalities were the driving forces in the development of the welfare society. Important initiatives were taken to better the conditions for the inhabitants. Local authorities took on many new tasks on their own initiative, including building schools, gymnasiums and hospitals. In addition, many municipalities established social insurance schemes. These new developments in the municipalities took place at the same time as other important reforms in the country: the right to vote was expanded, political parties were formed, new laws of succession were enacted etc. These developments led to big differences between rich and poor municipalities, because their income came mainly from taxes. The state practiced a laissez-faire policy and interfered very little in municipal decisions.

However, times were changing, and in the 1930s, during the depression, many municipalities took on a considerable amount of debt and came in a deep economic crisis. Gradually, the state played a more active role, for instance through tax equalisation and other initiatives to help municipalities to manage their tasks.

Several reforms were initiated after the World War II. A clearer division of labour between the levels of government took place. The welfare services (education, health and social services) were defined as local government responsibilities. The first decades were characterized by a strong growth in activity in the municipalities, tax equalisation, earmarking of central government grants and a higher degree of central government control. A central goal was to expand the welfare services and give the inhabitants the same services in the whole country. The municipalities became a more integrated part of a unitary state.

By the 80s a relatively high level of welfare had been achieved, and gradually some reforms took place. The municipalities were for the most part financed through earmarked grants and local taxes. The high number of earmarked grants was an administrative burden, both to the

local and at the central government. Large differences existed between municipalities and between counties in both the level of income and in the level of expenditure needs. A higher degree of redistribution was therefore necessary, and this was in 1986 achieved by the new general purpose grant scheme. The new general purpose grant scheme incorporated both the government grants and tax equalisation in the same system. To a greater degree, the local welfare services became subject to local political priorities, thus making the local politicians responsible for local welfare decisions. The Local Government Act of 1992 also allowed a greater degree of freedom to organize both the administrative and the local political system as it suited the municipality.

In Norway, decentralisation of tasks has been an important goal for a long period of time. Over the years an increasing number of tasks have been delegated to the local government sector. Decentralisation has been regarded as a necessarily tool to achieve a good allocation of services. Local knowledge has been regarded as a condition for making the right priorities, and decentralisation as a condition to achieve an efficient local sector. The local self-government is efficient because local authorities are closer to the public than the national government, and are therefore better at assessing the needs and demands of the inhabitants. In consequence, the municipalities often must do difficult priorities and chose among many good purposes.

To obtain cost efficiency the economic freedom is restrained and the financial frames are limited. The government seeks to control the expenditures through setting the income framework and the municipalities shall pay all their bills through their own incomes. A recurrent question in the political debate between the municipal sector and the government is the amount of the revenues and the economical funding.

At the same time, the period after 1990 has also been characterized by a generally higher degree of individual rights and there are signs that indicate more state micromanagement. Several individual welfare reforms that shall be implemented by the municipalities have been introduced: in 1994 all youths got the right to upper secondary school, in 1996 primary school was expanded by one year when school starting age was lowered from 7 to 6 and in 2011 the individually right to child care for children about one years of age were introduced. The general purpose grant scheme has also been under some pressure since it was intro-

duced in 1986. As discussed later, the number of earmarked grants remained high also after the introduction of the new fiscal system in 1986, even if the share of income from earmarked grants has decreased. As pointed out by Borge (2015) the division of tasks between the government tiers has also shifted from the county governments in recent years by the state takeovers of the public hospitals and child welfare institutions. Some keywords to understand the driving forces in these developments are perhaps: a reaction to the decentralisation through block grants and framework acts, strong sectorial interests, demands from the inhabitants for better quality, equal treatment and more services from the government, more specialised responsibilities, many small municipalities with limited resources and a nation more well-off than previous.

To sum up, equalising income and expenditures through the general purpose grant scheme have reduced the financial differences between the municipalities. In recent years there has been a reduction in the share of income from earmarked grants, but at the same time the number of earmarked grants is still relatively high. There are signs that indicate more micro-management of the municipalities and an emphasis on individual rights. As discussed later in this paper, state micromanagement and more detailed regulations of welfare services, weaken the municipalities' possibilities to prioritise and adapt welfare services to the needs of the inhabitants. At the same time, many of the municipalities are small and the question is if they are equipped to handle all their tasks. Towards the end of this paper the recent developments and the government's new reforms concerned with merging municipalities and giving them new tasks will be discussed.

4.3. Responsibilities

The relationship between the central and local government sector is based on a high degree of division of responsibilities.

Table 1: Central government responsibilities

Central Government responsibilities

The National Insurance Scheme

The Specialised health services

Specialised social services

Higher education/universities, labour
market, refugees and immigrants

National road network, railways, agriculture
issues, environmental issues

Police, courts, prison, armed forces, foreign
policy

Traditional national tasks such as taxation and social insurances are mainly the responsibility of the central government. The goals of equal treatment, cost control and a fair distribution of income between the inhabitants are difficult to achieve at a local level. In Norway, social insurance is generally the central government's responsibility. This also includes unemployment benefits. From 2002, central government has also been responsible for delivering specialised health services. As shown in the COFOG figures, the expenditures on health services are shared between the state and the municipalities.

The national aim is to offer a high level of welfare services with a balanced standard to citizens in all parts of the country. To a large extent the responsibility for carrying out central welfare tasks is given the municipalities and the counties. The degree of municipal freedom in how they solve the tasks varies across different areas. In general, basic welfare services are the most regulated.

Table 2: Municipality and county responsibilities

Municipalities	Counties
<ul style="list-style-type: none"> • Primary and lower secondary school 	<ul style="list-style-type: none"> • Upper secondary school
<ul style="list-style-type: none"> • Nurseries/kindergartens 	<ul style="list-style-type: none"> • Regional development
<ul style="list-style-type: none"> • Primary healthcare 	<ul style="list-style-type: none"> • County roads and public transport
<ul style="list-style-type: none"> • Care for the elderly and disabled, social services 	<ul style="list-style-type: none"> • Regional planning • Business development
<ul style="list-style-type: none"> • Local planning, agricultural issues, environmental issues, local roads, harbours 	<ul style="list-style-type: none"> • Culture (museums, libraries, sports)
<ul style="list-style-type: none"> • Water supply, sanitation and sewer 	<ul style="list-style-type: none"> • Cultural heritage
<ul style="list-style-type: none"> • Culture and business development 	<ul style="list-style-type: none"> • Environmental issues

Figure 1: Distribution of expenditures – municipalities

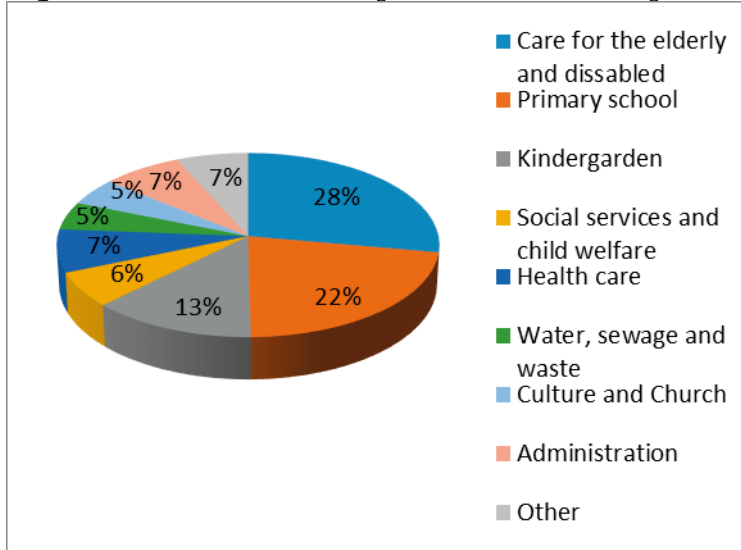
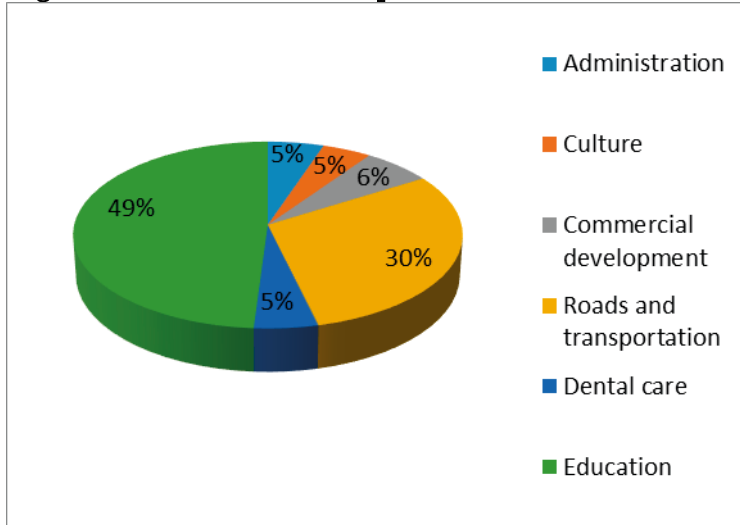


Figure 2: Distribution of expenditures - counties



4.4. Tools and principles

Legal tools

The organisation of and the activities in the municipalities are regulated by The Local Government Act and several more specific laws. The Local Government Act of 1992 determines the ground rules for the organisation of the municipalities and the county authorities, including how they work and their proceedings, the relationship with supervisory state bodies, etc. The act is to a certain extent a framework act.

Before 1992 the municipalities were bound to have an administration that was divided into specific fields, one school organisation for health, one for schools etc.

On the whole, the regulations in the act are the same for municipalities and counties. The Local Government Act does not regulate which duties to be carried out locally. These questions are covered by separate, more specific laws. The Local Government Act describes the minimum requirements concerning the local institutions all municipalities must have. Besides the municipal council and their executive committee, they must hire a chief municipal executive who is the head of the administration. The municipality can also choose a parliamentary system of

local government. Most of the municipalities and the counties have a "traditional system". However, a couple of the largest municipalities and counties have a parliamentary local system. However, with some exceptions, the municipalities are free to organize their administration as it suits them.

The Local Government Act also regulates the budgets and financial management. The most important requirement is the obligation to pass balanced budgets. The municipalities and counties shall run a surplus before loan transactions, and any budget deficit shall normally be covered over two years. In Norway, the municipalities' scope is limited negatively, meaning that they can take on any task they wish, as long as they are not expressly barred from doing so by law.

Financing tools

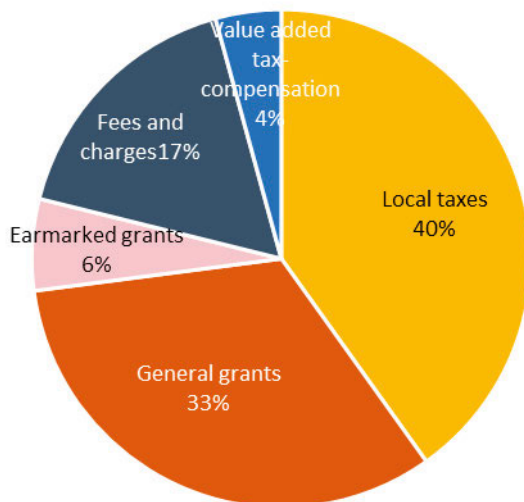
Some figures to put the local government sector in a national context:

- Local government consumption amounts to about 14 % of GDP in continental Norway
- Income in the local government sector amounts to about 18 % of GDP in continental Norway
- One in five of all employees in Norway work in the local government sector

These figures have been rather constant over the last 15 years. Historically, taxes have been an important source of revenue for the local authorities in Norway, and the municipalities and counties are essentially financed through taxes and general grants. After the general purpose grant scheme was introduced in the middle of the 80s, the consensus regarding the principles in the system has been relatively strong. At the same time the system has been under a certain pressure because the number of earmarked grants have remained high. The new general purpose grant scheme replaced a financial system based of several different earmarked grants. A high degree of redistribution was therefore necessary, and this was achieved by the new grant scheme. In Norway the block grants are so-called "free income", meaning that the local authorities can spend both revenues from taxes and general grants as they wish.

The general purpose grant scheme gives a high level of cost control as both the general grants and the tax level are set by the parliament. The government seeks to control expenditures through setting the income level. This is more efficient than to follow up the expenditures in detail. A high degree of decentralisation and decision making autonomy can be easier to achieve within a system based of top-down spending limits.

Figure 3: Composition of revenues 2016 – municipalities and counties.



The local taxes accounts for 40 percent of the total revenue, followed by general grants at 33 percent, earmarked grants at 6 percent and fees and charges at 17 percent. The last four years these shares have been rather stable. Local tax revenues come mainly from income taxes, but also include wealth tax, property tax and tax on natural resources. The "free income" share of the total income of the municipalities and counties is approximately 77 percent. Some of the responsibilities of the municipalities and counties are still being financed by earmarked grants, supplemented by financial contribution from the municipality itself and charges from the inhabitants. In addition, the municipalities have revenues from interests, stocks and property taxes.

Variation in total income between the municipalities can be explained by variations in the income taxes, several regional grants and property taxes.

Local taxes:

- Income taxes (including wealth tax and natural resource tax) from inhabitants
- Property taxes
- Tax on natural resources

The income tax from taxable income from persons is the most important tax revenue. Over 90 percent of total tax revenues are income taxes. Included in this number is also wealth tax from persons and tax on natural resources from water power plants, but these play a minor part of the income tax. Most of the local income tax is taxes on taxable income.

The total rate of taxation for the income tax is now 24 percent. The income tax is a proportional tax. The income tax from personal taxpayers are divided between local authorities and the state, but not divided equally. The tax rates for the municipalities and the counties are set annually in the parliament in order to achieve the desired amount of revenues from income taxes.

The municipalities do not have the authority to give tax allowances as the fiscal legislation is a central government responsibility, but they have the authority to lower the income tax rate. Since 1979, no municipality has made use of this opportunity.

In Norway the fiscal legislation is a central government responsibility. In the political debate in recent years, free tax rates have not been a big issue. There is a long tradition of tax equalisation, and a high degree of redistribution of tax revenues is obtained through the general purpose grants scheme. A recurrent question in the political debate is how much of the local taxes shall be redistributed and how much of the income shall stay in the municipality of origin.

Property taxes

The municipalities, but not the counties, also have the authority to collect property tax. In 2015 355 out of 428 municipalities had imposed property tax, but as a share of the total revenues the property tax is far

less important than the income taxes. The property tax only accounts for about 2,5 percent of the sector's total revenue. In 2006, the authority to collect property taxes was extended considerably. In practice, the municipalities can collect property taxes on every property, both from private households, secondary homes and from companies. To collect property tax is an opportunity to increase one's own revenues, but the level of the tax rate and other issues are strictly limited.

Earmarked grants

In recent years, the share of income from earmarked grants has decreased. In 2008 the earmarked grants accounted for 13 percent of total income in the local government sector, and in 2016 the accounted for only 6 percent. The explanation to the main part of the change is the kindergarten grants being included in the general grant in 2011. In spite of the reduction of the share, the number of earmarked grants is still relatively high. Today the number is 75 (2016), and it is a goal of the current government to reduce the number.

4.5. Recent developments

The present government has a comprehensive plan for local government reform during this parliament (Storting) session (2013-2017). The aim is that the reforms will result in larger municipalities which can take on additional responsibilities and more autonomy. The objectives of the reform are to secure good welfare services, equal services for citizens, comprehensive and coordinated societal, sustainable and financially robust municipalities, and strengthened local democracy. The government is planning to present a comprehensive bill to the Storting regarding the new local structure in the spring of 2017. Currently, necessary non-recurring costs for the municipalities during the amalgamation process are covered. Further, the municipalities will be compensated for loss of future central government grants for a transitional period of 20 years. Support has also been provided for various infrastructure projects in connection with municipal mergers. In 2016 the general purpose grants scheme was updated.

In a proposition to the Storting in May 2014((Proposition 95 S (2013-2014) Municipal proposition 2015)) the background for the reform is discussed. It has been 50 years since the last local governmental reform, and the municipalities have since then been assigned considerable responsibility for welfare services. At the same time, central government

micromanagement has increased. A greater range of tasks and more specialised responsibilities has led to a greater demand for better quality. Citizens have higher expectations and this leads to greater demands on municipalities with respect to strong specialist departments and adequate capacity and expertise. As this government see it, developments in the future will probably result in greater competition for qualified personnel. For example, the Expert Committee of Local Government Reform pointed to a number of surveys that show that small municipalities more frequently experience problems attracting employees with child welfare officer qualifications than larger municipalities. A strategy most municipalities have followed to ensure the delivery of good services with sufficient capacity and expertise is inter-municipal collaboration. Through inter-municipal collaboration the municipalities have moved a number of tasks out of the municipality. There are both pros and cons of inter-municipal collaboration. Extensive inter-municipal collaboration weakens local democracy by reducing opportunities to look at multiple tasks as part of a whole and making it harder for the citizens to understand what decisions are taken where. On the other hand, it is in many cases a necessary tool to solve important tasks for many municipalities.

At the same time, population growth, especially in central urban areas, is expected to remain high. Norway's population has grown by around 1.2 million, or 32 percent, since 1970. One trend has been that the larger municipalities have seen significant population growth, while small municipalities have seen significant falls in population. In the lead up to 2040, the number of senior citizens aged 67 or older will double. The greater need for services will be a challenge for all the municipalities, but especially the smallest. As pointed out in the Municipal proposition 2015, this also underlines the need for reforms.

The aim of the governmental reform is to equip the municipalities better to handle the tasks they already have, as well to prepare them for challenges and new tasks that will come over the next decades. One central aim for the present government is to spread power and build society from the bottom up. Different local communities face different challenges, and an important aim of the reforms is to give municipalities greater opportunities to find good solutions that suits their citizens.

In a white paper to the Storting in 2015 (Report to the Storting 14 (2014-2015) The Local Government Reform – New tasks for Larger Mu-

municipalities) the government presents new tasks for the municipalities. The Ministry believes that the system of generalist local government should remain the principal model for the local government sector and that new tasks should, as a general rule, be transferred to all municipalities. Firstly, the Government has initiated a series of processes that affect the division of responsibilities between the tiers of public administration that do not necessarily adhere to the timeline of the local government reform. Secondly, the Government proposes transferring several tasks to municipalities in a number of areas as part of the local government reform. The transfer of these tasks is contingent on larger and more robust municipalities. For example, mentioned in the white paper: dental health services, rehabilitation services, grants to volunteer centres, basic aids etc.

The review in the white paper also shows that there may be benefits to be gained from assigning some new tasks, such as public transport, only to the largest municipalities.

Thirdly, the white paper announces measures for reducing state management. The government has started working on a general review of the state management of municipalities with a view to reduce the micromanagement of larger municipalities. Larger municipalities can also provide a basis for reducing nationwide state supervision. The results of the general review will be presented to the Storting in the spring of 2017.

The county authorities has also been invited to commence discussions on merger alternatives with the aim of assessing and clarifying whether or not it is relevant to merge with neighbouring counties.

During the spring of 2017 the aim is to present a suggestion for the new local government structure and the new regions. At this stage (March 2017), the number of municipalities from 1.1.2020 seems to end up somewhere in the 350s.

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Chapter 5

Decentralisation of social policy in the Netherlands

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Abstract

The Netherlands has recently embarked on a considerable decentralisation of social policy. As of 2015, municipalities have new responsibilities in the domains of youth care, long-term care and income support. This contribution discusses some of the associated opportunities and risks. The grant design incentivises municipalities to minimise expenditure on their new tasks, which may yield efficiency gains but also entails a risk of underprovision. The ever larger role of municipalities in social service provision fosters the exploitation of economies of scope, but some important interactions with policies for which other parties are responsible remain. In particular, healthcare insurers become partly responsible for the provision of home care and institutional care remains a central government task. This may induce underprovision of municipal services and substitution towards services provided by other parties. Finally, the efficient scale for provision of some of the decentralised services, such as specialised youth care, appears to exceed the size of many municipalities. A brief discussion of policies to take optimal advantage of the opportunities and mitigate the risks concludes the paper.

⁹³ CPB Netherlands Bureau for Economic Policy Analysis.

⁹⁴ I am indebted to participants of the 5th Copenhagen Workshop on Decentralization of Education, Health and Social Protection, and in particular to Jørgen Lotz and Hansjörg Blöchliger, for helpful comments and suggestions. I also thank Remco van Eijkel, Krista Hoekstra, Kenny Martens and Marielle Non for their input.

5.1. Introduction

As of 1 January 2015, municipalities in the Netherlands have acquired important tasks in three broad domains of social service provision. They became responsible for all youth care services, ranging from universal and preventive services to highly specialised care. Through a major reform of the long-term care system, municipalities also acquired an important role in the assistance of people with physical or mental health problems in their home environment. Finally, they now provide income support for less than fully disabled persons who have no employment history (as opposed to former employees), as well as social welfare services such as mediation, training and subsidised employment. This decentralisation on the expenditure side is not accompanied by a decentralisation of revenues. Instead, the new tasks are funded through a lump-sum central government grant that takes account of differences in spending needs. As a result, the total grant amount from the central government has risen by about 25 percent, or roughly one percent of Gross Domestic Product.

One important source of motivation for these decentralisations is the expectation that as municipalities become the main supplier of social services, they will be better able to tailor provision to individual needs. In particular, the scope for overall efficiency enhancement through prevention and early intervention is believed to be considerable. Municipalities are in a position to invest in such policies and shifting the burden of more involved types of support and care onto them means that they may also reap the rewards, thus strengthening their incentive. As municipalities are expected to perform the decentralised services more efficiently, their budget is cut considerably relative to prior expenditure on these tasks. In the wake of the Great Recession and the need for fiscal consolidation it entails, these budget cuts constitute the second important source of motivation.

What are the main opportunities and risks of the decentralisations from an economic point of view? This contribution provides an overview, largely drawing on two earlier reports that CPB Netherlands Bureau for Economic Policy Analysis wrote at the request of the central government (CPB, 2013; 2014).⁹⁵ After a more detailed discussion of each of

⁹⁵ CPB Netherlands Bureau for Economic Policy Analysis is an independent think tank that performs scientific research aimed at contributing to the economic decision-making.

the decentralisations in turn (section 2), we will focus on three broad themes. The first is the role of financial incentives for municipalities (section 3). While the decentralisations strengthen financial incentives for cost-efficiency in the social domain, we will discuss several externalities that make these redistributive services prone to underprovision. This risk is particularly relevant for services for which the level of provision is difficult to measure and enforce.

A second theme is the interaction between different types of services (section 4). On the one hand, broadening the range of services that are locally provided may enhance efficiency through economies of scope. On the other hand, interaction of decentralised services with services provided by the central government or other parties may give rise to externalities or undesired substitution. Information on the use of social services at the individual level allows for a crude assessment of the relevance of these opportunities and risks quantitatively for the long-term care and labour market domains. While economies of scope appear to dominate in the domain of income support and social welfare services, interaction of municipal care with long-term care provided by the central government and by health insurers gives rise to considerable risks. In particular, as the central government remains responsible for institutional care, municipalities are not rewarded for investments that enable clients to stay at home and there is an incentive to substitute home care for institutional care.

Loss of scale economies is the third theme that will be touched upon in this contribution (section 5). This is particularly relevant for specialised types of youth care, for which both the number of users and the number of providers per municipality are small. High transaction costs and limited bargaining power appear to necessitate intermunicipal collaboration for the largest part of the youth care budget. However, intermunicipal collaboration has its own drawbacks, such as reduced accountability. The paper concludes with a discussion of policies to take optimal advantage of the opportunities and mitigate the risks of the decentralisations (section 6).

5.2. The three decentralisations

This section provides some more detail on each of the three decentralisations in turn. With regard to youth care, responsibilities were highly fragmented prior to 2015. Municipalities were mainly responsible for universal and preventive services, aimed at facilitating the normal development of children. Provinces provided or coordinated more specialised care and support in case of serious development and / or parenting problems, either residential or at home, as well as youth protection, youth probation and foster care. Health insurance companies were responsible for youth mental healthcare. The central government was responsible for the most specialised types of care, long-term care for physically or mentally disabled youths, as well as for juvenile justice policy and related institutions. As of 2015, municipalities carry the administrative and financial responsibility for almost all of these tasks, while their budget is cut by about 10 percent relative to previous expenditure.

Municipal tasks in the domain of home care prior to the present decentralisations included provision of benefits for the disabled, such as transportation, a wheel chair or home improvements, and assistance in daily housekeeping activities like cleaning and shopping. The central government was responsible for the largest part of long-term care, including the part of home care not covered by municipalities. The decentralisation of long-term care to municipalities is part of a wider reform of the long-term care system, in which health insurers also obtain new responsibilities. The general idea is that the central government remains responsible for institutional care and that the responsibility for home care is split between health insurers and municipalities, with medical care (nursing, bathing, dressing) going to the insurers and nonmedical care – a mix of rather heterogeneous services ranging from training in the use of medical aids, assistance in the organisation of daily structure to social day care – going to the municipalities. For these tasks, their budget is cut by about 10 percent relative to previous expenditure. Furthermore, the municipal budget for assistance in daily housekeeping activities is roughly halved. At the same time, access to institutional care will become considerably more restrictive, which should raise the demand for home care. Municipalities are supposed to accommodate these budget cuts by tightening eligibility criteria, by appealing more to informal care and by increasing their reliance on universal rather than individual services, such as community centre work. They can also charge user fees.

Municipalities were already responsible for social assistance and welfare to work programmes for people with full ability to work. The present decentralisations extend this responsibility to less than fully disabled persons who have no employment history, whereas eligibility criteria for income support are tightened for this group. The reform applies to new applicants and not to people who already make use of disability insurance. The central government remains responsible for this latter group, as well as for fully disabled persons. This implies that, unlike the other two decentralisations, it will take several decades for this reform to come fully into effect. The amount of the structural budget cut is therefore considerably less certain. One unknown on which it depends is the extent to which less than fully disabled persons will succeed in finding employment. The central government estimates that expenditure on this group will roughly halve. Furthermore, the provision of employment in sheltered workshops for less than fully disabled persons will be drastically reduced, and municipalities that become financially responsible should resort to other social welfare services such as wage subsidies instead. This reform is estimated to yield a cut of about 25 percent of the current budget for sheltered workshops.

5.3. Externalities and the risk of underprovision

The decentralisations create the opportunity to encourage cost-efficient provision of social services through financial incentives. The new tasks are funded with an unconditional block grant, which provides strong incentives for municipalities to exploit their knowledge about local needs and costs and to implement policies that minimise spending. The agencies that previously carried out the decentralised tasks did not face such high-powered incentive schemes. For example, the regional agencies that previously provided home care could not claim the remainder of their budget, whereas costs exceeding this budget were compensated if due to exceptional circumstances. This lack of strong financial incentives in a sector that is prone to supplier-induced demand may have resulted in overspending. The steep rise in the use of specialised youth care, witnessed over a period in which the number of youths hardly increased, may also reflect overspending.⁹⁶

⁹⁶ SCP (2011) documents that between 2000 and 2009, the annual growth in the use of specialized youth care amounted to about 7 percent, whereas the number of youths grew by 0.25 percent per year over this period.

Experiences with previous decentralisations of social assistance and assistance in daily housekeeping activities underline the importance of financial incentives. In 2004, the central government transformed the funding of municipal welfare provision from a 75 percent matching grant into an unconditional block grant – although various insurance mechanisms remained in place. This incentivised municipalities to enforce the eligibility criteria more strictly and to provide effective welfare to work programmes. The total number of welfare recipients has decreased as a result.⁹⁷ In 2007, municipalities became responsible for assistance in daily housekeeping activities and they were funded through an unconditional block grant. This led to a reduction in expenditure, partly because municipalities substituted more basic for more advanced types of assistance and partly because they were able to reduce tariffs of providers considerably in the procurement process.⁹⁸

While the strong financial incentive to minimise municipal spending may enhance cost-efficiency, it also entails a risk that municipalities provide less of the decentralised services than socially desirable. The redistributive nature of these services provides a first source of externalities. As emphasised by the classical literature on fiscal federalism, an incentive to underprovide redistributive services arises when beneficiaries tend to move to the municipalities in which provision is most generous.⁹⁹ This type of shopping behaviour in the Tiebout sense certainly occurs, but perhaps not on a scale that seriously undermines local social service provision. With regard to the present decentralisations, the risk appears to be most relevant for youth care, as young families are generally more mobile than elderly recipients of long-term care.

An incentive for underprovision also arises in the absence of household mobility, when the altruistic value that people attach to redistribution transcends municipal boundaries. This would imply that locally provided social services benefit the entire society, whereas individual municipalities bear the full burden. The quantitative significance of such altru-

⁹⁷ Van Es (2010) reports that the decentralization has reduced the number of welfare recipients by about 8%, mainly due to a higher outflow.

⁹⁸ SCP (2010) documents that in 2008, municipalities spent 16 percent less on assistance in daily housekeeping activities than the budget received from the central government, while the total number of hours provided did not fall.

⁹⁹ See Boadway and Wildasin (1984) for a textbook treatment.

istic preferences is difficult to measure, but there appears to be a widely felt aversion towards intermunicipal variation in the level of social services – particularly in the healthcare domain.¹⁰⁰ Reducing this level thus imposes a cost on society that is not internalised by individual municipalities. A flip-side to this argument is that proximity to the needy may actually raise the demand for redistribution.¹⁰¹ It is more difficult to ignore suffering when it occurs at your doorstep. This suggests that the risk of underprovision may vary according to the proximity of municipal inhabitants to the beneficiaries of the newly decentralised social services. For example, people may be more aware of how their municipality treats the elderly in need of long-term care, than of the treatment of youths in need of mental healthcare, simply because more people have needy elderly in their family or social network.¹⁰²

A third source of externalities that may induce local underprovision is the interaction of decentralised social services with services that are provided by other parties.¹⁰³ For example, when welfare provision was decentralised to municipalities in 2004, the central government remained financially responsible for the income support of disabled persons with no employment history. As it is not always easy to draw a line between the disabled and other welfare claimants, the two programmes are to some extent substitutes. Municipalities faced a strong financial incentive to divert claimants to the centrally financed income support programme, which increased considerably as a result.¹⁰⁴ Such externalities appear to be relevant for the present decentralisations as well, particularly in the domain of long-term care. The next section will explore this issue in more detail.

¹⁰⁰ Allers et al. (2013) report results from a questionnaire that indicate the widespread aversion towards differences in the level of social service provision across municipalities.

¹⁰¹ The notion of redistribution as a local public good originates from Pauly (1973).

¹⁰² A related argument is that the provision of these services may hold some insurance value, as people may need them in the future (Hoynes and Luttmer, 2011).

¹⁰³ See Marton and Wildasin (2007) for a formal analysis of this type of externality in the context of substitution between welfare and Medicaid in the US.

¹⁰⁴ Roelofs and Van Vuuren (2011) find that since the 2004 decentralization of welfare, at least one third of inflow into the disability insurance programme was diverted from social assistance.

The externalities discussed above do not have to lead to underprovision, if the central government can enforce a minimum level of service provision. Decentralised social services vary in the extent to which the government does or is able to do so. There are, for example, precise conditions for welfare eligibility, even if access to substitutes such as disability insurance is not always easy to delineate. For the newly decentralised long-term care services, objective measurement and enforcement of quality standards appear to be difficult.¹⁰⁵ Measurement and enforcement are likely to be even harder for specialised youth care. There are, therefore, limits to the extent to which the central government can mitigate risks of underprovision through monitoring and regulation in these domains. Moreover, regulation reduces the scope for municipalities to tailor provision to individual needs. Hence, municipalities are granted considerable leeway in determining eligibility – particularly in the domain of long-term care.

The impact of financial incentives also depends on the extent to which municipalities spend grants on the budget categories to which they relate. The stickiness to budget categories – even for grants of a lump-sum nature – is known in the literature as the flypaper effect. It mitigates the impact of incentives on cost-efficiency, while offering some safeguard against underprovision at the same time. For assistance in daily housekeeping activities, it appears that about half of a change in the grant that is unrelated to changes in needs is nonetheless spent on this service.¹⁰⁶

5.4. Interaction between different types of social services

The ever larger role of municipalities in the provision of social services may allow them to take advantage of economies of scope. Information sharing is probably an important source of such economies. For example, providers of assistance in daily housekeeping activities may signal

¹⁰⁵ CPB and SCP (2015) document the considerable regional variation in utilization of different types of long-term care, as well as a widespread discrepancy between formal assessments of individual needs and the actual utilization of care. This analysis applies mostly to care for which the central government was responsible and for which provision was supposed to be uniform across the country.

¹⁰⁶ See Kattenberg and Vermeulen (2015). This paper also finds an impact on the number of hours provided, whereas substitution between basic and advanced types of assistance appears to be an important channel of adjustment.

the need for other types of home care, or providers of job seeking assistance may signal mental problems. Sharing information will be easier if provision of the implied social services is the responsibility of one party, the municipality. This, in turn, will facilitate the match of services to individual needs. Economies of scope may also arise through sharing of other costs, for instance relating to administration or accommodation.

The transformation of social service provision that is now taking place appears indeed to be tailored to the exploitation of economies of scope. Many municipalities have set up neighbourhood teams that determine eligibility for social services and provide some of these services themselves. The teams are partly staffed by generalists – social workers with sufficient knowledge across all domains to make an overall assessment of the needs of a client. This approach is motivated by the fact that many households make use of multiple services at the same time. A generalist may be better able to coordinate these services. The assignment to specific neighbourhoods should reinforce the acquaintance of the social workers with local inhabitants and the local issues at play.

Another advantage of the increase in municipal responsibilities in the social domain is that it reinforces the incentive to invest in prevention. The overall need for social support may decrease if problems are diagnosed and addressed in an early stage. If the more involved types of support that are saved upon are a municipal responsibility, then their efforts in this respect are rewarded. The neighbourhood teams and the generalist approach are indeed set up with the explicit objective of facilitating prevention and early intervention.

Incentives are not as well aligned when different parties are responsible for related services. Municipalities have no financial incentive to invest in preventive policies that reduce expenditure of, for instance, health insurers or the central government. A further issue arises when substitutable services are provided by different parties, as this creates an incentive for diversion. The rise in uptake of disability insurance after the 2004 decentralisation of welfare provision, discussed in the previous section, illustrates the relevance of this mechanism. An important empirical question is therefore to what extent the newly decentralised services relate either to services for which municipalities are responsible already, or to services provided by other parties.

To what extent do the newly decentralised services interact with other municipal services, or with services for which other parties are responsible? CPB (2014) provides some insight into this question by exploring data on the use of a wide range of social services in the domains of care and income support at the individual level. The data refer to usage in 2011. Services may be classified into services that are now decentralised, services for which the municipality was already responsible and services provided by other parties. Of all users of services that are decentralised as of 2015, 58% would now use municipal services only. Of this group, 38% used services from multiple providers before. However, 42% of all users of the newly decentralised services also made use of social services that are provided by other parties. This suggests that the decentralisations may indeed foster the exploitation of economies of scope for certain groups, but also create risks of underinvestment and diversion for others.

Classifying the services into income support, care for which the municipalities are now responsible and care for which either the central government or health insurers are responsible provides some insight into the composition of these groups. Consider all users of care for which the municipalities are now responsible. Of this group, 24% also received income support from programmes for which the municipalities are now responsible. Economies of scope may therefore be realised for the group of people that combine income support with the use of nonmedical home care. Assistance in daily structure, for example, may help clients in getting fit for the labour market. Municipalities have an incentive to invest in this type of care, as it may ultimately reduce their expenses on welfare. For some people, social day care and sheltered work may be substitutable, so municipalities are in a better position to allocate them to the appropriate type of support now that they are responsible for both. Moreover, as municipalities are now responsible for both welfare and income support for people with limited ability to work, the risk of undesired substitution between social assistance and disability insurance is reduced. Hence, it seems that the decentralisations offers some significant opportunities for the exploitation of economies of scope when it comes to the interaction between care, income support and social welfare services.

With regard to the long-term care sector as a whole, however, incentives do not appear as well aligned. Of all users of care for which the municipi-

palties have become responsible, 42% also made use of care for which either the central government or health insurers are now responsible. For the group that combines municipal home care with home care provided by the health insurers, there may be underinvestment on behalf of municipalities, for instance in training in skills that reduce the need for nursing. Social day care may prevent mental problems that would require medical care. For the group that used municipal home care and institutional care within the same year, diversion is a relevant risk, as home and institutional care may be close substitutes. This is relevant, for instance, for elderly people suffering from dementia. Moreover, municipalities have little incentive to invest in care for people who are or may become eligible for institutional care. The risk of underinvestment also matters for the municipal support of informal care givers, who may play an important role in reducing the demand for care by other providers – including institutional care.

With regard to youth care, the decentralisation offers significant opportunities for the exploitation of economies of scope, as municipalities become responsible for all kinds of youth care and the sector was highly fragmented before. Interactions with other types of social services may also be considerable. Nevertheless, some potential issues remain. One is that at the family level, mental youth care may interact with mental care for adults and the latter is a responsibility of the health insurers. Healthcare insurers also bear financial responsibility for general practitioners and the provision of medicines. Finally, the payoff of effective treatment of childhood physical and mental health problems may last well into adult life and is unlikely to be fully internalised by individual municipalities.¹⁰⁷

5.5. Scale and collaboration between municipalities

One of the potential disadvantages of decentralisation is the loss of scale economies, as lower levels of government necessarily cater to smaller populations – in the Netherlands, the average number of inhabitants per municipality amounts to about 40 thousand. Our discussion in this section will focus on youth care, for which this issue seems par-

¹⁰⁷ Goodman et al. (2011) document the considerable long-term consequences of childhood physical and mental problems in several areas, including labour market performance and lifetime income. The effects of psychological health disorders during childhood appear to be far more important over a lifetime than physical health problems.

ticularly relevant. For most specialised forms of youth care, the average number of users per municipality does not exceed fifty and for some forms it is even considerably smaller. For example, the average number of users per municipality of the most specialised type of residential youth care equals four. In contrast, this average is about 150 for the most basic types of youth care and almost twice that number for the most common type of home care that recently has been decentralised. Developing policies and contracting providers for only a handful of youths is costly and making arrangements at a higher level of aggregation allows sharing these fixed costs over a larger number of users.

Economies of scale also prevail in the provision of specialised youth care. Hence, the number of providers in a region is typically small. For example, the average number of providers within a range of 25 kilometres from a municipality equals one for the most specialised type of residential youth care and it equals two or three for most other types of specialised care. This means that municipalities have little choice and providers have considerable bargaining power in the procurement process. Municipalities may increase their countervailing power and get a better deal by making arrangements at a higher level of aggregation.

The law of large numbers is another source of scale economies that seems particularly relevant for specialised youth care. There is a random element in the need for care that evens out when the population gets larger. For small municipalities, though, the demand for specialised types of care may be quite unpredictable and as specialised care tends to be costly, this involves considerable uncertainty about expenditure needs. Under the current financial arrangements, the financial risk is entirely borne by municipalities, but it may be reduced by risk sharing at a higher level of aggregation.

Against this background, it is no surprise that municipalities collaborate on the provision of specialised youth care. It turns out that about ninety percent of the entire budget for youth care will be spent by collaborations of municipalities. These collaborations carry out the procurement, and in some cases, also share financial risks. Procurement of the most specialised types of care is even coordinated at the national level.

Although intermunicipal collaboration in the provision of youth care facilitates the exploitation of scale economies, it comes at the expense of reduced accountability.¹⁰⁸ In contrast to municipal governments, these collaborations are not directly accountable to an electorate. Furthermore, the influence of individual municipalities is diluted in these large collaborations, which for youth care consist of about ten municipalities on average. Reduced accountability may lead to a lower quality of care or higher costs. The ability to tailor policies to local circumstances and exploit economies of scope within the youth care sector and the wider social domain is also diminished.

5.6. Conclusions and policy

The ever larger role of municipalities in the social domain may create economies of scope and the grant system incentivises to fully exploit them. The decentralisations may thus enhance the efficiency of social service provision. Nevertheless, there are several externalities that may induce municipalities to underprovide these services and some important scale economies may be lost – or recouped at the expense of reduced accountability.

These opportunities and risks play out differently in the three domains in which responsibilities were decentralised. Prior to the decentralisations, the youth care sector was particularly fragmented, so it stands to gain most from the exploitation of economies of scope, although the efficient scale of provision of specialised youth care – the largest part of the budget – exceeds the size of most municipalities. Underprovision is also a concern, as objective measurement and enforcement of a minimum service level are particularly difficult in this sector. The risk of underprovision of municipal home care is reinforced by the interaction with other segments of the long-term care sector, which may lead to costly diversion to institutional care. Interaction of home care with income support and social welfare services may generate economies of scope. Furthermore, decentralisation of disability insurance mitigates a diversion problem in the domain of income support.

¹⁰⁸ See Seabright (1996) for a formal analysis of the trade-off between the benefits of improved coordination at higher levels of aggregation and the costs in terms of reduced accountability.

What can be done to fully exploit these opportunities and mitigate the risks? In the first place, the funding of municipalities may be altered in various ways. Allocative efficiency and accountability in the local public sector may be enhanced by decentralizing revenues alongside expenditures.¹⁰⁹ The share of municipal expenditure that is funded with local taxes is particularly low in the Netherlands from an international perspective.¹¹⁰ A larger local tax base would also facilitate the absorption of shocks in social expenditures, which in turn would strengthen the local budget constraint. Soft budget constraints may be a particularly relevant issue for the decentralised provision of care, as the central government would incur a significant political cost by allowing local governments to fail in providing these services.¹¹¹

To the extent that the decentralised services remain funded through central government grants, it is not evident that an unconditional block grant provides the best incentives. The introduction of matching grants or other types of risk sharing provisions would mitigate the concern of underprovision.¹¹² Specialised youth care is perhaps the most obvious

¹⁰⁹ See for instance Rodden (2003) or Oates (2005) for a general discussion of the merits of funding local spending by local taxes and Asatryan et al. (2015) for recent empirical evidence from OECD countries. Using micro-simulations for the Netherlands, Van Eijkel and Vermeulen (2015) find that distributional effects of a shift from the national earned income tax to either a tax on the use of residential real estate or a head tax may be reduced considerably by design of the reform.

¹¹⁰ In 2010, this share averaged 37 percent in all OECD countries, but it did not exceed 10 percent in the Netherlands (OECD / KIPF, 2012).

¹¹¹ In a sample of OECD countries, Crivelli et al. (2010) find that soft budget constraints, as measured by reliance on central government funding and borrowing autonomy, increase decentralized healthcare spending. Nevertheless, in spite of generous provisions, municipal bailouts have been comparably rare in the Netherlands in recent decades (Allers, 2015).

¹¹² Wildasin (1991) shows that subnational governments may be incentivized to provide optimal redistribution through a system of matching grants. Moreover, as Smart and Bird (2009) point out, a grant that shares in actual costs may provide a second best way of targeting funds to where need is highest when cost drivers or need factors are difficult for the granting authority to measure accurately – which is typically the case when tasks are newly decentralized.

candidate, as both the risk of underprovision and the demand for insurance appear to be particularly relevant for this sector.¹¹³ Moreover, voluntary risk sharing in collaborations may be insufficient because of an adverse selection problem: municipalities with the least favourable risk profile have the largest incentive to insure.

The risk of underprovision may also be addressed by conditioning grants on output measures. The inflow into institutional care may well be the most promising example. Rewarding a low inflow relative to a benchmark based on demographic and socioeconomic characteristics incentivises municipalities to invest in preventive home care and it reduces the risk of diversion.

Grant design is not the only way to mitigate the risk of underprovision. The misalignment of incentives that arises through interaction with social services provided by the central government or other parties may alternatively be addressed by also shifting these services to the municipal level. The decentralisation of income support and social welfare services for less than fully disabled persons who have no employment history provides an important example in this respect. Nevertheless, an allocation of tasks that removes all interactions between centrally and locally provided social services is unlikely to exist, as long as both layers of government remain involved.

The central government will also address the risk of underprovision by monitoring the quality of local social services in several ways. The collection of reliable and consistent information on local service provision and outcomes is important in this respect. Such information also allows for benchmarking, which facilitates voters in the evaluation of their local government and enables municipalities to learn from best practices. Ultimately, innovation may well be one of the main fruits of decentralisation, but reaping it requires thorough investments in the collection, analysis and exchange of information.

¹¹³ For instance, when specialized youth care was decentralized in Denmark in 2007, an insurance fund was set up to compensate municipalities for excessive costs. In 2015, this fund covers 25 percent of expenses in excess of about 100.000 euros per client and 50 percent for expenses in excess of about 200.000 euros per client.

Finally, the scale economies involved in some of the new tasks raises the issue of efficient municipal size. Municipal amalgamation has been a persistent trend in Dutch history that is unlikely to stop in the near future. However, the trade-off with accountability also arises in this context – witness for instance the negative relationship between municipal size and turnout at local elections.¹¹⁴ Furthermore, it is not obvious that the central government should play a proactive role in this respect.¹¹⁵

¹¹⁴ Gerritsen and Ter Weel (2014) find that turnout in local elections falls by 2.5 percentage points after a municipal amalgamation. For municipalities in which the population size more than doubles, the effect is particularly strong and it lasts for several elections.

¹¹⁵ As the number of municipalities involved in an amalgamation is usually small, transaction costs may be sufficiently limited for Coasian bargaining to achieve an efficient outcome.

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Chapter 6

Decentralised Redistribution - Evidence from Japan

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Abstract

Japan's local governments are not only responsible for a larger share of public expenditure, but are also heavily involved in income redistribution by providing social benefits in kind and quasi-private goods. We investigate the possibility that the decision of Japan's local governments regarding benefit levels of child care and elderly care depend on the benefit level in neighbouring municipalities. Concerning the basic interaction function, we regress the output of child care and elderly care on spatial lag, the municipality's fiscal position, demographic composition, socio-economic characteristic as well as political factors.

Concerning the levels of child and elderly care, there is a statistically significant positive effect of neighbouring municipalities within the identical prefecture. However, it is not strongly affected by fiscal, demographic and political factors. These facts suggest that the decision of prefectures about the benefit levels of child care and elderly care depend upon the benefit level in neighbouring municipalities.

6.1. Introduction

A large body of literature by Musgrave (1959) suggests that it is difficult for sub-national governments to carry out redistribution in a world of mobile resources. In a federal system, lower-level provision of merit

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goods such as health and education, while desirable for efficiency, preference matching, and accountability, can create difficulty in attaining equity objectives in the presence of horizontal competition. Factor mobility and tax competition create strong incentives for state and local governments to underprovide such service and to restrict access to potential welfare recipients, such as the poor and old (Boadway and Shah(2009)).

Empirical research, however, does not agree about the existence of welfare competition. In the domain of welfare policy, countries have typically decentralised responsibilities to states and municipalities, to take advantage of local administration and knowledge. As OECD and KIPF (2011) points out, sub-national governments have spending responsibilities in crucial areas, such as education, health and social protection. In contrast to the widely held belief about the long-term consequences of tax competition, OECD (2013) points out sub-national tax rates have trended up rather than down and generally converged over time, regardless of tax type.

The Tiebout model is a major analytical framework for welfare competition, which argues that resource flows between jurisdictions obviate the need for political competition. There has however been much debate about the extent to which resource flows alone will work. Besley and Case (1995) suggest that resource flows can only be a long-run solution to differences in the policies of subnational governments. They build a model of such competition, where voters choose whether or not to reelect officials based on their performance while in office, using neighbouring jurisdictions to evaluate the performance of their incumbents. Salmon (1978) discusses the argument for decentralisation based on such yardstick competition, and Besley and Case (1995) offer empirical evidence that it matters for tax policy.

The present paper provides empirical evidence using Japan's municipal data in 2008. It analyses the extent to which the decision of municipalities about benefit levels of child care and elderly care depend upon the benefit level in neighbouring municipalities. The remainder of the present paper is structured as follows. Section 2 outlines the institutional relations across levels of governments. Section 3 reviews previous literature on Japan's welfare services from an efficiency and equity point of

view. Section 4 presents a simple empirical model. Section 5 presents the results. Section 6 contains some concluding remarks.

6.2. Institutional arrangements across levels of government

6.2.1 Assignment by type of expenditure

Japan's local governments undertake a wide variety of types of expenditures, spending almost 60 percent of total net public spending, but pure local public goods represent a relatively small component of total expenditure. Public goods account for 5.5 percent of GDP. The bulk of local expenditures are not public goods in the traditional sense, originally characterised by Samuelson (1954).

Instead, they fit into one of the following categories. A significant portion of local public expenditures on goods and services are not for public goods but for quasi-private goods, what Boadway and Shah (2009) refer to as public services. Large scale expenditure programmes involving education, health care and social services are of this sort. In Japan, the expenditure of local public service amounts to 3 percent of GDP. The public sector assumes responsibility for providing public service largely for redistribution reasons, rather than an efficiency type market failure argument. The case for decentralisation rests on the argument that sub-national governments are able to identify the special needs and to monitor the behaviour of recipients more efficiently.

Besides public service, the government is heavily involved in the provision of social insurance against unexpected adversities that are not insured by the private sectors. In Japan, municipalities have been providing universal health insurance for self-employed individuals and retirees since 1930s as well as long-term care insurance since 2001. These two kinds of social insurances account for 5.5 percent of GDP.

Finally, transfers to individuals are components of the overall redistributive policy, which can take many different forms. For sub-national levels of government, transfers that are targeted to individuals according to their particular circumstances and needs are of this sort. In Japan the Public Livelihood Assistance plays a significant role in providing transfer to needy families since 1950. Annual expenditure of the Public Livelihood Assistance amounts to 2.1 per cent of GDP. Targeted trans-

fer is a strong candidate for decentralisation since these transfers rely for their delivery on a local agency whose role is to identify the needy and monitor them for continued eligibility.

The upshot is that decentralised redistribution in a broad sense adds up to 10.6 per cent of GDP (Mochida (2012)). As pointed out by Hayashi (2008), Japan's local governments are not only responsible for a larger share of public expenditure, but also heavily involved in income redistribution by providing social benefits in kind and quasi-private goods. It contrasts sharply with the fact that the national government redistributes income by providing cash benefits to individuals.

6.2.2 Means of harmonisation

The second issue concerns the means of harmonisation. To the extent that the national government is responsible for redistributive equity, the manner in which public services and targeted transfers are provided is of interest to it, even if their provision is decentralised. In most nations with multiple levels of government, some mechanisms are in place by which national governments can influence how lower-level governments design their programmes. A common procedure used is to impose conditions on transfers from the national government. These conditions will require that certain features be built into programme design in order to be eligible for the full amount of the transfer.

The key issue here concerns how detailed or specific the conditions are. In Japan, the law allows the central government to influence local governments' spending decisions through delegated functions financed by earmarked grants. These grants are not only earmarked to specific areas (e.g. public works, education or social welfare) but they are made conditional on local governments complying with strict and detailed operational standards (Mochida (2009)).

For most welfare benefits provided by local governments, eligibility criteria and benefit levels are set by the Ministry of Health, Labour and Welfare. The Livelihood Protection Law forbids local governments to set benefit levels above the standard level. The education system was legislated after the Second World War with strict standards for school curricula, textbooks and teacher qualifications (OECD (2005)).

Under the ideology of small government, however, deregulation and cuts in grants were urged and carried out until the present since the 1990s. For one thing, the programme providing free medical care for the elderly was changed, and small charges are now imposed. At the same time, however, the national government ministries made every possible effort to substantially maintain existing levels of activities and tried to decentralise (Muramatsu, Iqbal and Kume (2001)). In particular, the Ministry of Health and Welfare began systematic mobilisation of the localities and health workers.

Welfare was the focus of the discussion on decentralisation, which was triggered by the Second Provisional Administrative Reform Commission. Four types of decentralisation were discussed: a) a relaxing of the agency delegated system, b) the transfer of authority, c) expanded use of the so-called corporate delegation formula, and d) a reduction of the national government's burden of grants-in-aid. On the whole, the local governments expanded their authority, albeit conditionally, over welfare policy (Muramatsu, Iqbal and Kume (2001)). In particular, they assumed a great proportion of the financing of welfare. As to elderly care, in 1980 the national government bore approximately 60 per cent of welfare expenditures, but now its share had decreased to around 30 per cent. Similarly, the responsibility of the national and local governments concerning the financing of welfare programmes for children showed a reverse pattern since 1986.

In this way, decentralisation progressed through the transfer of authority regarding welfare policy to local governments. It does not mean, however, that the local governments used their increased policy prerogatives entirely as they wished (Muramatsu, Iqbal and Kume (2001)). It is a matter of empirical analysis.

6.2.3 Income redistribution

Local expenditures on welfare are distributed on a slightly progressive base. Although the benefits of public services are not readily measurable, the beneficiaries of these two expenditures are relatively clear. Gathering information from the Annual Report of Family Income and Expenditure, Boadway, Hobson and Mochida (2001) examined the incidence of two major sets of public expenditures on private goods: education and social welfare. They allocated aggregate expenditure on educa-

tion into each decile according to the number of the different kinds of pupil. For social welfare, aggregate expenditure should be assigned by a proxy measure that reasonably reflects the number of specific beneficiaries.

In the usual benchmark case, certain expenditures by their very nature are assumed to provide roughly equal per capita benefits, which are spread uniformly across the population. Education and health are usually thought of in this way. The real world seems to be somewhat different from this assumption. The benefits of primary, lower secondary and high schools are modestly progressive, while expenditures on kindergartens and universities are roughly proportional. On balance, the benefits of education are de facto slightly progressive in Japan.

Other expenditures, like the social welfare responsibility of local governments, are likely to be more progressive, in the sense that their benefits accrue relatively more to low-income groups. This supposition is verified almost completely by the estimation. As the study demonstrates, welfare benefits for households are sharply progressive; welfare for the aged is progressive, while child welfare is roughly proportional to income. All these things make it clear that the benefit of publicly provided private goods in Japan should be viewed as slightly progressive relative to the benchmark case.

6.3. Previous empirical literatures in Japan

6.3.1 Welfare migration or Yardstick competition

One of the concerns for decentralised redistribution is that the associated welfare competition may threaten the implemented welfare policy. Much of the previous research on interregional migration in Japan has focused on the labour migration of young people. However, little attention has been paid to migration among the elderly because most elderly people in Japan live with their family, and the families act as the primary caretakers of the elderly.

Using the econometric approach, Nakazawa (2007a) finds that the elderly who live alone and feel the need for long-term care may want to move to municipalities that have greater availability in long-term care facilities compared to other municipalities. The migration pattern of

females shows a tendency to concentrate in the big cities. The implications of the study are straightforward. If the elderly continue to migrate in hopes of receiving long-term care services in a given municipality and this migration has the effect of lowering the quality of this care, the long-term care insurance system in Japan is in danger of becoming a 'race to the bottom'.

Empirical research, however, differs regarding the existence of welfare competition. For instance, municipalities assume responsibility for providing maternal and child health in Japan. They subsidise the expense of prenatal care until the pregnant woman utilises it fifteen times. The amounts of subsidy for prenatal care, however, vary widely among municipalities. While the minimum standard set by the central government is roughly equal to 60 thousand Yen per pregnant woman, 7% of municipalities subsidise under the standard level. On the other hand, 22% of municipalities provide a subsidy over 100 thousand or without any limitation.

Bessyo and Miyamoto (2010) investigate how the subsidy amount for prenatal care per pregnant women relates to the decision of neighbouring municipalities, using spatial autoregressive model. The study finds that there is statistically significant positive effect of neighbouring municipalities within the identical prefecture. These facts suggest that the performance of neighbouring municipalities within an identical prefecture may give voters information to evaluate their own municipality. Concerning other control variables, fiscal revenue per capita has statistically significant positive effect on the size of subsidy. Because coefficients of other control variables are nearly equal to zero, the size of the subsidy for prenatal care is strongly affected by neighbouring municipalities and the fiscal strength of the said municipality.

6.3.2 Fiscal gap and horizontal equity

The amount of welfare services may be influenced not only by the performance of the neighbouring municipality but the fiscal strength of the said local governments. Kobayashi and Hayashi (2011) find that the more the fiscal position is healthy, the more it can spend school expense subsidies for needy families in Japan. The study investigated the impact of moving from specific grants to general grants on school expense subsidies for needy families. The law leaves the decision of eligibility crite-

ria and benefit levels of the school expense subsidies to the municipalities. Until FY2004, municipalities received specific grants, which specified detailed requirements for how they should be used.

However specific grants were replaced largely by general purpose grants in FY2005, and then school expense subsidies began to depend a great deal on each local government's fiscal position. Kobayashi and Hayashi (2011), utilising panel estimation, found that annual subsidies per new pupil and the recipient-eligible person ratio are greatly affected by the fiscal position of local government considered. The study also indicates that the process of aging leads to a reduction in school expense subsidies per new pupils, as pointed out by Poterba (1997).

One of the concerns with decentralised redistribution is horizontal equity. Local budgets tend to be redistributive and local residential taxes are proportional to income. This progressive nature leads to a call for full or more than full equalisation of the residence-tax capacity in Japan (Boadway, Hobson and Mochida 2001). However, despite layers of inter-governmental transfers, such standardisation is not realised in the National Health Insurance, Long Term Care Insurance, Public education and Public Assistance to the Poor, which impairs fair management of the Japanese system of redistribution.

6.3.3 Influence of political factors

Besides the variables mentioned above, there is some evidence showing that the welfare services are influenced by political factors, such as the partisanship of the council, governor's power base and his motivation for re-election. To simplify the logic, a social democrat governor has tendency to expand redistributive expenditure while a centre-right governor is inclined to increase expenditure for economic development. In Japan, the relationship between the local executive branch and the council can be characterised as the presidential system. Both governor/mayor and assembly members are directly elected by voters respectively. They are standing on equal footing. Actually, the governor/mayor gains an edge on the council.

Sunahara (2006) investigated how prefecture governments' policies are affected by political factors. Applying panel estimations, the study found that not only had the influence of the conservative camp on develop-

ment policy attenuated since 1990s, but so had the leftists on redistributive policy. Redistributive policy was not affected by leftist governors even before 1990s, contradicting the usual hypothesis. It should be interpreted with caution, but as the fiscal health of local government had deteriorated since 1990s, political partisanship could not play a leading role in expanding expenditure.

6.4. Empirical analysis

6.4.1 Spatial autocorrelation

In the past decade, welfare competition has been observed for some OECD member countries where sub-national levels of government enjoy at least some degree of expenditure autonomy. Most studies follow the frequently used approach of spatial econometrics. The welfare service in one SCG depends on the service levels of neighbouring SCGs and a set of SCG characteristics, such as income, demographic composition, etc. The basic interaction function is built as follows:

$$y_i = \lambda \sum_{j=1}^n w_{ij} y_j + \sum_{k=1}^n \mu_{ik} x_{ik} + \varepsilon_i$$

Where y_i denotes the levels of welfare service corresponding to SCG I, w_{ij} is nonstochastic weights, x_{ik} is the SCG characteristic, ε_i is the disturbance term, and λ is the spatial autoregressive coefficient. A positive and significant λ can be interpreted as welfare interaction, and its size reflects the strength of the interaction. It often proves convenient to write the model in matrix notation as

$$\mathbf{y} = \lambda \mathbf{W}\mathbf{y} + \mu\mathbf{x} + \varepsilon$$

Where $\mathbf{W}\mathbf{y}$ is spatial lag in \mathbf{y} and \mathbf{W} is the spatial-weighting matrix. Then $\mathbf{W}\mathbf{y}$ yields a spatially weighted average of the welfare benefits in the neighboring municipalities. Concerning \mathbf{W} , we use inverse-distance spatial-weighting matrices where the weights are inversely related to the distance between the units. Spatial-weighting matrices allow us to conveniently implement Tobler's first law of geography: "everything is related to everything else, but near things are more related than distant things."

Because random shocks that affect the levels of welfare service (\mathbf{y}) probably affect the spatial lag term ($\mathbf{W}\mathbf{y}$), we treat the spatial lag as endogenous. We believe that the correlation between the spatial lag and $\boldsymbol{\varepsilon}$ is not equal to zero. On the other hand, we have no reason to believe that the correlation between \mathbf{x} and $\boldsymbol{\varepsilon}$ is nonzero, so we assume that \mathbf{x} is exogenous. Because we are treating $\mathbf{W}\mathbf{y}$ as an endogenous regressor, we must have an additional variable that is correlated with $\mathbf{W}\mathbf{y}$, but uncorrelated with $\boldsymbol{\varepsilon}$. To handle this endogeneity, we use $\mathbf{W}\mathbf{x}$ as instruments, in line with Besley and Case (1995).

6.4.2 The output of welfare services

In order to estimate the interaction function mentioned above, we need to select a set of indicators that measure the levels of welfare services. Because the output data is more accurate than the input data, such as per capita expenditure, to capture the levels of welfare service, we use the output data as a basic indicator. The present paper depends on the Comparative Survey of Public Administration in Municipalities (afterward, CSPA index) as basic indicators¹¹⁷. The CSPA index was built from answers to a questionnaire distributed all municipalities in 1998, 2000, 2002, 2004, 2006 and 2008. The individual response to the questionnaires is aggregated into “low-level” indicators that capture different outputs of local public services. For child care, these indicators include capacity of nursery school, number of waiting list, child care fee, length of opening hours, care for sick child, medical care subsidies for baby etc. All low-level indicators are transformed into a standard score using following formula.

$$Z_i = \frac{10(x_i - \mu_x)}{\sigma_x} + 50$$

Where Z_i is the standard score of service i , x_i is the low-level of indicator, μ_x is the mean of the indicator and σ_x is the standard deviation. Finally, there is a composite indicator of the public services. Constructing a composite indicator involves assessing the relative importance of each low-level indicator. It is difficult to assess relative importance, as is well

¹¹⁷ The Comparative Survey of Public Administration in Municipalities is provided by Nikkei Inc. (2009).

known, but the CSPA index uses predetermined weights¹¹⁸, which sum to one and are multiplied with the low-level indicators as follows.

$$y_i = \sum_{i=1}^n z_i v_i$$

Where v_i is the weight of the i th service and y_i is the overall composite index. These processes indicate that the CSPA index is the weighted average of the standard score of the individual output of public services. Because of the preliminary nature of the present paper, we focused on two kinds of welfare-related service, namely elderly care service and child care service delivered by the Kantō region in 2008. The Kantō region is a geographical area of Honshu, the largest island of Japan. The region includes the Greater Tokyo Area and encompasses seven prefectures: Gunma, Tochigi, Ibaraki, Saitama, Tokyo, Chiba and Kanagawa.

6.4.3 Potential determinants of the outputs

We estimate the basic interaction function regressing the output of child care and elderly care on spatial lag, the municipality's fiscal position, demographic composition, socio-economic characteristics as well as political factors.

Child care and elderly care may be influenced by the fiscal position of municipalities. *Fisc* stands for fiscal capacity index (defined as the ratio between standard fiscal capacity and standard fiscal needs). *Dtr* refers to the debt service ratio (defined as the ratio between debt service and general revenues). *Ger* denotes the general revenues per capita: general revenues include local tax, equalisation grants, tax sharing, etc.

The output of child and elderly care may be driven by a demographical composition. *Fem* is the labour participation rate of women. *Wln* denotes the waiting list of a nursery school. *Eld* is the share of elderly in the population. Socio-economic characteristics also play a significant role in determining the service levels. *Tbs* stands for tax base per capita. *Dpop* refers to daytime – night-time population ratio.

¹¹⁸ For child care, the weights of low level indicators are as follows. Capacity of nursery school (3/60), number on waiting list of the nursery school (5/60), child care fee (5/60), length of opening hours (8/60), care for sick child (3/60), care for school aged child (3/60), medical care subsidies for baby (10/60), safety measure (10/60), counter measure for falling birth rate (10/60).

Besides the mentioned variables, there is some evidence showing that both child care and elderly care are influenced by political factors. *Mut* denotes dummy for the mayor who stays in office over four consecutive terms. *Ldp* refers to dummy for the mayor who gets a referral from the conservative party in an election campaign. *Mix* stands for dummy for the mayor supported by a mix of political parties (Liberal Democratic Party and the Democratic Party of Japan) in election campaign¹¹⁹.

6.5. Estimated result

6.5.1 Moran’s I statistics

The standard measure of spatial dependence is the Moran’s *I* statistic. Negative values indicate a negative spatial autocorrelation and the inverse for positive values. Values range from -1 (indicating perfect dispersion) to $+1$ (perfect correlation). A zero value indicates a random spatial pattern. This measure is calculated and shown in table 1. The Moran test calculates a value of 0.06 and 0.027 for child care and elderly care, respectively, suggesting that we can reject the null hypothesis that there is zero spatial autocorrelation.

table 1 Test for spatial dependence

	child care	elderly care
Moran's I	0.06	0.027
Z score	6.86	3.4
P-values	0.00	0.00

Moran's I values can be transformed to Z-scores in which values greater than 1.96 or smaller than -1.96 indicate spatial autocorrelation that is significant at the 5% level.

6.5.2 Interaction effect

For the instruments to be valid they need to be correlated with W_j and uncorrelated with ϵ . We apply the Cragg and Donald minimum eigenvalue statistics as a test for the weak instruments problem. The test statistics exceed the critical value as shown in table 2 and table 3, so it

¹¹⁹ As for the political base of mayors, we used the database provided by The Japan Research Institute for Local Government (2008).

is safe to say that our instruments are not weak. In the test for the correlation between W_x and ε , on the other, we use the Sargan test. This test follows a χ^2 distribution with a degree of freedom equal to the number of over identifying instruments. For both child care and elderly care benefits, we cannot reject the null of instrument's exogeneity. These results confirm that estimation of a spatial lag model based on IV seems valid. In table 2 and table 3, we also report two OLS specifications as baseline for comparison.

We have demonstrated a significant interaction effect in both child care and elderly care provided by Japan's municipalities. The reaction curves are found to be upward sloping, meaning that higher benefits in neighbouring municipalities lead to higher benefits of the municipality considered. The quantitative effect of the IV estimation implies that an increase in the index of child care by 1 in neighbouring municipalities will raise the benefit levels in the municipality by 0.85. The OLS estimate indicates a somewhat smaller interaction effect. The spatial error correlation is negative under migration, and this negative effect may dominate in our estimation.

So far, the empirical literature on welfare competition usually offers evidence about the US states, UK local government and Swedish and Norwegian local governments (Fiva, J. H. and J. Rattsø (2006)). We know only two studies outside North America and Europe. Bessyo and Miyamoto (2010) investigate how the amount of subsidy for prenatal care per pregnant woman relates to the decision of neighbouring municipalities, applying the spatial autoregressive model to Japanese data. They find that the effect of statistically significant strategic interaction is of a magnitude of 0.85. Nakazawa (2007b) investigates how the levels of home help system in elderly care is affected by the decision of neighbouring towns and villages. The study identifies an interaction effect with a magnitude of 0.63 for towns and villages. Our study adds to the accumulated evidence that welfare competition matters.

Table 2
 dependent variable: the NIKKEI index of child care

	A OLS	B OLS	C IV
spatial lag(λ)		0.66***(0.16)	0.85***(0.17)
fisc	0.46(2.85)	0.82(2.72)	0.92(2.62)
dtr	-0.090(0.092)	-0.0022(0.089)	-0.0030(0.086)
ger	0.032**(0.013)	0.039***(0.012)	0.040***(0.012)
fem	-0.28**(0.13)	-0.24*(0.12)	-0.22 (0.12)
wln	0.0055(0.0041)	0.0045(0.0039)	0.0042(0.0038)
eld	-0.22*(0.12)	-0.29(0.12)	-0.31***(0.11)
tbs	1.86(2.02)	0.11(1.97)	-0.0037(0.0019)
dpop	0.029(0.037)	0.010(0.035)	0.0046(0.034)
mut	1.31(0.90)	0.79(0.86)	0.65(0.83)
ldp	0.40(1.32)	0.92(1.26)	1.068(1.22)
mix	0.21(0.75)	0.74(0.72)	0.89(0.70)
R ²	0.213	0.288	0.333
Wu hausman F statistic			5.76(0.017)
Cragg-Donald test			54.06
Sargan test			15.93(0.101)
obs	169	169	169

Standard error in parentheses. ***, **, * denotes significance at 1%, 5%, 10% level respectively. A constant term is included in all regression(not reported). Sargan test with 10 degree freedom, p -value in parentheses. Critical value for Cragg Donald test is 20.90.

Table 3

dependent variable: the NIKKEI index of elderly care

	A OLS	B OLS	C IV
spatial lag (λ)		0.55**(0.24)	1.085***(0.30)
fisc	-4.26(3.05)	-32.56(3.11)	-0.92(3.08)
dtr	-0.11(0.098)	-0.095(0.098)	-0.073(0.096)
ger	-0.010(0.014)	-0.010(0.014)	-0.010(0.013)
fem	0.16(0.13)	0.16(0.13)	0.15(0.13)
wln	0.0031(0.0044)	0.0041(0.0044)	0.0051(0.0043)
eld	0.20(0.13)	0.24*(0.13)	0.27**(0.13)
tbs	2.36(2.16)	2.10(2.14)	1.84(2.09)
dpop	0.13***(0.039)	0.12***(0.039)	0.11***(0.038)
mut	0.62(0.96)	0.48(0.95)	0.34(0.93)
ldp	0.094(1.41)	0.059(1.39)	0.024(1.36)
mix	0.96(0.80)	1.02(0.79)	1.07(0.77)
R ²	0.162	0.124	0.163
Wu hausman F statistic			7.88(0.0056)
Cragg-Donald test			22.15
Sargan test			15.80(0.105)
obs	169	169	169

Standard error in parentheses. ***, **, * denotes significance at 1%, 5%, 10% level respectively. A constant term is included in all regression (not reported). Sargan test with 10 degree freedom, p-value in parentheses. Critical value for Cragg Donald test is 20.90.

6.6 Other determinants of child and elderly care

Fiscal variables such as the fiscal capacity index (*fisc*), debt service ratio (*dtr*) and general revenue per capita (*ger*) are not valid for the estimation. Contrary to the expectation, the coefficients of these variables are not significant, except that of general revenue for child care. Elderly care is not affected by the fiscal variables at all. These results indicate that the gap between local expenditure and revenue is almost completely compensated by equalisation grants in Japan.

We also incorporate demographical factors by including female labour participation rate (*fem*), number on the waiting lists for nursery schools

(*wln*) and the share of the elderly (*eld*). We expect these variables capture the demand for child care and elderly care in the local jurisdictions. While the share of elderly has a positive and significant effect on elderly care, all other variables are not significant. It is puzzling that a higher female labour participation rate is associated with less child care services. Tax base per capita (*tbs*) and the daytime – night-time population ratio (*dpop*) has no effect on child care and elderly care (although it is positive and significant for the daytime – night-time population ratio for elderly care).

We incorporate political factors by including the political base of the mayor and dummy for being re-elected multiple times as a variable to capture ideological differences and political stability. We had expected that a nominee who got a referral from the conservative party (*ldp*) would expand the expenditure for economic development and discount the need for welfare services. In addition, political stability captured by *mut* and *mix* gives rise to corruption and soft budget problems. Our estimations do not support these expectations. The coefficients are not statistically significant at all. The result indicates both child care and elderly care are not affected by the political base of mayor but neighbouring municipalities, which is consistent with the findings of Sunahara (2006). It should be interpreted with caution, but as fiscal health of local government has been deteriorating since the 1990s, political partisanship could not play a leading role in expanding expenditure. In addition, the importance of ideological conflict had diminished since the end of cold war.

6.7. Concluding remarks

Japan's local governments are not only responsible for a larger share of public expenditure, but also heavily involved in income redistribution by providing social benefits in kind and quasi-private goods. Decentralisation progressed through the transfer of authority on welfare policy to local governments. It does not mean, however, that the local governments used their increased policy prerogatives entirely as they wished. It is a matter of empirical analysis.

We investigate the possibility that the decision of Japan's local governments about benefit levels of child care and elderly care depend on the benefit level in neighbouring municipalities. In order to estimate the interaction function mentioned above, we use a set of indicators that

measure the output of welfare services. The CSPA index is the weighted average of the standard score of the output of individual public services. Because of the preliminary nature of the present paper, we focused on two kinds of welfare-related service, namely elderly care service and child care service delivered by the Kantō region.

We have used the spatial econometrics methods to estimate the interaction effect among local governments. Concerning the basic interaction function, we regress the output of child care and elderly care on spatial lag, the municipality's fiscal position, demographic composition, socio-economic characteristics as well as political factors. Concerning levels of child and elderly care, there is a statistically significant positive effect of neighbouring municipalities within the identical prefecture. However, it is not strongly affected by fiscal, demographical and political factors. These facts suggest that the decision of prefectures about benefit levels of child care and elderly care depend upon the benefit level in neighbouring municipalities.

Moran's I test suggests that we can reject the null hypothesis that there is zero spatial autocorrelation. Because random shocks that affect the levels of welfare service probably affect the spatial lag term, we treat the spatial lag as endogenous. To handle this endogeneity, we use Wx as instruments in line with Besley and Case (1995). For the instruments to be valid, we apply both the Cragg and Donald test and the Sargan test. The test results indicate that estimation of a spatial lag model based on a IV approach seem valid.

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Chapter 7

(De-)centralised Social Transfers and Services in Germany: Between Central Regulation and efficient Local allocation

Gisela Färber and Marco Salm¹²⁰

Abstract

According to public finance theory, both the central and the local governments are responsible for the allocation of public goods, while redistribution is assigned to the central government only. However, the provision of social services includes intentionally allocative and redistributive aspects. The conflict arising from Musgrave's 'three functions theory' will be illustrated on the basis of three social tasks assigned to the local level in Germany. Beyond this, the article illustrates that the social services provided on a local level have a similar effect as a fiscal equalisation mechanism, which the tax-sharing system itself is not able to meet.

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7.1. Introduction

The Federal Republic of Germany is a welfare state. The economic downsides of a free market economy are balanced out by making use of welfare policy. The so-called social market economy is based on social insurance systems established in the 19th century¹²¹, turned into a comprehensive social welfare state after the founding of the Federal Republic of Germany. In 2014, social security constitutes the largest sector in terms of expenditures (553 bn EUR), followed by the central government (344 bn EUR), the states (342 bn EUR) and the municipal level (218 bn EUR).

Municipalities and counties play an important role in social policies in Germany in a double sense:

- » they administer federal and state policies according to federal and state laws (obligatory tasks);
- » they establish proper social policy programmes within their right of self-administration (voluntary tasks).

The costs of the latter must without any doubt be covered by proper local own-revenues. More and more conflicts have emerged during the last 20-30 years by increasing costs for the local execution/administration of federal and state laws, among them a considerable share of laws regulating social transfer payments.

Until 2006, the federal government could assign tasks directly to the municipalities, with the result of making extensive use with regard to

¹²¹ In the case of social securities (pension, health care, unemployment and work accidents), the roots go back to the 1870s initiated by Prussian Reich Chancellor Otto von Bismarck. Since then, there exists a network of transfer payments and cost coverings with nationwide standardised rules covering the most important risks of poverty of individuals and families. They are constructed as social insurances for citizens who are in need of social protection; these are mainly employees, until a certain income level, and their families. Social insurances are financed by – mostly symmetrical – contributions of employees and employers. Particularly the pension scheme and the specific transfer payments and services for unemployed are covered by transfer payments from the federal budget.

public welfare. With the reform of federalism (2006)¹²², the federal government is no longer authorised to transfer any functions directly to the municipal level (Art. 84 (1) BL)¹²³. However, the pre-assigned welfare functions (before 2006) on a municipal level remained in force. And these functions are featured by a very dynamic development: the social expenditures increased in the period 2003-2012 from 49.2 to 73.4 bn EUR. The increasing share of social expenditures is not covered by transfer payments from the federation and the states, but has to be financed from the local government's own revenues.

The social expenditures of municipalities and counties (and of minor importance of villages and smaller cities) diverge severely among the states and across the municipalities. The decisive factors in this regard are uneven socioeconomic and demographic change. Both have a direct impact on local governmental expenditures due to determinants such as unemployment rate, age structure of the residents and urbanisation. The social structure of municipalities determines the fiscal capacity, on the one hand, and the amount of social benefits to be paid on the other hand. Therefore, it is empirically proven that social structure and budgetary crisis of municipalities go hand in hand: Municipalities have to cope with very high social expenditures in less favoured regions characterised by poor economic structure and low tax revenues. These municipalities are trapped in a 'vicious circle' of budget problems, resulting in a dwindling financial room to manoeuvre and a decaying infrastructure. On the other hand, municipalities in fast-growing regions with a favourable labour market situation and high levels of income face expenditures on social welfare and for basic security well below the average.

The objective of this paper is, firstly, to give an overview on social expenditures of the three levels of government and social securities. They have significant redistributive implications from a political and financially perspective. Secondly, the very complex multilevel mechanisms of financing decentralised transfer payments and services is illustrated by referring to public finance theory and German practice of assigning

¹²² The most comprehensive reform of the Basic Constitutional Law was put into practice in 2006, aiming at clearer legislative powers among the federal and states governments.

¹²³ "Federal laws may not entrust municipalities and associations of municipalities with any tasks."

competences across the levels of government. Thirdly, selected ‘basic types’ of redistributive policies will be illustrated by referring to three obligatory social tasks assigned to the local level, and at the same time, problems of insufficient cost covering and (partially) missing incentives for efficient and effective allocation are discussed. Fourthly, the interregional equalisation effects of social securities and the tax sharing fiscal equalisation scheme are discussed. They constitute a stable framework for uniform decentralised social policies. Finally, we describe some possible ways to establish better and more accountable rules of cost covering for centrally regulated and decentralised administered social services and transfer payments.

7.2. Basic Principles of the Assignment of Competencies

7.2.1. Theoretical Background

Musgrave (1939, 1959), as the pioneer of public finance theory, categorised governmental economic activities into three branches, which still constitute the main principles for assigning competencies to this day.¹²⁴ Referring to the standard Musgrave model of the public sector, the responsibility for stabilisation, distribution, and allocation should be assigned to different levels of government – Central, State and Local. Within this system, economic stabilisation and income distribution should generally be assigned to the central government and the allocation of public goods – depending on the benefit incidence – to the central government or the local governments. In line with this public finance rationale, all public services should be provided – no matter what level is responsible – by the respective level of government that internalises costs and benefits.¹²⁵ The related decentralisation theorem presumes that there is no perfect information given (due to free riding) and, therefore, the central government provides a uniform provision of public services across all jurisdictions.

The presumption of Musgrave and Samuelson is that there is no “market-type” solution to determine the level of expenditures on public

¹²⁴ Musgrave, R. (1939): Voluntary Exchange Theory of Public Economy. The Quarterly Journal of Economics, Cambridge, Mass., 213-237 and; Musgrave, R. 1959. The Theory of Public Finance: A Study in Public Economy, MacGraw-Hill, New York.

¹²⁵ Oates, Wallace E. 1972. Fiscal Federalism. NY: Harcourt Brace Jovanovich, 55.

goods¹²⁶ because there is no conditional link between expenditures and taxes. However, Musgraves' student, Charles Tiebout (1956), (theoretically) solved the problem. The efficient way to provide public services is feasible on a local level: People "shop" around municipalities choosing the "menu" offered of alternative bundles of costs (local taxes) and benefits (local public services).¹²⁷ The result would be homogenous Tiebout-like groups of residents within each municipality, which is – of course – difficult to achieve. To preserve homogeneity within the municipality, some kind of exclusion, e.g. as suggested by Buchanan (1965), might be necessary in order to prevent – for instance – that the "poor chase the rich" (Buchanan and Goetz, 1972). As this is difficult to achieve, the assignment of competencies becomes more and more complex by properly considering (positive/negative) externalities or spill-overs.

It might become even more complex, if we further consider the political decision-making process where politicians might not always go along with public finance rational at all times. All these concepts have in common that full costs or benefits are not reflected appropriately. As a result, one might conclude that the efficient allocation of public goods is not an easy task, because Musgraves' functions are in conflict: in this case, the central redistribution (uniform provision) and the efficient local allocation function (individual provision). Therefore, the demarcation of functions along the levels of government involves considerable overlapping and inter-governmental coordination.

In order to solve these problems, the central and local allocation of services goes along with a variety of financing instruments that reflect the degree of congruence among the decision-maker, user and payer of public goods provision. While centrally financed public goods and services are financed by large taxes in order to balance the externalities across municipal borders (central government as tax-collector for lower level governments within a revenue sharing system), the allocation of public

¹²⁶ Musgrave articulated the free-riding problem in his 1939 article "The Voluntary Exchange Theory of Public Economy" and emphasised later, in "The Theory of Public Finances" that public and private goods provision differs in the free-riding problem; see Samuelson, Paul A. 1954. *The Pure Theory of Public Expenditures*. *Rev. Econ. Stat.* 36, 387-389.

¹²⁷ Tiebout, Charles M. 1956. *A Pure Theory of Local Expenditures*. *Polit. Econ.*, 64, 416-424.

goods at the local governmental level is mostly financed by user charges, fees and local taxes.

7.2.2. Assignment of Competences in Germany

The German federalism is a very specific one. It is often referred to as unitary federalism, because competencies of the Länder were dismantled in favour of the Federation after the war.¹²⁸ It features a federalist design, from a fiscal and legal perspective. Therefore, it is not only following fiscal federalism, but also a legal perspective as the Federation (Bund) and the States (Länder) constitute independent levels of government. Each – Bund and Länder – withhold “full quality of state”, which means that they possess legislative, executive/administrative and judiciary powers.¹²⁹ German federalism is insofar a special type of federalism often called ‘executive’ or ‘administrative’ federalism as the majority of legislation is centralised at the level of the Federation and the execution/administration of federal laws is decentralised at the level of the Länder.¹³⁰

The Länder have the right of legislation in certain areas, like police, schools, universities and environmental affairs. Their executive responsibility for implementing federal law and their own legislation are administered by various state agencies or are delegated to the counties or county-free cities (Figure 2). Counties are special associations of municipalities consisting of very small cities and villages that cannot guarantee a ‘professional’ self-administration in all aspects, because of their small size. The States have the right to decide about the structure and organisation of state agencies and about the size and structure of local governments. Therefore, the execution of federal laws strongly varies across Germany. The law of the upper tiers, however, determines the

¹²⁸ By doing so, standardisation of regulations was achieved across the territory; see Hesse, K. 1962. *Der unitarische Bundesstaat*, Karlsruhe.

¹²⁹ Schubert, K. and M. Klein. 2011. *Das Politiklexikon*. 5., aktual. Aufl. Bonn: Dietz.

¹³⁰ Laufer, H.; Münch, U. 2010. *Das föderative System der Bundesrepublik Deutschland*, München.

administrative decisions of the lower tiers; this guarantees a uniform execution.¹³¹

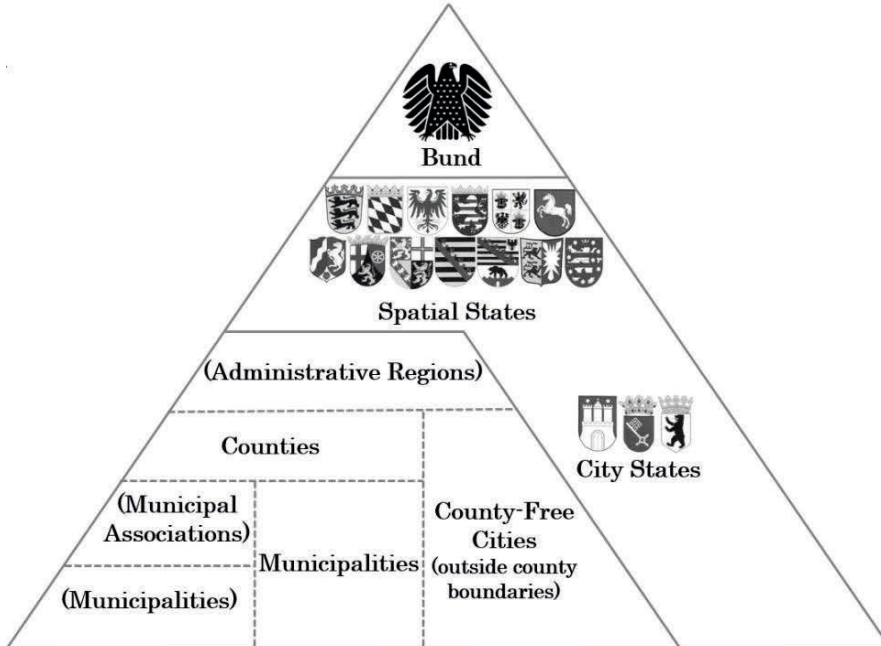
The Federation in Germany has solely a weak administrative capacity. Federal administration consists of the Ministries of Federal Government and a certain number of federal agencies administering affairs of a supra-regional importance (e.g. surveillance of the banking sector and insurances, international migration and refugees, environmental affairs)¹³². Federal administrations with regional and local agencies only exist for the social insurances (public pension scheme, social health insurance, social long-term care insurance, unemployment insurance and social accident insurance). They are organised under a regime of self-administration of the social partners (trade unions and employers' unions) and do not follow the direct intervention of the Federal Government; the responsible Ministries only cover the legal audit.¹³³

¹³¹ Unfortunately, there is very little knowledge about the real uniformity or the variety of execution of federal laws (see Zeitz, D. 2013. *Bewertung der Einfacher-zu-Projekte unter dem Blickwinkel eines Vollzugsbenchmarking*; FöV Discussion Papers No. 76, Speyer).

¹³² Grimmer, K. 2004. *Öffentliche Verwaltung in Deutschland*, Heidelberg.

¹³³ Thieme, W. 1995. *Einführung in die Verwaltungslehre*. Köln, Berlin, Bonn, München, § 10.

Figure 1: Levels of government in Germany



Source: Authors based on Bundeszentrale für politische Bildung.

In the field of social policies, the Federation regulates the services and transfers of the social insurances, social policies concerning all cases of subsistence level incomes, the issues of child and youth welfare and the assistance for disabled persons. The latter are a result of traditional local tasks, which were regulated uniformly all over Germany by the Federation in 1952 (Bundessozialhilfegesetz). Other generous transfer payments like housing subsidies (Wohngeld) and student loans, which formerly were assigned to the state level, were centralised in the 1950s and 1960s when the federal budget generated large surpluses and when federal government offered 50% cost sharing and more against the right of central regulation (Färber, 2012). Today the Federation has started to take over increasing shares of overall assistance for housing and heating, according to SGB XII (since 2014), and the needs-based pension supplement for old age (45% in 2012, 75% in 2013, total expenditures from 2014 onwards).

The Länder have only minor socio-political responsibilities, as many of their responsibilities in this field fall under concurrent legislation. Overall, they are responsible for certain areas of public health and care.

The local government level is responsible for the basic access to public services including social services. Among the compulsory tasks assigned to the local level by superior legislation are social benefits such as basic income for unemployed under Book II of the Social Code (SGB II), child and youth welfare (Book VIII of the Social Code, SGB VIII), and social welfare (Book XII of the Social Code, SGB XII).

A few tasks are governed under joint – Bund and Länder – responsibility (Art. 91 a-d GG): regional economic promotion, agricultural structure and coast guard, e-government, and ‘performance comparison’ (benchmarking). Here high federal and state civil servants decide about the programmes and particularly the distribution of the considerable financial means under specific rules of vote. The Federation and the States hold half of the number of seats in the Bundesrat (16+16); decisions need a three-quarter majority of the total number of votes.

Municipalities constitute the lowest level of administration; the constitution handles them as part of the Länder, however, it protects them through Art. 28 GG, which guarantees the local right of self-administration and financial autonomy. Local governments and associations of communities (e.g. counties, associations of municipalities) execute the laws of the upper tiers on the one hand, and decide about all affairs of local importance on the other hand. Municipalities within counties can centralise tasks of supra-local importance and containing considerable inter-local spill-over to the county level.

The budgets of all jurisdictions are independent of each other. Although many States and particularly local governments depend on considerable transfer payments from the upper tier governments to finance their expenditures, they set up their proper budgets and pass them to their Parliaments and Local Councils for legislative approval.

One of the most important problems of German fiscal federalism is the rule that the duty for cost covering for a certain public task follows the right of execution, not the right of legislation. This means that the upper tier establishing new or additional regulations does not cover the

costs of its administration. Only certain laws regulating specific social transfers contain rules that the transfer payments are shared 50:50 (e.g. housing subsidies) or 65:35 (e.g. student allowances) between the federal tier and the states. Respective problems of cost covering by the decentralised levels can also be found in the field of European legislation.

The Länder have in principle the same right to decentralise further the administration of federal laws to their counties and municipalities. Since 2006, all state constitutions have embedded the so-called principle of connectivity, i.e. the Länder must cover the costs if they decentralise additional administrative tasks to their communities¹³⁴. The regulations vary from state to state with regard to the process of measuring the costs of administration. Municipalities have won several legal proceedings before State Constitutional Courts with regard to cost covering for decentralised tasks; many more are expected in the future.

7.3. Local Social Services and Transfer Payments: Selected Examples

The complexity of the assignment of functions and finances will be illustrated in the context of SGB II, SGB VIII and SGB XII according to Figure 6.

The responsible bodies for social services are – primarily – the county-free cities (*kreisfreie Städte*) and the counties (*Landkreise*). Municipalities within county boundaries are responsible for the day-care centres and local child day care. Big differences of the assignment of the respective competences have to be considered among the spatial states due to the regional divergences of settlement structures as well as the territorial structure of local communities.

¹³⁴ Mückl, S. 2006. Konnexitätsprinzip in der Verfassungsordnung von Bund und Ländern, in Henneke/Pünder/Waldhoff (ed.), *Recht der Kommunal Finanzen*, München, p. 33 ff.

Figure 2: Social welfare (compulsory tasks) at municipal level

Basic Security Benefits for Job-Seekers (SGB II)	Child & Youth Welfare (SGB VIII)	Social Assistance (SGB XII)	Asylum (AsylbLG)
<i>Assistance for housing and heating</i>	Youth-/Social Work	Assistance towards living expenses	
	Family Support	<i>Needs-based pension supplement in old age and in the event of reduced earning capacity</i>	
	<i>Pre-Primary & Primary Education</i>	Assistance towards healthcare	
	Help in Education	Integration assistance for disabled persons	
		Assistance towards nursing care	
		Assistance in other circumstances	

Source: BMAS 2015, own compilation.

The three examples – (1) assistance for housing and heating (SGB II), (2) pre-primary and primary education (SGB VIII) and (3) needs-based pension supplement in old age and in the event of reduced earning capacity (SGB XII) will be analysed regarding the vertical rules of cost covering and the horizontal divergences among the states. Comparative local data are only available amalgamated at the state level.

7.3.1. Basic Security Benefits for Job-Seekers (SGB II): Assistance for housing and heating

“Basic security benefits for job-seekers (Grundsicherung für Arbeit-suchende) under Book II of the Social Code (SGB II) is a tax-funded system designed to provide people who are capable of earning with full and rapid help and support to help themselves (BMAS, 2015, 33).”

The basic security system enables beneficiaries to live a life that covers a minimum subsistence level in Germany. It was introduced in 2005 by merging unemployment assistance for long-term unemployed (formerly paid by the federal government) and social assistance (formerly paid by

the municipalities) in the so-called ‘Hartz IV reform’. The overall cost of SGB II is split among the federal government and the municipalities.

The standard rate (e.g. a single adult person receives 399 EUR in 2015) to cover living expenses is generally paid by the federal government (Federal Ministry of Labour and Social Affairs) and counties and county-free cities are generally responsible for providing appropriate levels of assistance with regard to housing and heating.¹³⁵ Both services are provided by the local Job Centres, where the local employment agency and the municipality work together. In order to provide all services concerned under one administration, 105 counties and county-free cities have opted to cover the responsibilities involved.¹³⁶

Table 5: Share Rate – Assistance for Housing and Heating (SGB II)

	2006	2007	2008	2009	2010	2011	2012	2013	2014
	Bn EUR								
Municipal	13.8	13.6	13.3	13.6	13.7	13.6	13.5	13.8	14.1
Federal	4.0	4.3	3.9	3.5	3.2	4.9	4.8	4.7*	3.9*
	in % of total costs								
Municipal	77.5	76.0	77.3	79.5	81.1	73.5	73.8	74.6	78.3
Federal	22.5	24.0	22.7	20.5	18.9	26.5	26.2	25.4	21.7
									¹³⁷

* Target.

Source: Bundeshaushaltsplan 2014, Einzelplan 11; Statistisches Bundesamt, 2012, Soziale Mindestsicherung; Schröder, 2015, Personen & Zahlungsansprüche (SGB II), BIAJ.

In this context, the municipalities are responsible for paying the reasonable rent and the heating costs for actual expenses incurred accord-

¹³⁵ The standard rate applies to basic security benefits for job-seekers (SGB II) in the form of Unemployment Benefits II or in the form of assistance towards living expenses (SGB XII). However, municipalities pay for housing and heating only in case of SGB II and the Federation pays in case of SGB XII since 2014. By doing so, the Federation reduced the financial burden of the municipalities. In 2013, there have been 921.041 beneficiaries receiving 323 EUR for housing and heating on average per month according to SGB XII (Statistisches Bundesamt, 2015, Fachserie 14, 2.2.).

¹³⁶ Federal Ministry for Labor and Social Affairs 2015. Social Security at a Glance, Berlin.

¹³⁷ The shares according the federal budget 2011 – 2014 do not coincide with the shares of the law. The differences probably result from accounting practices.

ing to Art. 22 SGB II. However, the term ‘reasonable rent’ is not specified by law and therefore difficult to determine: generally, the calculation follows a local rent index, i.e. the bigger the city the higher the allowances (about one-half of the beneficiaries live in one of the 76 largest cities).¹³⁸

Besides the basic living allowance, the Federation covers/repays a (changing) share of the local costs for housing and heating. The share was, according to the law, 30.4% in 2013, 27.6% in 2014 and 31.3% in 2015-2016 of the overall cost for housing and heating (Art. 46 (5) SGB II).¹³⁹

Legal and professional supervision is generally the responsibility of the Federal Ministry for Labour and Social Affairs (FMLSA), which transfers the responsibility to the Federal Employment Agency (Art. 47 SGB II). The legal authority for the counties and county-free cities are the competent states authorities. With the approval of the Bundesrat, general administrative regulations may be adopted, such as basic legislative issues of service delivery and the billing of services rendered (Art. 48 SGB II).

The numbers of beneficiaries are not split equally across Germany as the richer states – Bavaria and Baden-Württemberg – and respectively their cities face numbers below average (see tab. 2).¹⁴⁰ The regional average costs for housing and heating differ among the states as do the respective regional shares of federal cost covering of total transfer payments for subsistence level income of employable people and their families. In one third of the states, the costs of housing and heating exceed the pure income transfer payments; the reason is high leases in agglomerations.

¹³⁸ Statistisches Bundesamt 2004. Sozialhilfe im Städtevergleich 2003 – Ein Vergleich 76 deutscher Großstädte, 7f.

¹³⁹ The only exemptions to this rule are Baden-Württemberg and Rhineland-Palatinate. Both receive a higher share of cost recovery by the Federal Government.

¹⁴⁰ Statistisches Bundesamt 2004. Sozialhilfe im Städtevergleich 2003 – Ein Vergleich 76 deutscher Großstädte, 7f.

Table 2: Number of recipients of costs for housing and heating (CHH) in 2013

Land	Recipient households	CHH total	Net payments to recipient households	Payments for CHH per recipient household per month	Share CHH of total net payments
	number	1000 EUR	1000 EUR	EUR	%
BW	229,041	988,511	1,977,826	191.9	50.0%
BY	232,562	982,323	1,950,030	194.0	50.4%
BE	31,694	1,449,007	2,862,903	211.7	50.6%
BB	150,227	52,376	1,142,475	172.6	45.8%
HB	50,432	225,311	456,618	202.7	49.3%
HH	100,297	4,963	936,097	228.1	53.0%
HE	207,187	957,613	1,874,989	194.8	51.1%
MV	113,665	390,383	859,575	167.4	45.4%
NI	305,645	1,275,721	2,613,806	182.7	48.8%
NW	828,415	3,728,942	7,634,884	194.3	48.8%
RP	114,517	447,121	959,740	170.2	46.6%
SL	42,040	172,910	357,000	190.4	48.4%
SN	239,297	789,827	1,772,867	161.8	44.6%
ST	166,975	546,418	1,251,368	159.2	43.7%
SH	118,163	499,723	1,008,382	189.5	49.6%
TH	108,429	351,179	791,055	157.5	44.4%
GER	3,323,832	13,825,048	28,449,616	188.1	48.6%

Source: Schröder, 2015, Personen und Zahlungsansprüche (SGB II), BIAJ.

However, the high federal shares of cost covering of subsistence income, including about 25% of the costs of housing and heating, is a solution which fits more with theoretical requirements. Before, unemployment insurance paid reduced unemployment benefits for the long-term unemployed, and local governments had to close the gap if the benefits undercut the subsistence level of income. Due to the fact that housing and heating assistance is still paid by local governments, there is still a local incentive to promote employment.

The 100% covering for the costs of housing and heating has contributed to increasing leases particularly in the bigger cities and agglomerations. Herewith, the increase in rents is especially immanent for small apartments, driving other groups of leasers not receiving housing subsidies (like students and young employees with an income just above the subsistence level) out of the market. In some cases, local governments in

shrinking regions accommodated the long-term unemployed within their own housing stocks and receive now the federal share as a 'specific subsidy' for their otherwise unoccupied real estate. Increasing expenditures for SGB-II-benefits, among them the local allowances for housing and heating, are expected due to recent waves of refugees who will be transferred to the programmes of subsistence level allowances when granted asylum and not finding a job. However, local governments in structural weak regions cannot afford increasing social expenditures, which will lead to conflicts between the Federation and the Länder.

7.3.2. Child & Youth Welfare (SGB VIII): Pre-Primary Education

Child and Youth Welfare, according to SGB VIII, is a preventively designed welfare system in order to support young people in their individual and social development, reduce inequalities, protect them from dangers and provide advice and support to parents concerning education issues (§ 1 Abs. 3 SGB VIII). The spectrum of services provided under SGB VIII includes pre-primary education (child day care) that belongs – unlike in other nations – to child welfare and not to the school system.

The local youth welfare offices of the local level are responsible for guaranteeing and financing public youth welfare services. In accordance with the subsidiarity principle, most services are provided by the public sector. The local bodies have to provide facilities on time and on demand. However, there is a broad variance with regard to quality and quantity of welfare services across the municipalities as they have a broad margin of discretion.

In fact, the Federation has no competences in the field of child day care and kindergartens, which has been a local task from the beginning. Child and youth welfare constitute a core area of local public services and social policy in Germany, which is based on the Child and Youth Welfare Act of 1990 (KJHG, SGB VIII). In 1993, all regulations concerning child and youth welfare were introduced into the Social Law Book VII and VIII. The law(s) is the legal frame for intervention by the local youth administration whenever families are not able to guarantee the child's right for security, integrity and education.

Since 1996, the legal right for children from the age of three years until they enter school to visit a day care facility was introduced as a "by-

product” of the (restricted) permit of abortions according § 218 STGB. This right was expanded in 2007, and from 2013 onwards, parents are legally entitled to make use of day care facilities for children from the age of one year (§ 24 SGB VIII). Since 2007, a large expansion of day care capacities could be recorded; the gross expenditures have subsequently increased by 77% from 12.8 bn EUR in 1996 to 22.3 bn EUR in 2013.¹⁴¹ Although the Federation never had any competences in financing kindergartens, the federal government established certain grants for investment expenditures for new kindergarten places.

Major expenditures with regard to Child and Youth Welfare are borne by the local governments; amounting to 69% of total expenditures.¹⁴² However, the states stepped into the multi-level financing game by promoting day care places to get mothers back to work earlier and to promote the reconciliation of work and family life. They have established specific regulations about maximum group sizes, the qualification of the kindergarten teachers and the fees to be paid. In return, to more or less costly state regulations written in law of each state government local governments receive grants and matching grants for investment expenditures, transfer payments for personnel expenditures for all kindergartens (municipal, churchly and other independent organisations) that meet the requirements of the laws. Local government often pay subsidies for investment expenditures to churchly and free owners in order to set incentives for them to cover the expensive task.

¹⁴¹ Statistisches Bundesamt. 2015. Statistiken der Kinder und Jugendhilfe, Tabelle ZR 1.1 & ZR 1.2; Gliederung nach Bundesländer in Tabelle LT 1. Expenditures in 2013 see Table 4.

¹⁴² See Table 1.

Table 3: Expenditures and revenues of child and youth welfare 2001-2013 in 1,000 EUR

Year	Total	Among them		Revenues	Pure expenditures
		Kindergarten and child day care	Aid for education and integration of handicapped children		
2001	19,210,662	10,427,626	5,124,549	2,098,195	17,112,466
2002	20,176,896	10,951,366	5,476,958	2,177,703	17,999,194
2003	20,612,447	11,290,788	5,636,946	2,212,071	18,400,376
2004	20,671,147	11,430,891	5,634,389	2,134,939	18,536,208
2005	20,865,232	11,542,452	5,668,067	2,042,990	18,822,242
2006	20,924,286	11,638,762	5,650,389	2,171,699	18,752,587
2007	22,798,216	13,091,747	5,911,269	2,247,134	20,551,082
2008	24,583,518	14,227,842	6,406,879	2,341,654	22,241,864
2009	26,906,600	16,223,407	7,104,488	2,614,958	24,291,642
2010	28,893,054	17,384,754	7,512,224	2,616,268	26,276,786
2011	30,529,519	18,490,327	7,838,176	2,634,008	27,895,510
2012	32,231,903	19,720,234	8,204,275	2,444,504	29,787,399
2013	35,526,752	22,270,131	8,706,551	2,707,200	32,819,552

Source: Statistisches Bundesamt, [<https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/Soziales/Sozialleistungen/KinderJugendhilfe/Tabellen/AusgabenEinnahmenEntwicklung.html>].

The financial situation and incentives have changed since the legal right for a kindergarten place was introduced in 1996 and 2013. Since then, the guarantee for sufficient places is a local task. Most states have established grant programmes for building new kindergartens, but left the ratios of transfer payments for personnel expenditures more or less unchanged. In Rhineland-Palatinate for example, the churches receive 31% of standardised personnel expenditures for kindergartens and municipalities receive 30%. The churches threaten to close their kindergartens if they do not receive higher subsidies from local governments. Because an ‘external’ kindergarten run by churchly or other independent organisations is less costly than one run by the community, they make increasing payments, thereby increasingly covering the costs of all places within their territory.

In those cases where the number of kindergarten places is insufficient, local governments pay subsidies to private day care places. So-called

day-mothers earn their income by taking care of children for an honorary. Municipalities pay standardised salaries per child and day. These places are in total less expensive than fully equipped kindergarten places. As the salaries are not very high, the potential of these day care places has to be regarded as limited, but their number is crucial at the margin.

Another financial challenge results from the political decision of some Länder to abolish parents' fees. The idea is that equal opportunities of children results from early child/pre-school education, which should be free in order to incentivise this type of day care for poorer families, which on average have lower education degrees and human capital. Fees should no longer be a barrier for early childhood education. However, no Land that has abolished kindergarten fees has totally replaced the loss of local revenues by increased transfer payments.

Further, financial challenges result from full day kindergarten places. Germany's tradition for half-day school and day care systems has been criticised for many years. Now, with the needed participation of excellently qualified women in the labour market, the demand for full day kindergarten and schooling has reached the political agenda. For many local governments, the topic is sensible in order to meet the expectations of voters in future elections. Demographic changes have taught local politicians that the attractiveness of their economic location depends on the supply of highly qualified mothers. Full day kindergarten and schools have, therefore, a high return on investment.

However, the problem herewith is the asymmetry of public expenditures and revenues. The communities have to cover the additional expenditures (not all states subsidise the increased personnel expenditures for full day kindergarten in the same way as half day institutions!)¹⁴³, but they receive only a minor share of the additional revenues, i.e. income tax and social insurance contribution. Local governments only receive a 15% share of the income tax, the States profit by 42.5% of the income tax and the federation is the big winner by getting all additional social insurance contributions and also 42.5% of income tax. This incentive structure constitutes a vicious circle for local finance.

¹⁴³ For schools the Land covers the salaries of the teachers.

The financial burden for children and youth welfare in total and for kindergarten in particular vary across the Länder. The parents make different use of their legal right; e.g. 32.3% of all children under the age of three are looked after in day care facilities in former West-Germany, while 52% are looked after in former Eastern-Germany.¹⁴⁴ The participation rate varies from 23.0% in North Rhine-Westphalia to 58.3% in Saxony-Anhalt (March 2014). The kindergarten share was and still is traditionally higher in the former GDR than in Western Germany. The lower share of children under three cared by day-mothers (21.3% in West and 9.2% in Eastern Germany) is not surprising because of the outlined diverging cultural behaviours, the emigration process of young qualified women from Eastern to Western Germany that is taking place and the shrinking number of newborns to be cared for.

To understand the demand for day child care in recent years, a further transfer payment needs to be taken into consideration. Upon the political pressure of Bavaria, the federation had established a new transfer payment for those parents who do not use a publicly subsidised day care place but take care of their child at home themselves (Betreuungsgeld). The allowance amounted 100 EUR per month from August 1, 2012, and was increased to 150 EUR per month from August 1, 2014. Parents receive the care allowance up to 22 months after the expiry of the parental allowance (Elterngeld), which is usually paid until the baby turns 14 months. In March 2014, there have been 455,321 cases of day care allowance, hereof 425,865 in Western and 29,456 in Eastern Germany. Critical analyses gave evidence that in particular poorer families preferred the transfer payment instead of early childhood education for their children.

However, the Federal Constitutional Court has ruled that the day care allowance is unconstitutional, because the Federation has no competence for transfer payments in that field of policy.¹⁴⁵ Herewith, the Federal Court explicitly favours distributional policies at the decentralised state level and sees no reasons why the states cannot decide for themselves about this type of allowance.

¹⁴⁴ Statistisches Bundesamt 2015, Kindertagesbetreuung & Statistik der Kinder und Jugendhilfe.

¹⁴⁵ See Bundesverfassungsgericht BVerfGE, Decision of the First Senate July 21st, 2015 - 1 BvL 2/13. *BvF 2/13 - Rn. (1-75)*, [http://www.bverfg.de/e/fs20150721_1vf000213.html]

Table 4: Day Care for children up to the age of three years in March 2014 and 2015

Land	March 2014				March 2015			
	Number of children in kindergarten	Share of children in kindergarten in %	Number of children in external day care	Share of children in kindergarten	Number of children in kindergarten	Increase to previous year in %	Number of children in external day care	Share of children in kindergarten
BW	66,465	27.8%	10,330	15.5%	68,918	3.7%	10,267	14.9%
BY	81,693	27.1%	7,151	8.8%	85,621	4.8%	7,119	8.3%
BE	42,632	46.0%	4,382	10.3%	44,534	4.5%	4,361	9.8%
BB	29,078	57.8%	4,092	14.1%	29,475	1.4%	3,951	13.4%
HB	3,620	26.9%	831	23.0%	3,865	6.8%	847	21.9%
HH	19,857	43.0%	2,138	10.8%	21,109	6.3%	2,168	10.3%
HE	37,719	28.8%	7,486	19.8%	40,559	7.5%	7,373	18.2%
MV	16,962	56.1%	4,600	27.1%	17,431	2.8%	4,288	24.6%
NI	41,286	27.9%	11,936	28.9%	42,809	3.7%	11,798	27.6%
NW	73,999	23.0%	31,137	42.1%	84,988	14.9%	32,969	38.8%
RP	27,483	30.6%	2,361	8.6%	28,388	3.3%	2,056	7.2%
SL	5,152	27.0%	504	9.8%	5,557	7.9%	475	8.5%
SN	45,207	49.9%	7,108	15.7%	46,868	3.7%	7,203	15.4%
ST	29,115	58.3%	564	1.9%	29,216	0.3%	630	2.2%
SH	14,961	30.3%	5,405	36.1%	16,703	11.6%	5,036	30.2%
TH	26,340	52.4%	1,107	4.2%	26,856	2.0%	1,100	4.1%
GER	561,57	27.4%	10,113	18.0%	592,90	5.6%	101,64	17.1%
Western GER	372,24	32.3%	79,279	21.3%	398,52	7.1%	80,108	20.1%
Eastern GER	189,33	52.0%	17,471	9.2%	194,38	2.7%	21,533	11.1%

Source: Statistisches Bundesamt 2015, Kindertagesbetreuung & Statistik der Kinder und Jugendhilfe.

Table 5: Child and youth benefit expenditures per capita in 2013 and change to previous year

Land	Total expenditure		Among them...			
			Child day care		Aid for education	
	EUR per capita	Change to previous year	EUR per capita	Change to previous year	EUR per capita	Change to previous year
BW	417.4	17.3%	288.2	22.2%	88.7	10.2%
BY	399.0	13.1%	283.2	16.5%	76.6	5.3%
BE	563.7	6.4%	370.9	7.7%	131.2	4.7%
BB	483.4	6.6%	336.4	8.0%	106.6	4.8%
HB	568.9	8.7%	275.3	5.8%	246.4	11.0%
HH	530.3	3.7%	326.4	1.6%	154.0	10.2%
HE	512.0	12.1%	326.9	16.1%	126.2	5.7%
MV	390.9	9.1%	251.2	10.8%	105.9	9.0%
NI	390.3	10.7%	235.5	14.3%	114.0	6.7%
NW	435.4	7.4%	258.4	9.8%	132.0	3.9%
RP	455.1	7.8%	301.9	10.3%	113.2	3.7%
SL	484.5	8.6%	271.5	10.2%	155.4	5.5%
SN	453.2	9.6%	345.2	10.3%	73.6	15.1%
ST	405.0	8.1%	286.9	9.9%	84.6	6.7%
SH	372.9	12.2%	229.1	17.9%	101.6	4.8%
TH	386.9	7.0%	283.2	8.7%	62.0	5.5%
GER	439.9	10.2%	284.9	13.0%	107.8	6.1%

Source: Author; Federal Statistical Office. 2015. Pressemitteilung – 26/15.

The influence of the states on local expenditures in day childcare is considerable: They determine maximum size of child groups per teacher, they give subsidies for building new places, they regulate salaries of day mothers and they decide on parents' fees, which influence the net expenditure burdens of the municipalities¹⁴⁶. Therefore, the expenditures per capita vary considerably among the states – e.g. from 387 EUR in Thuringia to 569 EUR in Bremen (German average is 440 EUR)¹⁴⁷,

¹⁴⁶ See Färber (2000)

¹⁴⁷ Statistisches Bundesamt 2015, Pressemitteilung – 26/15.

which cannot be explained by the participation rates only. These differences are mostly determined by state regulations set (e.g. salaries, children-teacher ratio, and – in particular – the amount of investment expenditures for new kindergarten places. The Federal Ministry for Families, Aged Persons, Women and Youth has started a debate to introduce quality standards, which would cause further expenditures at the local level.

In this context, problems result from the incongruent assignment of competences concerning task, expenditures and revenues. The local governments are in the weakest and most ‘expensive’ position by fulfilling the federal guarantee of kindergarten places and taking responsibility for fulfilling state regulations without sufficient funding; instead, they are even blackmailed by churchly and free owners of day care providers. From a methodological point of view, there is no transparency revealing the cost of child day care caused by the respective level of government, of which a certain amount must be paid by the local governments themselves as day care expenditures are without any doubt a typical local task. Methodologically, the compliance costs of kindergarten places could be measured by the standard cost model, which would clearly assign the respective cost-shares to the three layers of government. Such an initiative was unanimously accepted by a Parliamentary commission in Rhineland-Palatinate, but shifted after the election in March 2016. State members of Parliament and also local government representatives greatly feared that empirically tested standard costs would result in too much transparency and, respectively, conflicts. However, conflicts could be solved in the long-run by developing a reliable empirical method to calculate compliance costs of local tasks imposed by upper layers of government. This should be the next steps to establish better rules of financing decentralised public goods.

7.3.3. Social Assistance (SGB XII): Needs-based pension supplement in old age and in the event of reduced earning capacity

“Social assistance (Sozialhilfe) provides a safety net to protect people from poverty, social exclusion and hardship; it helps individuals and households who are unable and lack the resources to meet their own needs and have insufficient entitlement under other insurance and welfare systems that come before it (BMAS, 2015, 114).”

Table 5: Recipients of needs-based pension supplement in old age and in the event of reduced earning capacity in 2013

Land	Total	Among them: in pension age	
		number	per 1000 inhabitants
31.12.2005	630,295	342,855	22
31.12.2010	796,646	412,081	24
31.12.2011	844,030	436,210	26
31.12.2012	899,846	464,066	28
31.12.2013	962,187	497,433	30
31.12.2014	1,002,168	512,262	31
März 2015	994,658	511,915	31
Länder in March 2015			
BW	95,569	50,663	25
BY	120,299	68,546	28
BE	14,990	8,654	63
BB	40,087	23,894	74
HB	82,694	44,778	37
HH	105,353	50,543	31
HE	258,679	142,611	40
MV	43,000	22,107	27
NI	15,196	8,146	37
NW	38,704	19,514	31
RP	63,963	33,842	53
SL	23,926	7,790	14
SN	21,824	6,501	18
ST	30,441	11,340	11
SH	23,898	7,736	14
TH	16,035	5,250	10

Source: https://www.destatis.de/DE/PresseService/Presse/Pressemitteilungen/2015/08/PD15_292_221.html

Social assistance forms the last safety net in Germany. It is intended for (exceptional) cases that are still not covered by the social security system and functions as basic security. Generally, everyone (even without German citizenship) is entitled to social assistance. Formerly, needs-based pension supplement was a separate primary benefit since Janu-

ary 2003. However, since 2005, needs-based pension supplement was re-introduced into the social assistance law.

Needs-based pension supplement is paid from the age of 65 and in the event of reduced earning capacity between ages 18 and 64. The pension supplement is equal in amount to assistance towards living expenses. The expenses are estimated by making use of a 'basket of goods', including food, accommodation, clothing, body care, household effects, heating and everyday personal necessities to take part in cultural life (BMAS, 2015: 116ff). The assistance is generally paid as a flat rate: The standard rate for an adult entitled to assistance running their own household as a single person is 399 EUR; children entitled to assistance of an age between 7-14 years receive 234 EUR per month. They may be entitled to further assistance in case of costs not covered in the standard rate, such as setting up a household, initial outfitting with clothes and initial outfitting based on maternity needs. Income (e.g. pensions) is taken into account for social assistance, but not the resources of children or parents.

The country-free cities and the counties [see above] are legally and economically in charge for social assistance, and they cover the costs from their own budgetary revenues (§ 3 SGB XII).”.

Against the backdrop of the economic crisis resulting in major budget deficits at the local level, the Bundestag convened a Finance Reform Commission for Local Governments (“*Gemeindefinanzreformkommission*”) in 2010. In this context, different approaches to relieve the financial burden of the municipalities were discussed, especially with regard to social protection. As a result, there was a gradual takeover of the expenditure of the pension supplement by the federal government. It could be assumed that this happened because social security is within the federal government’s competence. With decreasing incomes and, respectively, payments into the social security system as a result of long-term unemployment since the 1980s in Western and, after unification, in Eastern Germany, there will be a substantial increase in need-based pension supplement in the upcoming decades. The share of federal funding is subsequently steadily increasing from 15 percent in 2011 to 100

per cent from 2014 onwards.¹⁴⁸ The federal part is refunded via transfer payments through the respective state budgets.

Table 8: Gross and net expenditures per inhabitant of needs-based pension supplement in old age and in the event of reduced earning capacity, 2013

2013	Gross expenditures			Net expenditures		
Land	Total	Outside of homes and hospitals	Within homes and hospitals	Total	Outside of homes and hospitals	Within homes and hospitals
	Euro per inhabitant			Euro per inhabitant		
BW	50.7	35.5	15.2	46.9	34.4	12.6
BY	49.6	34.8	14.9	48.9	34.0	14.9
BE	122.7	101.7	20.9	116.2	100.0	16.2
BB	45.1	32.9	12.2	42.0	31.6	10.3
HB	119.7	101.3	18.6	117.9	99.5	18.4
HH	126.3	108.7	17.6	117.8	103.9	13.9
HE	78.0	64.0	14.0	76.6	62.7	13.9
MV	62.3	42.5	19.7	56.1	40.8	15.3
NI	76.5	52.6	23.8	69.1	51.4	17.7
NW	80.7	61.9	18.8	79.5	60.7	18.8
RP	55.3	41.2	14.0	53.5	39.7	13.8
SL	78.1	61.3	16.9	77.0	60.3	16.7
SN	33.4	23.9	9.5	32.7	23.3	9.4
ST	67.3	29.8	37.6	46.9	28.7	18.2
SH	76.0	56.6	19.4	73.5	55.4	18.2
TH	32.2	23.1	18.7	30.9	22.2	0.0
GER	67.4	50.2	17.3	64.2	48.9	15.3
Western GER	68.8	51.5	17.3	66.2	50.3	15.9
Eastern GER	61.9	44.6	17.3	56.2	43.4	12.7

Source: Statistisches Bundesamt:

https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/Soziales/Sozialleistungen/Sozialhilfe/EinnahmenAusgaben/Tabellen/Ausgaben_Grundsicherung.html

¹⁴⁸ Bundesministerium der Finanzen: Bundeshaushaltsplan 2014, Einzelplan 11, p. 79.

The transfer of cost covering from local governments to the Federation has provided the congruence of the powers of legislation and funding. Federal decision to decrease the level of pensions will no longer lead to increases of local expenditures in future; the additional expenditure burden will account to the federal budget. However, the new rule of centrally (re-)financing the needs-based pension supplement represents a further mechanism of fiscal equalisation based on regionally and locally divergent needs which the system of tax sharing and distribution has not been able to meet.

7.4. Social insurances and multi-level fiscal equalisation (“tax sharing”) as instruments of inter-regional redistributive policies and equivalent living conditions

The three examples outlined illustrate the problems involved in the efficient provision of social local public goods. The problems are not resulting from an inefficient Tiebout competition, but from imbalances caused by the incongruence of legislation and financing powers. Many of these laws were centralised a long time ago under the regime of Art. 72 BL, which requires the centralisation of legislation in order to achieve the ‘equivalence of living conditions’ across the territory of Germany. Due to the re-union of Western and Eastern Germany in 1989, the article was changed from ‘uniform’ to ‘equivalent’ living conditions in 1990 in order to weaken the re-distributional requirement.

The original construction of central legislation of decentralised social public goods and transfers had assumed that after the rebuilding of Germany after World War II and the huge economic growth rates of that period, the convergence of the economic capacities and the resulting fiscal capacities would continue. In the 1960s the idea gained ground that an economic crisis could be prevented by using the newly introduced Keynesian instruments. On this basis, social securities and the multi-level fiscal equalisation scheme have built the framework to secure stable income. Both systems effect an important interregional redistribution of public revenues through their different constructions:

- » Social insurances transfer financial means and incomes from wealthier regions with high incomes and low unemployment to poorer regions with low incomes and high unemployment. They

build by transfer payments¹⁴⁹ the stabilisation of monetary incomes across Germany, taking into account certain divergences of incomes depending on productivity gaps and regional price differences.

- » The fiscal equalisation system distributes the shared taxes, which amount to more than 70% of total tax revenues, vertically and horizontally among federal, state and local governments in order to finally achieve – in the vertical sense – a financial means to cover the costs of ‘their’ respective public goods provision and – in the horizontal sense – to achieve an equivalent financial setting across the states. Special needs play only a very minor role in the form of some Federal Supplementary Grants. Beyond that, each Land is free to decide which needs factors are included into the fiscal equalisation formulas for the municipal equalisation system within the respective states.

However, severe structural economic change, which started in the 1970s, persists in some Western regions and in Eastern Germany even today. The convergence of economic capacities of the Eastern States seems not to converge any longer, although emigration has significantly decreased. Meanwhile, the immigration of refugees and inner-migration between peripheral rural regions and bigger cities/metropolitan areas in favour of the latter dominate the demographic patterns which influence the population-size-based fiscal equalisation systems.

Structural economic change has engraved social expenditures at the local level since the 1980s. Those communities where the loss of jobs induced long-term unemployment had to cover not only subsistence incomes, but also increasing expenditures for aid for education for children of unemployed families. The share of pupils who left school without certificates and from non-integrated immigrant families increased the number of long-term unemployed by people who had never worked in the labour market. Therefore, the expenses of these municipalities for – compulsory – social expenditures, which just cover social damages, are much higher than in cities and regions with growing employment. The latter are able to spend for local public goods from growing revenues,

¹⁴⁹ In case of the Social Health and Care Insurances by securing the households against high expenditures which would overburden average income abilities to pay.

while the communities in the regions of structural economic change, particularly in the Ruhr region, in Rhineland-Palatinate and in the Saarland, accumulated public debt in their current accounts. They had to pay interest expenditures instead of infrastructure investment expenses. The centrally regulated compulsory social expenditures have crowded out voluntary local expenses and investment expenditures in the regions concerned. Therefore, the equivalence of living conditions, which severely depend on public infrastructure and other state and local services, is threatened by the uneven distribution of compulsory social expenditures. The amount and the regional spread has never been foreseen by the founders of the financial constitution. The centralisation of funding of compulsory decentralised social services and transfer payments is, therefore, a consequent mean to avoid the overload of local governments. But it cannot replace autonomous competences of state and local governments and their own-revenue competences.

7.5. Summary and Conclusion

The German Basic Law demands ‘equivalent living conditions’ all over Germany. The fiscal equalisation scheme among the states only orientates on the number of residents living within the states. These numbers are contrasted with the financial capacity of each state in order to balance the tax capacity and the expenditure burden throughout the federal territory.

This mechanism reflects structural problems across the states only indirectly, as demographic change and high numbers of unemployment result in below average state tax revenues. Therefore, the fiscal equalisation mechanism is only one instrument in order to achieve the outlined goals. Structural imbalances are already balanced out – at least to some extent – by the federal government (with tax money) and the social security system (with benefit contributions). They provide adequate public and statutory benefits (e.g. Unemployment Benefits I financed by tax money and Unemployment Benefits II financed by statutory contributions) with the effect of balancing structurally strong and structurally weak states and regions. Therefore, it is not astonishing that the federal government slightly overtakes some municipal expenditures as – for instance – outlined in the case of SGB XII (needs-based pension supplement in old age). By centralising those expenditures, federal tax money is better at achieving the effect of equivalent and uniform living conditions.

This approach also follows public finance theory, such as the ‘three functions theory’ of Richard A. Musgrave. The central and the local government should be responsible for the allocation of public benefits. Both have, of course, different redistributive effects (different spatial benefit incidences). The spatial effects in-between central and local service provision already illustrate that there is a conflict of functions (Musgrave, 1976: 16ff), especially between redistribution and allocation. Musgraves’ demarcation of functions is by large true; however, it does not reflect that there is considerable overlapping and inter-governmental coordination necessary in order to evolve the functions. The ‘right’ decision in-between redistribution and allocation is also a decision concerning centralisation or decentralisation of public goods and service provision. Whenever public goods are assigned to the central level, there should be a vast heterogeneity across the territory. In the same context, if it is assigned to the local level the unbalanced benefit incidence could be balanced out by tax-transfer schemes. The underlying taxes are mostly progressively designed, based on ‘ability to pay’, therefore achieving already redistributive effects. However, the degree of the level of redistribution is especially determined on the expenditure side: The level and type of public programmes financed decides upon the degree of distribution (central) or efficient allocation (local). This conflict is predominant in the case of social public service provision in Germany.

The three examples outlined show that the conflict of central regulation of compulsory decentralised local services and transfer payments are able to create uniform living conditions in Germany because these local public goods do not depend on the local fiscal capacity. However, these tasks do crowd out other – ‘voluntary’ – local services because the multi-level equalisation system only covers divergent financial needs among municipalities within a State, but not across the Länder. The centralisation of funding like in the case of needs-based supplementary pensions payments is partly helpful, but not a convincing solution. The competence of administration remains at the local level, which could lead to a generous permit of transfers in order to keep administrative cost moderate on a local level. However, the most important burden for local governments and source of deficient efficiency is the federal guarantee of local services without transferring sufficient funding.

A preferable solution could be – beside more transparency of the costs of service production – the inclusion of a certain number of financial needs indicators into the fiscal equalisation among the States. A general revision of the assignment of tasks could be another conclusion. Beyond that, an empirical calculation of the cost induced by the respective levels of government by applying the standard cost model could be a feasible solution. Generally, one could conclude that the more homogeneous the need for social services (and respectively the public expenditures) is throughout the territory, the lower the level of service provision should be. This follows the subsidiarity principle, where local governments are more efficiently deciding upon the local needs and, respectively, the allocation of social services. If there are spatial or structural imbalances throughout the territory, the central government should be responsible in order to balance disproportionate regional social burdens. Inter-regional imbalances and respective effects of the distribution of tax revenues among the layers of government and among the jurisdictions of the same layer should explicitly be included.

The negotiations among the Federation and the States, which are supposed to come to fundamental decision for the reform of the intergovernmental financial relations from 2020, are still discussing solutions. The States have agreed on a new and simpler equalisation formula, which results in a tax distribution that is very close to the current one, but did not ask the Federal Minister of Finance before making their decision. The latter however has to pay for the losses of the new formula in order to achieve a unanimous vote for the reform, but desires in exchange a stronger role of federal tax administration. The problems of diverging financial need resulting from central legislation are not discussed and therefore have to be shifted to the next reform, which will come soon after 2020.

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Chapter 8

Less regulation or more? Recent trends in guidance of Finnish local government

Antti Moisi^{150 151}

Abstract

This paper describes and discusses the recent and ongoing public sector reforms in Finland. More specifically, the paper deals with policies to reorganise the provision of public services, to reduce municipal tasks and to deregulate public service provision. Through deregulation, the government is seeking to reduce the sustainability gap in public finances by 0.5 percentage points. However, implementation of this deregulation policy requires careful analysis taking into account both the costs and benefits of regulation. There is no blueprint to alter the amount of regulation in the public sector. This paper discusses these themes and also the pros and cons of classifying public services into local public goods, services with redistribution and services with externalities.

8.1. Introduction

Regulatory reforms have been a topical issue for several years in countries around the world. Such reforms have aimed not just to reduce regulation but also to improve the quality of regulation. The effects of regulatory reforms on the business sector have been evaluated extensively, and generally the results support the view that reforms are beneficial:

¹⁵⁰ Finnish Council of Regulatory Impact Analysis.

¹⁵¹ I thank Lars-Erik Borge, Pawel Swianiewicz, Niels Jørgen Mau Pedersen and other Copenhagen workshop participants for useful comments. All remaining errors are mine.

less or better regulation has been found to improve productivity, boost innovation, and increase investment and entrepreneurship (OECD, 1997).

Deregulation of the public sector itself seems to have been less of an overall policy issue, however. The same applies to central government regulation targeted at the subcentral level. This is somewhat surprising, taking into account that the trend in many countries has been towards decentralisation and delegation of powers from the central to the subcentral level. Overall, it seems that in many countries, guidance of the subcentral level by the central government has increased considerably over time (Hood et al. 2000, Ministry of Finance 2013, Sørensen 2014). Nonetheless, the effects of regulation reforms concerning the public sector have not been studied or discussed much, at least not from the macro perspective. This is despite the fact that several countries have identified a need for such reforms in (Hood et al., 2000, Sørensen 2014). This is not to say that considerable economics literature does not exist on the benefits and costs of regulation concerning single public services, for example school class sizes (see e.g. Fredriksson et al. 2013, Chetty et al. 2011) or waiting times in healthcare (Siciliani 2013). But since the empirical evidence of the effects of various regulatory reforms has often been mixed, and because the evidence has often been case-specific, it has been difficult to make clear policy recommendations.

The traditional fiscal federalism literature perspective on norms and regulation is that in the case of local public goods there is no need for central interference. This is mainly because there are no important benefit spillovers (Tiebout 1956). On the contrary, each municipality ought to be allowed to choose its own level of public services. The model has been subsequently extended to impure local public goods (Oates 1972). But in many countries, especially in the Nordic countries, the local service menu consists not just of local public goods but also of redistributive tasks and merit goods that have been delegated to local government (Rattsö 2002, Moisio 2010). One of the main objectives of this “administrative federalism” has been the efficiency of service provision, which is largely based on service responsiveness to local needs and preferences. It has also been argued that decision-making at the local level is more transparent to taxpayers/citizens and that voter participation in elections and political activity in general is greater in decentralised systems. But the flip side is that decentralisation of redistributive and mer-

it public services has created a need for central government to guide local government in the provision of services, mainly because of equity concerns and to protect vulnerable minorities.

The present Finnish government aims to reverse the trend of continually increasing the delegation of tasks from the centre to local government, and to reduce the norms and regulations concerning service tasks. To support the process, a project to classify the 500 municipal tasks and almost 1000 norms and regulations that steer these tasks have been launched (Saastamoinen et al 2016). The ultimate aim of the project is to identify the regulation of municipal services that creates an unnecessary burden for municipal decision-makers.

This paper describes the current system of normative and fiscal guidance of municipalities in Finland and recent measures to ease such regulation. The paper proceeds as follows. The second section briefly describes the Finnish version of decentralisation and tries to briefly answer questions such as: “Why, how and to what end have education, healthcare and social expenditures been decentralised?”, and “What are the driving forces behind decentralisation?” that were put forth by the 2015 Copenhagen seminar organisers. Section three focuses on the future prospects for Finnish local government, discussing especially the recent central government policy to tighten the fiscal rules, loosen the regulation of services and reduce the service burden of municipalities. Section four summarises and concludes.

8.2. Decentralisation: the Finnish way

8.2.1. From past to present

The foundation of the modern municipal government in Finland dates back to the 1860s and 1870s, when the first laws on rural municipalities and towns were enacted and local authorities gained the right to levy taxes. Another major legal landmark was some 50 years later, when local self-government was included in the first Finnish Constitution in 1919. Intermunicipal cooperation, which is important especially in the Finnish context, was added to municipal legislation in 1932.

In the early days, most rural municipalities were poor, so the first municipal services consisted of simple tasks such as road maintenance, basic education and income support for the poor. The cities and towns

were wealthier and took care of more tasks. Only a few municipalities were able to offer some health services to their inhabitants, for example by hiring their own doctors and even by founding municipal hospitals. But the need for local health services was obvious because of the long distances and poor road access to the nearest towns. Although the central government maintained a regional hospital network, the role of municipal hospitals increased rapidly. By the 1920s there were a total of 236 hospitals, 142 of which were administered by municipalities and 60 were private. This development was seen as more or less a necessity, as the central government was not able to provide services in all parts of the country. The municipalities therefore took a voluntary lead, although reluctantly, in developing not just health but also education services for their residents. Later, the central government often formalised the situation by enacting a law on the services that the municipalities had initiated themselves (Manninen, 2010).

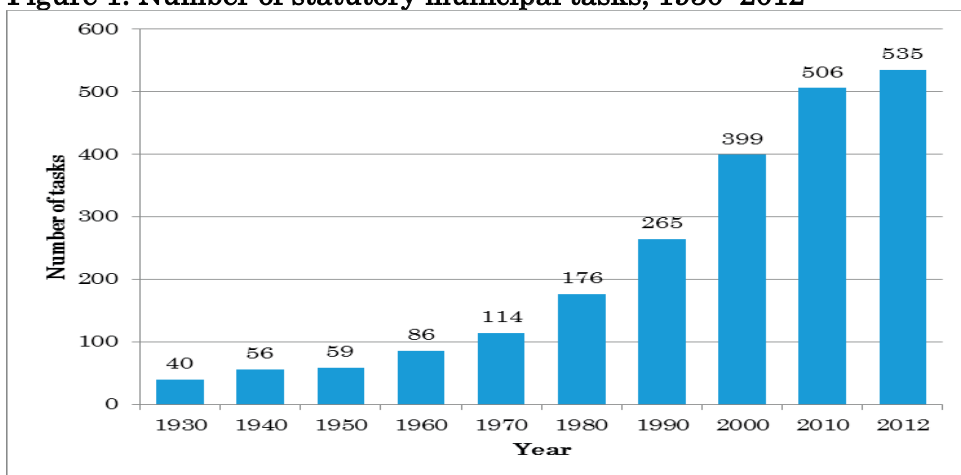
By the end of the 1950s it had become common practice for the central government to assign new or existing statutory tasks to municipalities. For instance, state-owned general hospitals were transferred to local government ownership in 1956. According to the law, the hospitals were to be operated by joint municipal authorities, administered through 20 hospital districts. Each municipality was obliged to belong to a hospital district. There was a similar development in education, with many private and central government-run comprehensive and upper secondary schools becoming municipal schools.

The central government funded part of the expenditures, first by earmarked grants. In some cases, the poorest municipalities received a slightly higher grant, but mostly the grants per inhabitant were the same for all municipalities. By the 1960s it had become evident that differences in the municipalities' ability to raise revenues should be taken into account in some formal way in the transfer system. As a result, a classification of municipalities into 10 groups according to their economic situation was developed. Between the 1960s and 1990s most grants were matching grants and the grant rates varied according to the classification, so that the rates were highest in class 1 (poorest municipalities) and lowest in class 10 (richest municipalities). Gradually, the grant system was used as an incentive for municipalities to expand their services. But over the years it became clear that the matching grant system was increasing municipal expenditure, and so in 1993, the match-

ing grant system was replaced by a formula-based block grant system. The grant formulas have been updated several times since then. The latest grant system reform was in 2014, the aim being to simplify the formulas and make the system more transparent. However, the formulas include several need and cost factors.

The expansion of local government tasks (education, health and social services) was especially rapid in the 1970s and 1980s, but has continued to increase up to the present (Figure 1). Currently, practically all basic social and healthcare services and most education (except tertiary education) services are provided by municipalities or by joint municipal authorities (Table 1). The present government (in power since May 2015) has promised not to increase municipal tasks during its four-year term. In fact, the new government plans to reduce the number of municipal tasks. The norms and regulations concerning the tasks are also due to be eased. This is discussed in more detail in section 3.

Figure 1. Number of statutory municipal tasks, 1930–2012¹⁵²



Municipal finances and service provision are monitored by a so-called Advisory Board, which comprises representatives from both central government and the Association of Finnish Local and Regional Authorities.

¹⁵² The tasks as defined here refer to all statutory functions that the municipalities are obliged to perform. For example, basic healthcare and comprehensive schooling are tasks. In addition to the “major public services”, the definition of tasks includes many very minor functions.

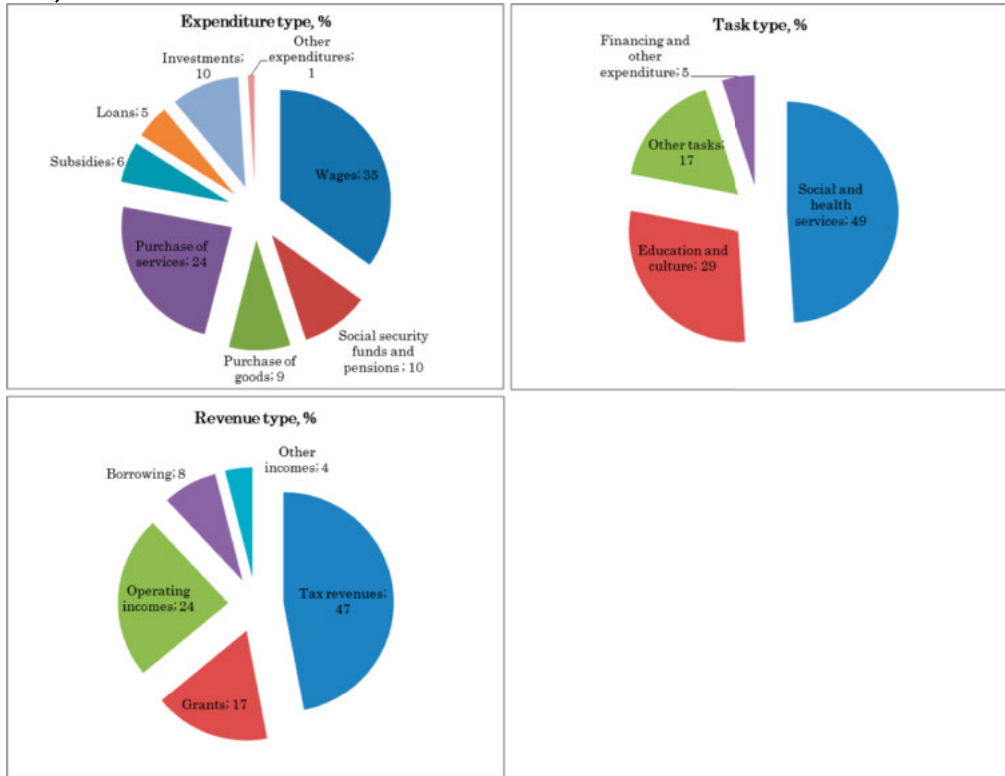
The Board has economic and assessment sections for preparing matters. Until 2015, the Advisory Board prepared the Basic Services Programme and the Basic Public Services Budget. (The new monitoring system is described in section 3). The Basic Services Programme and the Basic Public Services Budget were introduced in 2003 (these procedures were given legal status in 2008), and the purpose of these instruments was to achieve a better balance between financial resources and the tasks and obligations of municipalities. The Advisory Board prepared an annual budget review (as part of the Basic Public Services Budget) and the service assessment. The aim of these was to monitor changes in the local government operating environment and in the municipalities' statutory duties together with developments in local government finances (tax revenue, central government transfers) and expenditure. The Board was charged with making proposals to enhance local government revenue and expenditure and measures to meet productivity targets for the municipal sector. In practice, the Municipal Department of the Ministry of Finance prepared the matters for the Advisory Board.

Financial control of municipalities has been effected via the grant system, altering revenue bases and tax rates, fiscal rules and setting norms and regulations concerning the tasks. Municipal grants have been altered mostly in a procyclical manner. Tax rate regulation has been applied only to property tax rates (there are upper and lower bounds), but property taxes form only a small portion of a municipalities' tax revenue. Central government has altered municipal corporate tax revenues by adjusting the municipal share of the revenues. The fiscal rule has equated to the balanced budget rule, which stated that municipalities were expected to balance their budgets within a four-year planning period. However, up to 2015 there has been no sanction for not adhering to this rule. There has also been a so-called crisis municipality procedure, which applies various criteria to define municipalities suspected of having economic problems. Any municipalities on this list were closely examined by a group of external experts, who made recommendations as to how the municipalities should improve their situation. In 2015, a new system to monitor and guide municipal finances was introduced. This is described in more detail in section 3.

Table 1. Summary of municipal tasks (Moisio et al. 2010)

Education
Comprehensive and upper secondary schools
Vocational institutes
Polytechnics
Adult education
Basic music and art education
Culture
Libraries
Other culture services (theatres, museums, orchestras...)
Healthcare
Primary care
Specialist care
Dental care
Environmental healthcare (health protection)
Social services
Child day-care
Elderly care
Care for the disabled and mentally handicapped
Child protection and welfare
Income support
Welfare for intoxicant / drug abusers
Public utilities
Water and energy supply
Waste management
Street and road maintenance
Environmental protection
Public transport
Sports and leisure
Parks and outdoor areas
Sports facilities
Other
Land use planning and building supervision
Promoting commerce and employment
Municipal housing, public building

Figure 2. Municipal expenditures, tasks and revenues (percentage of total), 2014



Until the present day, there have never been any serious political plans to add an (intermediate) layer of government between the municipalities and central government. As a result, intermunicipal cooperation has had an important role in the Finnish way of organising and providing public services. The most common form of intermunicipal cooperation in Finland is the joint municipal authority. Joint authorities are set up by two or more municipalities, mainly for tasks that require a larger population base than small municipalities have alone. Membership of a joint authority is voluntary, except for hospital services and regional councils, where each municipality is obliged by law to belong to a joint authority. Joint authorities are financed solely by their member municipalities. The joint authorities are run by a council whose members are nominated by the member municipalities. Joint authorities have helped the municipalities solve the problems of benefit spillovers, economies of scale and equity of service provision. This situation is about to change

as the government plans to transfer social and health services to a new intermediate level of government (regions).

8.2.2. Municipal services in Finland¹⁵³

8.2.2.1 Health services

Primary healthcare

At present, primary healthcare services are provided by health centres, which are operated either by single municipalities or by joint municipal authorities. In 2010 there were 194 health centres¹⁵⁴: 130 of these were operated by single municipalities, 38 were run by joint municipal authorities and 26 by a “host municipal” arrangement. Each member municipality pays for its agreed share of the costs, mostly according to service use by its residents. In the host municipality situation, one municipality arranges healthcare for two or more municipalities.

Compared to primary healthcare arrangements in most other countries, the Finnish health centres provide a large variety of services. In addition to basic primary care, the health centres also offer maternal and child healthcare, cancer screening services, community nursing, school healthcare, dental care, physiotherapy and occupational healthcare. They also usually have inpatient departments, with typically 30–60 beds, which are occupied mainly by elderly and chronically ill patients.

In addition to municipal healthcare, there is an occupational health service system financed by employers and the State, which is responsible for much of the healthcare of the workforce.

Contracting out in primary healthcare to private producers has been a growing phenomenon. In some small municipalities there is no alternative but to contract out because of difficulties in attracting doctors to permanent (or even temporary) positions in municipal health centres.

¹⁵³ This section closely follows the description provided in Moisio et al. (2010).

¹⁵⁴ A health centre may have one or more healthcare stations. In rural municipalities health services have typically been concentrated in one health station, but in big cities there are a number of health stations and other healthcare facilities.

Hospitals

Finland is divided into 20 hospital districts that run the hospitals in their area. Every municipality is required by law to be a member of a joint municipal authority administering a hospital district. These public hospitals run by joint municipal authorities provide about 95% of all specialist medical care. The rest is provided by the private sector, and this is mostly concentrated in the biggest cities.

8.2.2.2 Social services

Social and welfare services consist of care for the elderly, child day care, care for the disabled, child protection and income support for the poor.

Care for the elderly is a combination of home-help services, various support services, an informal care allowance, housing services and institutional care. Client fees cover about a tenth of the cost of the services. One of the aims of the central government has been to reduce institutional care. For municipalities, institutional care is very expensive even though the user fee for long-term institutional care is 85% of the clients' incomes, which lowers the net expenditure.

Municipalities also provide child care services. Finland was one of the first Nordic countries to introduce public child care provision (the Act on Child Day Care of 1973). By law, all children under school age are entitled to municipal day care when maternity leave ends. As an alternative, local authorities can pay a home-care allowance to families with children under three years who are looked after at home or a private care allowance for children under school age who are looked after in private day care centres. Two thirds of day-care places are in day-care centres. Children's day care is subject to a fee. The fee charged is determined by the family's income. Income from such fees covers approximately 15% of the overall cost of the services. Before starting school, six-year-olds have to attend pre-school in day care centres or at comprehensive schools.

It is worth mentioning that many local governments use contracting out and competitive tendering for some social and welfare services (especially in services such as care for the elderly and the handicapped).

Municipalities also provide income support for persons who cannot earn a reasonable living. This income support is based on a case evaluation by the municipal authorities. Municipalities receive a 50% reimbursement from central government to finance income support expenditures.

8.2.2.3 Educational services

Basic education

The Finnish school system is based on universal and uniform 9-year compulsory basic education provided by comprehensive schools. Most comprehensive schools are municipal institutions but there are also a few privately run comprehensive schools. Municipal schools are financed by municipalities with a state grant (non-earmarked block grant). Private schools get their funding directly from central government. All education is free for pupils.

Finnish basic education ranks among the top 12 countries in international comparisons of learning performance (OECD PISA, 2013). International comparisons have also shown that the costs of education per pupil are close to the average of the OECD countries (Moisio et al., 2010). One reason for the good results may be local self-government, which has made it possible to organise basic education so that the needs of pupils in all age groups are met (Blöchliger et al 2012). Also, the high pedagogical standards for teachers and the relatively uniform quality of schools, regardless of location, may explain the good performance. Teachers with a permanent position are municipal civil servants who must have a Master's level academic degree. Teachers must also pass practical training in the field before obtaining their qualification.

Upper secondary education

After completing basic education, pupils can apply for upper secondary education through a joint application system independent of where they live. Upper secondary education is divided into general upper secondary education and work-oriented vocational upper secondary education (the so-called dual model of upper secondary schooling). Both routes of education provide eligibility for higher education such as polytechnic and university studies. The majority of upper secondary and vocational education is provided by municipalities or joint municipal authorities. Vocational education, in particular, is often provided by joint municipal au-

thorities. The responsibility for financing is shared by the central and local government.

Polytechnics

Polytechnics provide professionally oriented higher education that prepares students for professional expert work and research. Polytechnics are involved in research and development based on regional development needs. Most polytechnics are municipal institutions or are owned by joint municipal authorities. There are also some private providers.

Adult education

Adult education services include, for example, open higher education, language proficiency certificates, personnel training, vocational further education, training for immigrants and general upper secondary education. Adult education is provided by adult education centres, located in nearly all municipalities, and by summer universities. Adult education centres are mainly run by municipalities or joint municipal authorities.

8.2.2.4 Other municipal services

Libraries and cultural services

Library services are available in every municipality and they are free of charge to users. About 80% of residents use library services. Local authorities also run art institutions and museums, provide art education, support art and cultural heritage and provide opportunities for cultural and artistic activities. There are also municipally run theatres and symphony orchestras.

Sports, leisure and youth policy

There are around 30,000 different sports facilities in Finland, the majority of which are owned and maintained by municipalities. Non-profit sports clubs often operate the sports activities and the services are usually subject to a fee. Youth facilities, camps and other leisure activities, workshops for those requiring special support, and various groups and channels for influence and participation are available for the young.

Land planning, infrastructure and housing

Municipalities are responsible for land use planning in their area. Local policies in land use affect settlement structures, the location of busi-

nesses, residential areas and transportation. Municipalities are also responsible for building supervision; they grant environmental permits, monitor the state of the environment and control functions affecting the state of the environment.

Municipalities are responsible for road maintenance and the maintenance of parks and outdoor areas. They also organise public transport in their own area. Municipalities are responsible for municipal waste management in their areas.

Municipal utilities owned by the municipalities and, more rarely, private corporations are responsible for the water supply and sewage systems. Almost 90% of the population has access to a municipal water supply. Residents pay water and sewage charges which cover the costs. In many areas, municipalities are responsible for the distribution of electricity and district heating. The biggest cities may have their own energy generation companies.

8.2.3. The main challenges to the local public sector in Finland and recent attempts to solve the problems

The Finnish economy is struggling to recover from the economic slump it entered in 2009. Public finances have remained in deficit for six consecutive years now, and in 2014 the Finnish general government deficit breached 3% of GDP reference value. The present weakness of the economy and structural problems are the main problems in the Finnish economy. As economic growth is expected to remain sluggish for the next few years, economic growth alone cannot correct the imbalance in public finances or reverse the debt-to-GDP ratio. This situation emphasizes the need for structural reforms in the labour market and the public sector.

For local government, the gloomy prospects for the economy mean that the starting point for preparing for a future ageing population is worse than was thought a few years ago. Therefore, the need to make progress in the preparation of structural reforms in the local government sector is more important than ever.

The government is therefore currently preparing several reforms affecting local government. The most important reforms at the moment are

the healthcare reform (which the previous government failed to accomplish) and reform of local government tasks and regulation. The already completed reforms include a revision of the Local Government Act, the intergovernmental grant system reform and a new system of fiscal guidance of municipal finances by the central government. Some of the reforms that were previously on the agenda are now on hold or have been postponed: the metropolitan governance reform and municipal merger reform are not high on the present government's agenda. In the following, two recent failed reform attempts are discussed.

8.2.3.1 Municipal merger reform

Already in 2005, the government launched its PARAS reform, saying that in order to be able to provide health services, the provider (single municipality or joint municipal authority) should have a population base of at least 20,000 inhabitants. Since in 2010 only a quarter of municipal health providers had a population base of more than 20,000, this threshold meant a fairly radical reform. The reform gave municipalities some room for manoeuvre as they were free to decide whether to achieve the minimum population base through municipal mergers or enhanced cooperation. As a result, a total of 67 new cooperative areas had been started in healthcare and social services by the end of 2013. The PARAS reform also promoted voluntary municipal mergers through special merger grants. The minimum population requirement and merger grants jointly resulted in several mergers so that, by the end of 2012, the number of municipalities was reduced by 96 municipalities.

The following government (in office between 2011 and 2015) had an even more ambitious plan for municipal mergers. The government's aim was to reduce the number of municipalities from 320 to about 100. However, the reform has not been successful as only a handful of mergers have been agreed. The reform faced strong resistance from the municipal sector, and the process slowed down considerably during the municipal hearing process. Also, the decision to bundle municipal reform with social and healthcare service reform proved to be a mistake¹⁵⁵. The political quarrelling between the main parties was also one reason behind the failed reform attempt. When it became clear that the municipal sector resisted the large-scale merger reform, the government

¹⁵⁵ This is despite the positive experiences from other countries supporting the idea of bundling reforms, see e.g. Blöchliger and Vammalle (2012).

proposed that only municipalities with a population of 50,000 or above would be entitled to provide advanced social and healthcare services. But the problem with this plan was that the smallest municipalities would have been obliged to pay to the “host municipalities” for the services used by their residents, without being able to participate in the decision-making. This situation was considered to be against the constitutional autonomy principle and the Constitutional Law Committee of the Parliament rejected this plan. A third plan was then announced. Social and health services would be transferred from municipalities to five regional providers, who would get their funding from the central government and from the municipalities. This proposal meant in practice that the municipal reform was abandoned.

8.2.3.2 Healthcare and social services reform

The reform was launched by the government in 2011. In the first phase, as mentioned above, the healthcare reform was bundled with the municipal merger reform. The idea was to create very big municipalities that would be strong enough to provide most social and health services without the need for municipal cooperation. In this model only the most advanced and costly healthcare would be concentrated in a few national units. But when it became clear that the municipal merger reform would not advance as planned, the plan was altered so that the provision of key social and health services was to be handed over to the so-called “host municipalities”. The host municipalities would have been municipalities with over 50,000 inhabitants and they would have provided most health and social services for their smaller neighbouring municipalities. But, as mentioned above, this plan was found to suffer from constitutional problems.

The third plan was then presented. In this case, a model of five regional providers (organised as joint municipal authorities) was proposed. The aim of the proposal was first and foremost to utilise economies of scale by concentrating health and social services in five big regions. The problem of the plan was that, due to political disputes, provision and production were to be separated. So, in addition to the five regions, the plan was also to have 19 smaller joint municipal authorities that would be in charge of production of social and healthcare services. These 19 joint authorities would receive their funding from the five regions. The funding of the regions was to be organised through municipalities, who would

still collect tax revenues and receive central government grants. Municipalities would have paid their share of the social service and healthcare expenditures to the region, and the regions would then “buy” the services from the producer units. Moreover, the Constitutional Law Committee of the Parliament eventually (in March 2015) rejected this plan as being unconstitutional. This was because the Committee saw that the decision-making power of single municipalities was too small. This decision meant that the preparation of social services and healthcare reform was postponed to the next Parliament and the next government. The current government is preparing a new approach to reforming the social and healthcare system. As of March 2016, planning of the reform is still ongoing. At the moment, however, it seems that a new intermediate tier between central and municipal government levels will be formed and that the new counties will be in charge of social and health services, perhaps already from 2018.

8.3. Future of decentralisation in Finland: discussion

8.3.1. A trend reversed: tightening fiscal rules and loosening regulation of local public services?

There is a rich literature on the effects of fiscal rules targeted at subnational government (see e.g. Borge and Hopland 2014, Blöchliger 2013, Sutherland et al. 2006, Dafflon 2002, Bohn and Inman 1996). Although a detailed summary of this literature is beyond the scope of this paper, some findings can be presented regarding the policy aspects. The main message is perhaps that fiscal rules can be an effective way to guide subnational government, but implementation is case-specific. Moreover, fiscal rules cannot replace well-functioning subnational government. Nor can fiscal rules work well if there is no commitment to obey the rules at the local level. At central level, the commitment to sanctions and no bailout seems crucial. If there are strong enough incentives for local politicians to follow fiscally responsible policy and/or if financial markets can have a role in monitoring and sanctioning subnational government, there should be less need for strong fiscal rules set by central government.

As for the normative regulation aspect, there is also a lot of case-specific research, but less so from an overall policy design point of view. It seems to be largely an empirical question whether, for example, regula-

tion of staff qualifications is useful or harmful. One way is to classify local government tasks according to fiscal federalism theory and draw policy conclusions from that aspect. If, for example, central government regulates services that are clearly in the category of “local public goods”, it should be safe to say that this kind of regulation can be abandoned. The situation in the case of redistributive tasks is less clear. Especially in the Nordic countries, but also elsewhere, central government has delegated merit goods to local government. To safeguard equity aspects and coordination, there is then clearly a need for some kinds of norms and regulations. The hard empirical question is then what regulation is beneficial and what is “red tape”?

Traditionally, the Finnish municipal sector has only been subject to mild fiscal regulation but rather detailed service regulation. This may change, however, because in 2015 the central government introduced a new system to guide municipal finances and because the government is preparing measures to reduce municipal tasks and normative regulation. This section briefly describes these two policy changes.

8.3.1.1 Fiscal rule change explained

An important motivation for tightening the fiscal rules for subnational government in Finland was the introduction of the European Fiscal Compact. In particular, the need to be able to guide the public sector as a whole has driven the recent reforms. Until 2015, the fiscal rules that regulated the municipal sector were modest. There were no constraints on borrowing, tax revenues (except for property tax) or spending. The budget balance rule was weak because it required the municipalities to balance their budget within a four-year period, but there were no sanctions if the municipality failed to do so. Moreover, the rules focused only on municipal accounts. This was problematic from the guidance aspect because the borrowing of joint municipal authorities and municipally owned companies was largely ignored by these rules. It could be that some municipalities had substantial guarantee responsibilities in some companies or joint municipal authorities, and these would not have been taken into account when measuring the fiscal health of the municipalities.

Another major disadvantage in the Finnish system prior to 2015 was that the line ministries were able to assign new tasks to municipalities

without taking into account the full cost of these new tasks. They only needed to make sure that the new task would fit the central government spending limits. This situation was possible because the grant for new tasks was only 50% and the municipalities had to cover the rest of the expenditure from their own revenues.

Therefore, the government prepared the “local government finances programme” as part of the general government fiscal plan. The new local government finances programme replaced the previous Basic Services Programme and Basic Services Budget. In the new system the government will set (yearly) a balance target for local government finances for the next four years, and decide at the same time on the measures required to achieve the target. The balance target is set for the medium term (4 years) and measured in terms of municipal sector “net lending”.

The government will also set a local government spending limit, which constrains central government so that there is a euro limit (for each line ministry) for the change in expenditure accruing to municipalities from central government measures during the parliamentary term. In addition, the central government grant for new municipal tasks has been 100% of the expenditure (not at the municipal level but at the macro level) since 2015.

Furthermore, the government also altered the fiscal rules applied to the municipalities. First, the rules now apply to the whole “municipal enterprise”, taking into account the companies that the municipalities own or have liabilities in. Second, the joint municipal authorities are now regulated by the fiscal rules just like municipalities. Third, the requirement to balance budgets within four years is now binding in the sense that if the municipality fails to balance its budget, it will be closely supervised by central government (a so-called crisis municipality procedure). Fourth, the criteria for the “crisis municipality” procedure were altered. If a “crisis municipality” fails to comply with the recommendations of the external committee, there is the possibility of a forced merger at the end of the process.¹⁵⁶

¹⁵⁶ It is still unclear whether failure to follow the recommendations/programme of the external experts will be enough to trigger a forced merger. The law says that if the municipality is clearly not economically viable so that it is unable to provide services to

8.3.1.2 Plans to reduce the municipal tasks and ease regulatory burden

As described in section 2, there are currently over 500 municipal tasks that are regulated with nearly 1000 norms, most of which have a legal status. The present government has started programmes aiming to reduce the number of municipal tasks as well as to ease the regulation concerning municipal tasks. These programmes are still at an early stage, so this section gives just a brief overview of the situation. The aim, however, is to identify norms which are unnecessary or which act as a barrier to improved efficiency. So far, the only database that can be used for this kind of work is the Ministry of Finance questionnaire, which was sent to line ministries in 2013 asking several questions about the tasks and norms/regulations concerning the tasks. At the moment, there is another ongoing questionnaire that has been sent to municipalities, asking the view of municipal decision-makers on the present tasks and regulation.

For the moment, the only available data is the Ministry of Finance report and the data collected for preparing it¹⁵⁷. Using a simple approach to classify the tasks into four groups, we can have an idea of the present state of the normative regulation: a) services with spillover effects, b) local public goods, c) services with a redistributive effect, and d) private goods.

A preliminary classification of the 167 social and health services that are listed in the database shows that over half of the tasks have some spillover effects (see also Saastamoinen et al, 2016). Only nine tasks can be categorised as local public goods and 13 tasks have been classified as having redistributive effects. There are no services in this group that have been categorised as private goods. In addition, there are quite a few tasks that are hard to categorise. Using this approach, one could immediately say that the nine local public goods could be removed from the regulation because these can be decided solely by the municipal councils. For the rest, more work needs to be done because with redistributive tasks and tasks with spillovers at least some regulation may be needed to meet the targets set for the services.

its residents, it can be forced to merge. This decision would not be made by a single ministry but by the cabinet that is led by the prime minister.

¹⁵⁷ The data for this study was received from the Ministry of Finance. Previously, the data has been described by Ministry of Finance (2010).

Table 2. Municipal tasks regulated by the Ministry of Health and Social Affairs (n=167)

	Number of tasks	Share, %
Services with spillover effects	91	54.49
Local public goods	9	5.39
Redistributive services	13	7.78
Private goods	0	0.00
Unclear (at the moment)	54	16.77

Another way to look at the material is to classify the norms. Using the data concerning the regulation on municipal social and health services, we see that the bulk of regulation is difficult to categorise in any specific category that we have created so far. The largest groups of norms are targeted at cooperation with other officials, reporting, planning and staff qualifications.

Table 3. The norms/regulations under the responsibility of the Ministry of Health and Social Affairs (n=525)

	Ministry of Health and Social Affairs regulation	
	Number of norms	Share, %
a) Number of employees	5	1 %
b) Group size (of service users)	4	1 %
c) Staff qualifications	34	6 %
d) Staff education structure	5	1 %
e) Availability of service within time limit	18	3 %
f) Obligation to make plan	35	7 %
g) Obligation to cooperate with customers	26	5 %
h) Obligation to cooperate with other officials	50	10 %
i) Reporting obligation	37	7 %
j) Other	<u>311</u>	<u>59 %</u>
Total	525	100 %

8.4. Summary and discussion

This paper has described the recent developments in fiscal and normative regulation of the Finnish subnational government. There is a clear policy to increase fiscal rules and to loosen normative regulation. It is too early yet to conclude what this means for decentralisation in Fin-

land. Local self-government is highly valued in Finland, but the increasing need to coordinate public finances as a whole may diminish the role of local decision-making. If this development reduces people's interest and participation in local affairs, it will surely be a defeat not just for local autonomy but for Finnish society in general.

On the other hand, the ongoing reform of social and health services may ease the pressure on municipalities and preserve the functioning of local democracy. Also programmes that aim to reduce over-regulation of municipal services are promising. Of course, as in many other cases "the devil is in the detail", as there seems to be no mechanical or formal way to alter the amount of regulation in the public sector. Cutting public service regulation should be based on careful analysis that considers both the costs and benefits of regulation. This is no easy task, but one that is surely worth trying.

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Chapter 9

Financing education by sub-national governments in Poland

Paweł Swianiewicz¹⁵⁸

9.1. Introduction - local governments in Poland and their role in delivery of social services

Since 1998, regionalisation reform Polish sub-national government system consists of three tiers:

- 16 regions
- 314 counties plus 66 cities of county status (which perform functions of both municipal and county tiers)
- 2480 municipalities

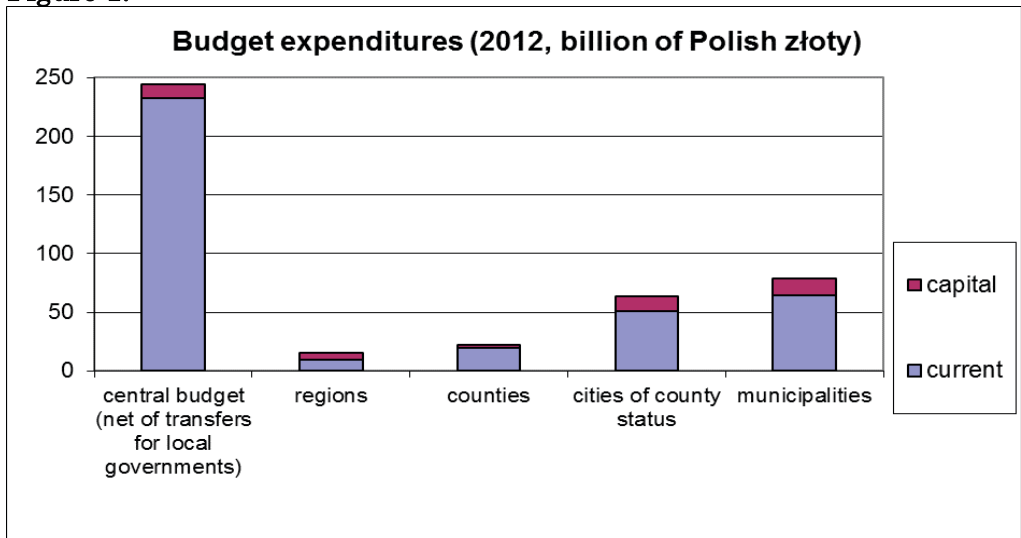
Altogether, Polish sub-national governments spend over 14 per cent of annual GDP, which is the highest figure among all countries of Central and Eastern Europe. If Poland is the most decentralised country of that region of Europe (at least in terms of functional dimension of central-local relations), it is – as we will see in the further parts of the paper – to a large degree due to an extensive role in provision of social services. Municipal tier is by far the most powerful among all three levels of sub-central authorities. It concerns both functions (which is reflected by the high share of the total budget spending – see figure 1) and finance – municipalities to a larger extent than counties or regions are financed by revenues from own sources, and the municipal tier is the only sub-national level enjoying limited discretion to set its own tax policies. Regions are very influential political actors¹⁵⁹, but their role in service delivery and their financial autonomy is very limited.

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¹⁵⁹ Although several authors drew attention to the fact that this significance originates mainly from the role of regional governments in managing funds allocated within EU regional policies. Regions have their own Regional Operating Programmes and enjoy a

The role of local governments in delivery of social services has been evolving throughout 25 years of operation of municipalities (since 1990) and over 15 years of county and regional governments (since 1999). Since the very beginning of decentralisation reforms, municipalities became responsible for pre-school education, a wide range of social care functions (including payments of financial aid to the poor who are not eligible to receive unemployment benefits) and took over management of several local culture as well as sport and leisure facilities. The most important milestones in changing responsibilities in the area of social services have included:

Figure 1.



- 1994 – extending functions of over 40 of the largest cities (with populations above 100,000) who became responsible for running primary and secondary schools, local ambulatories and hospitals and stationary care services for disabled and elderly people.
- 1996 – taking over responsibility for primary schools by all municipalities (in the period from 1991-1996 taking over schools

high degree of discretion in allocation decisions related to their implementation. In that sense, their role is temporary only. After the EU structural funds are exhausted, they may turn again into not very influential “ugly ducklings”, which would replicate the model we know from 1998-2004, before their role in EU regional policy had begun (see Swianiewicz 2014, also Hausner 2013).

was voluntary, and in 1995, schools were run by local governments in ca. every fifth municipality).

- 1997 – reform in national housing policy created the system of housing benefits that are administered and paid (based on uniform, national criteria) by municipal governments.
- 1998/1999 – county and regional reform allocating significant social service functions to counties, which became responsible for secondary education, labour policies, taking care of the homeless and handicapped and several facilities related to culture. But at the same time, the responsibility for healthcare has shrunk in big cities since a separate system of national health insurance run by independent institutions has been built. From 1999 onward, county and regional governments have been responsible for the management of county and regional healthcare facilities, they finance relevant investments, they appoint directors of their hospitals, but current financing comes directly from the National Health Fund, which has no connection with sub-national budgets.

In addition to those milestones, there have been numerous detail changes in the scope of functions and local autonomy of decision making, sometimes going in the direction of stricter central level control (through strict norms and standards) and sometimes leading towards more discretion of local policies.

This changing role is reflected by the fluctuations in the role of social services in sub-national spending, which are presented in figures 2 and 3.

Figure 2

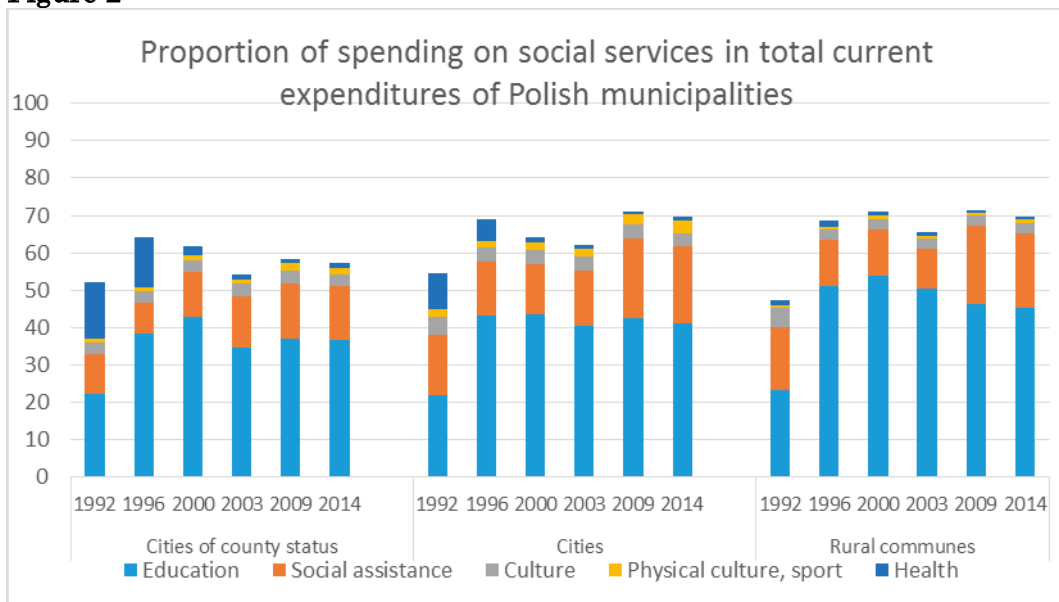
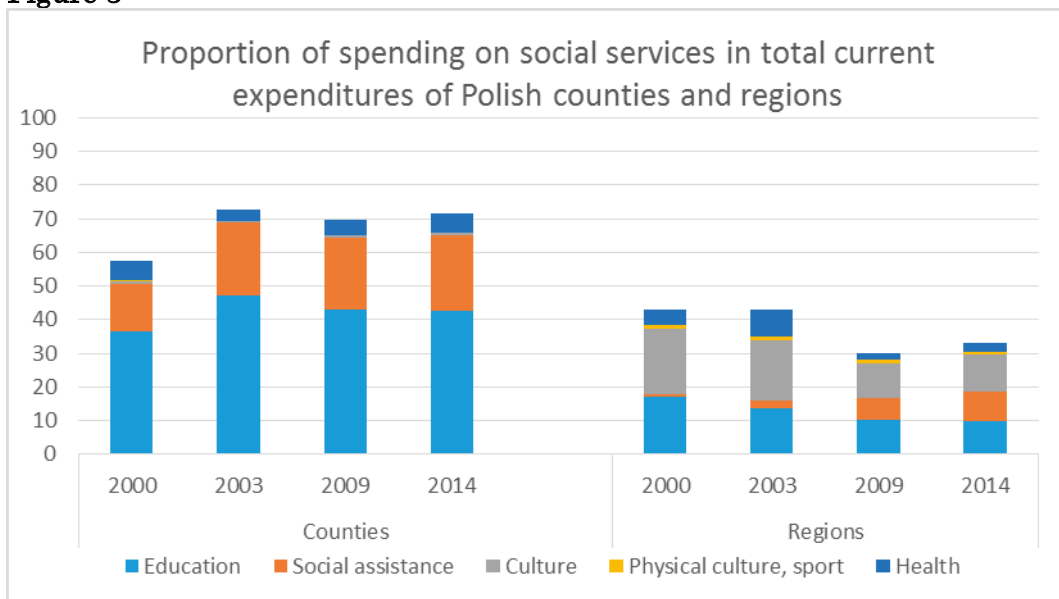


Figure 3



As we see in the figures, both municipalities and counties spend close to 70% of their operating budgets on social services. The proportion is

slightly lower (ca. 60%) in the largest cities, which have more extensive infrastructure responsibilities and considerable spending related to public transport systems. Social services are relatively unimportant for regions which are predominantly focused on economic development strategies. The proportion of spending on social services sharply increased in 1996, after taking over responsibility for primary schools. Then it slightly decreased due to increasing spending on maintenance of technical infrastructure. But, in the second half of previous decade, social services gained importance in local government spending again. The latter trend was connected to two phenomena: (i) more specific central regulations on standards of social services requiring more spending, (ii) pushing technical infrastructure outside of the budget (due to privatisation, establishing semi-independent municipal public utility companies, etc.) – the process impacted by New Public Management, which is still a dominant “religion” of numerous Polish politicians and experts on local public services.

It is also clear from the figures that education is by far the most important social function, at least in terms of the resources involved. It constitutes almost half of operating spending in rural municipalities, over 40% in counties and cities and well over 1/3 of total current expenditures in the largest cities. That justifies the selection of education for the detail presentation in following sections of this article.

As we all know, social services do not fit into typical functions prescribed for decentralisation by fiscal federalism theory. What were the reasons and arguments of reformers who opted for allocation of broad scope of social functions to the local level? The question has never been asked in the public debate in an open way. But from the tune of discussions on specific issues and decentralisation discourse, one may extract two major arguments. First, that local governments are closer to the issues which are to be dealt with social policies and they know specific local needs better, so they can make more effective policy choices. Second, the general belief that local governments are more efficient in their spending, so they may achieve more (than agencies of the central government) with the same amount of financial resources. During some periods and among certain experts and politicians, that belief has had the status of an unofficial decentralisation ideology.

But the real picture is more complex. In practice the two popular beliefs described above are in conflict with the tendency of the central level bureaucracy (and a large share of national politicians) to strictly regulate the functions to be delivered by local governments. If there is an unsolved issue related to the level of the service, the simplest solution seems to be to pass the law dictating to local governments how to deal with the issue. But if we dictate them what to do, how may the potential benefits of decentralisation materialise? How may local governments utilise their local knowledge and be more efficient in resource spending? This is reminiscent of the classic dilemma of delegation of power from politicians to bureaucrats, which has been extensively discussed by political and administration theories (see e.g. Huber & Shipan 2009). To apply that theory one needs only to replace bureaucrats by local governments. The central level can allow substantial discretion to local governments, but at the risk that local governments will use their expertise to deliver functions in a way which is not to the like of central level politicians (or ministries). But if the centre tries to counter this risk by giving low discretion to the local level, then the local knowledge is wasted, which damages the potential advantages of decentralisation. The practice provides many examples of the tension between the two tendencies, although recent years provide more evidences of the “control option” slowly prevailing. In more and more instances, local governments become agents implementing national priorities, rather than autonomous actors formulating and implementing their own policies. This situation in turn undermines the rationale behind allocating social services to the local level. The incoherency of the two tendencies may be explained by the fact, that there were different people (experts) who were the most influential at different stages of the reform process. Ideologists of decentralisation and local autonomy had more to say during a period when allocation of functions and the whole architecture of inter-governmental system was constructed. But later on, politicians and bureaucrats with a more centralist attitude played larger roles in filling the frame with detail regulations and everyday practices.

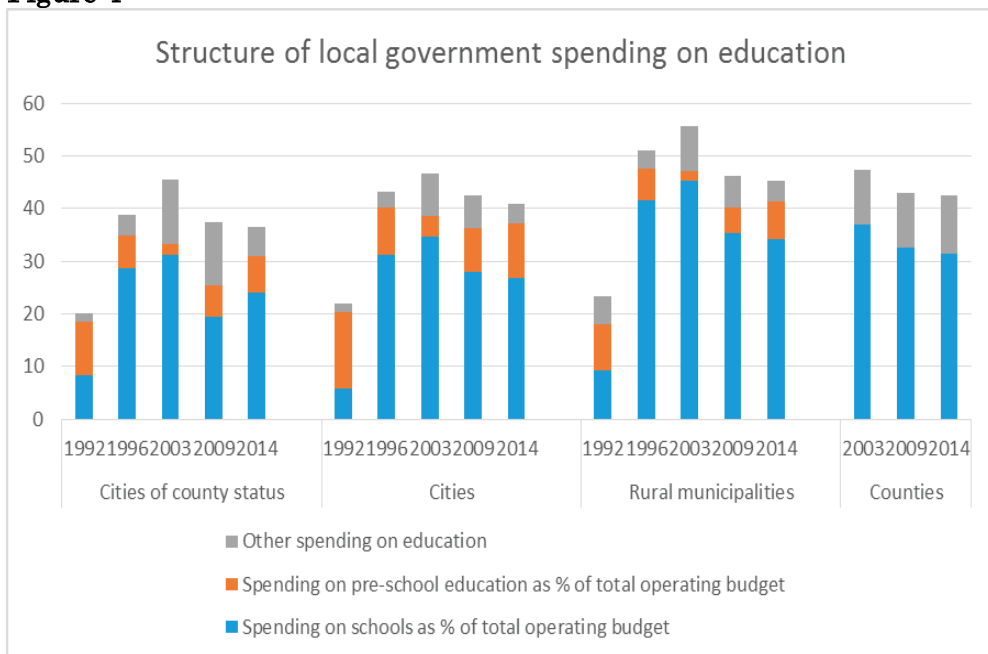
9.2. Local government responsibility for education

As it was mentioned in the introductory section, the crucial turning point for decentralisation of education was 1996, when responsibility for operating primary schools was passed to municipal governments. Initially, the authors of local government reform planned to decentralise schools immediately in 1990. But that plan was changed after vivid pro-

tests of teachers' trade unions, who considered jobs for the newly created and unknown local government less prestigious and more unsecure than working for the central government (Regulski 2003). The decentralisation of schools was delayed to 1994, and in 1993, the new Prime Minister made the decision to further delay till 1996. In the meantime, it became clear that contrary to the fears of teachers, local governments have not treated education as "spending of secondary importance". Just the opposite, most of them selected schools among their strategic priority and devoted a substantial part of their own resources to improve quality of education.

Responsibility for education services is divided among tiers of government. Pre-school education is a domain of municipal governments, as is primary school education (which itself is divided into two stages – 6 years plus 3 years). It means that education until 15 years of age is delivered by municipal governments. Counties are responsible for secondary school, which usually takes three years. The scope of local responsibilities is wide – it includes not only maintenance of buildings and support staff, but also decisions on the school network (which is politically very sensitive, especially in rural areas), appointing of school headmasters and paying teachers' salaries. The scope of local discretion in relation to those individual functions has been fluctuating, and it is discussed in the following parts of this paper.

Figure 4



As it is clear from the figure 4, schools constitute the major part of spending on education, although their share in total operating budgets of local governments has been gradually decreasing over last decade or so. Spending on pre-school education is much lower, but the trend of changes has been almost opposite to that concerning schools. Kindergartens were consuming most educational spending in early 1990, before the running of schools was taken over by local governments. But later, in the second part of the last decade of the 20th century, many pre-school facilities were closed, attendance rate of children was very low (see discussion in further sections of the paper) and the change was reflected in the spending structure. The trend has reversed during the recent decade, when the discourse related to pre-school education has changed and government policy has started to promote higher targets of attendance rate. In rural areas (where the network of kindergartens was particularly poor) the process was also supported by the EU funds available for pre-school education, absorbed both by local governments and local as well as nation-wide non-governmental organisations.

9.3. Financing school education

9.3.1. Education grant

To discuss financing of schools by local governments in Poland, we need to discuss both the revenue and expenditure side.

Current spending on schools is supposed to be secured by the “education grant”, which is the major part of the general purpose grant for local governments. An education grant represents a hybrid type of grant, which may be located between two classic types of transfers: general purpose and specific purpose. The calculation of the amount is based on estimation of needs related to school maintenance (as explained below), and the received amounts are supposed to be spent on teachers’ salaries and other spending related to the current functioning of schools. But the expenditure side of the received amounts is neither restricted nor controlled by the central government. Therefore, it is fully legal to spend part of the education grant on any other service provided by local government (although in practice – as we will see later on – such situations are rare). Such hybrid types of transfers are more and more common in the inter-governmental arrangements in several countries (Bahl 2010, Boerboom and Huigsloot 2010). The underlying reason behind an education grant is securing minimal standards of education in every local government, in spite of its fiscal affluence.

The general rules of distribution of this part of the grant are set in the Law on Local Government Revenues, but the responsibility for precise allocation falls to the Minister of Education. The Law decides only that the criteria of allocation should include the number of pupils attending schools in a given locality (which is not necessarily equal to number of pupils living there), types of schools (primary, secondary, vocational) and the number as well as the level of qualification of teachers. But the precise formula of allocation is decided on an annual basis by the Ministry of Education, after extensive discussions in the Joint Committee of Central and Local Governments (where major local government associations represent interests of the local communities).

The idea of the educational grant is usually not contested¹⁶⁰, but the amount devoted to it as well as the precise allocation formula are subjects of vigorous debates. The most controversial issue is the total amount of the transfer – local governments often complain that it is not sufficient and they need to supplement it with revenues from other sources, which indirectly reduce their capacity to deliver other services. But the construction of the formula is also related to a few more general controversial issues:

- The formula includes several coefficients (weights), so effectively the allocation is per “weighted pupil”. Some of the weights only marginally affect to the final allocation. The whole system becomes non-transparent and most of beneficiaries (including local government treasurers) have difficulties understanding the rationale behind it.
- The formula is also instable, it changes every year (even if changes are usually of marginal meaning for the final allocation of resources) and it is often the result of deals in the Joint Committee, where particular local government associations try to influence it in a way which would be beneficial for their members. By far the most important coefficient is a weight for rural schools – and it provides a good illustration of that instability. Its precise value has been changing several times over the last dozen years or so¹⁶¹.
- The dominant part of the costs (ca. 70%) is related to the teachers’ salaries, but local governments have no influence on their level. For example, local government associations are not directly involved in the negotiations of salaries with teachers’ trade unions, and the decisions are made entirely on a central government level. Moreover, due to several limitations arising from the special Teacher’s Charter (being a separate law), local authorities have very little influence on employment policy and the for-

¹⁶⁰ With few exceptions, such as a study by former vice-Minister of Finance W. Misiąg with M. Tomalak (2010) in which they proposed to strengthen the own revenue base and equalisation mechanism and to liquidate the education grant at the same time. (Schools might be financed by own revenues and equalisation grant). But that radical though interesting concept has not met with substantial interest from either local governments or central government administration.

¹⁶¹ Numerous examples of those changes as well as the extensive wider discussion of strengths and weaknesses of the formula may be found in: Levitas & Herczyński 2002, Herbst, Herczyński & Levitas 2009.

mal vocational grades of teachers on which their salaries are dependent.

- As it was mentioned above, the most important single element of the formula is the so called “rural school weight” (the weight of the pupil in rural schools has been fluctuating from 1.20 to 1.48). The general logic behind that coefficient is very clear. Local government either needs to organise very small schools in small villages or it has to organise transport of pupils to larger, more centrally located, schools. Both solutions are more costly than running the school in an urban environment. But is it much less clear why the same weight is applied to every rural school, regardless of its real location and socio-economic environment. Part of the schools which are formally rural are located in densely populated, rich suburbs of the largest cities, and there is no reason to offer special financial support to those schools. There are studies¹⁶² demonstrating that there are two relatively simple variables that reflect real variation of spending needs much better than the current “rural coefficient”: population density and dispersion of rural settlement structure. But it is difficult to understand the resistance of the Association of Rural Local Governments to change the system along those more precise measures¹⁶³. The present system leads to socially inefficient decisions such as the construction of a new school next to a newly developed housing estate, but in a place which is located just outside of the city limits (i.e. formally in the rural environment) in order to benefit from the higher education grant.
- In spite of the dilemmas discussed in the previous item, in 2015 the new coefficient for “small schools” was added to formula. On the one hand, the new weight is a support for maintenance of schools in small, often depopulating villages (such schools are not only educational institutions, but also local social and cultural centres). But on the other hand, the presence of that coefficient is against the fundamental rule of the grant allocation formula, which suggests that measures which can be influenced by local

¹⁶² The first general concept of such a system was formulated in Swianiewicz 2004, 2006. A very comprehensive, precise proposal of the formula was later developed by Herczyński and Siwińska-Gorzelał 2010.

¹⁶³ The resistance is easier to understand at the political economy level. A considerable proportion of members of the Board of the Association of Rural Local Governments has been mayors of suburban municipalities, which benefit from the current system.

government policies should not be part of the allocation formula. Such a situation may produce unwanted distortions of local policies and lead to the increase of the costs of the education system.

But contrary to what one may expect from the relatively unstable system, which is open to political bargains system, there has been no signs of using the education grant allocation formula in order to maximise partisan gains of the central government coalition. Perhaps the explanation can be found in the fact that the Polish local government system is the least partisan in Europe, with over 70% of mayors and similar proportion of municipal councillors candidating as non-partisan independents (Fallend et al. 2006).

As it was mentioned above, local governments often complain that the education grant is not sufficient to cover school costs. Indeed, the data analysis suggest that every year actual current spending on schools is substantially higher than the received grants¹⁶⁴. Indeed, in 2013 municipal governments spent 22.5% more on schools than the amounts received from the central government, and the gap seemed to increase during the recent years.

In practice, the formula works in a way which is more favourable for financing secondary education than primary schools (Herbst, Herczyński & Levitas 2009) and that explains why counties (which take care of secondary schools) contribute much lower own revenues to the school system. On a county level, the gap between the received grant and the actual current spending on schools was just 1.8%.

But there is also a second reason for the low contributions of county governments – they are much poorer than municipalities, so they have no “surplus money” which they could use, so they are forced to implement more severe cuts in their education budgets. It is very difficult to assess how much of those additional funds involved originate from under-estimation of needs by the education grant and how much are a result of extra spending (such as additional equipment, additional classes

¹⁶⁴ The precise calculation of the deficit is not an easy task, and estimations of various authors differ. In this paper we take into account current spending on education – spending on pre-school education (which is not supposed to be covered by education grant) – received education grant – received various specific grants for schools.

of foreign languages, sometimes also additional special benefits paid to the teachers) allocated by local governments who could afford those extra services. But of course, in the public debates every single penny spent from own resources is presented by local government associations as proof of under-financing of schools by the state. But, it is also true that spending on schools is very high in the ranking of political priorities of most local governments, and several municipalities decided to devote substantial resources to increase the level of locally provided services, even if it creates the potential danger of free-riding pupils from neighbouring municipalities.

Allocating extra money for education is the reality of most local governments, but not all. There is also a shrinking minority which “benefits from the education grant” (i.e. spends less on the schools than what is received from the state). In the 1990s, that group was relatively large, e.g. in 1994 – 17% of all local governments who took over responsibility for primary schools. But the size of that group quickly shrunk at the end of 20th century, to just 1% in 2000 (see Swianiewicz 1996, Ćwikła 2001). More contemporary data is provided in table 1. It demonstrates that nowadays spending on schools less than what is received from the school grant is a very rare phenomenon. But it is slightly more frequent in big cities (cities of county status), who run not only primary but also secondary schools. And it is even more common among counties (who are responsible for secondary schools only). In 2014, only 69% of counties were subsidising schools from their own resources, while for 39% the education grant was providing at least sufficient funds.

Table 1. Proportion of municipal governments who spent on schools more than what was received from the central government in form of grants.

	2001	2004	2009	2013
<i>Cities of county status</i>	98%	100%	88%	80%
<i>Other cities</i>	98%	97%	97%	98%
<i>Rural municipalities</i>	95%	94%	95%	97%

9.3.2. Financing schools – spending side issues

Apart of the limitations related to teachers’ salaries and career development, there are also other regulations which directly or indirectly influence the spending side of school financing.

The first of these is the obligation of subsidising schools which are not operated by local governments (private, run by NGOs, church institutions etc.). Those schools have to be licensed by the central government administration, which is also responsible for their monitoring (with the very minor role of local government in the control and monitoring system). The recruitment process for private schools as well as the tuition payment schemes are freely decided by the owners, with almost no intervention of public authorities. In the 1990th the local government was obliged to transfer the amount calculated per pupil in those schools equal to at least half of the per pupil education grant received from the central budget. But later, the rule was changed and the education grant is treated as a kind of “education voucher”, which is the same regardless of the type of school pupil is attending. Consequently, local government is obliged to pay for every pupil in private school an amount equal to the received education grant divided by the number of pupils in the municipality. Obviously, several private schools also charge tuition to be paid by the parents of their pupils. Not surprisingly, many private schools are better off than schools operated by local governments. The group of schools run by other organisations is very much diversified – it includes both non-profit schools operated by NGOs in poor rural regions and private schools targeted at upper middle class families in affluent municipalities, e.g. in major cities or their suburbs. Surprisingly, the same level of public support for all of those schools is taken as granted, and it is not brought on the political agenda by any of political parties. Still, it should be remembered that non-local government schools are a small part of the education system in Poland – they compose 11% of the primary and 21% of all secondary schools, but in terms of the number of pupils they are attended by no more than ca. 5-6% of all children (see table 2).

Another important issue is related to free-riding. Since most local governments spend more on schools than what they receive in the form of education grants, it means that pupils attending schools in the city but living in another municipality are partially financed by local tax payers from the municipality where the school is located. There are no regulations related to reimbursement of those costs by the home municipality of a pupil, and in practice, voluntary reimbursement agreements are extremely rare. But more surprisingly, there is also no component of the equalisation system which would take into account this phenomenon.

Table 2. Ownership structure of schools in Poland (2013)

	Number of schools				Number of pupils			
	Local govt.	NGOs	Church	Private	Local govt.	NGOs	Church	Private
Primary schools	88.3%	7.7%	0.6%	3.4%	95.5%	2.4%	0.6%	1.5%
Upper primary (13-15 years old)	87.3%	6.6%	1.8%	4.4%	94.8%	2.2%	1.8%	2.2%
Comprehensive secondary (16-18 years old)	78.1%	8.3%	3.9%	9.6%	94.6%	1.5%	1.6%	2.3%

The reason is at least partially related to the fact that, officially, the education grant is fully sufficient to provide primary and secondary schools, and central government seems to assume that any spending above the grant level is a discretionary decision of local governments.

There are no statistics allowing the precise estimation of that free-riding phenomenon. Indirectly we may try to assess it comparing the number of children in given age cohorts with the number of pupils enrolled to local schools. Those estimations suggest that the issue is of marginal importance in primary schools, but it grows significantly at the secondary schools level. Regional and sub-regional urban centres surrounded by rural areas with no or very few secondary schools are especially vulnerable to that phenomenon (the phenomenon described by Herbst & Swianiewicz 2002 already on the basis of 2000 data). Although secondary schools are managed by county (not municipal) tier governments, but the concept of cities of county status, which administratively cuts them off from surrounding rural counties, makes the issue more visible and sometimes more painful for the budgets of those cities. Table 3 shows some extreme cases of free riding regional centres in 2013. This data indirectly proves that secondary schools in mid-size and large cities serve numerous pupils from the surrounding counties, which in turn confirms the free-ride phenomenon. Surprisingly, it is another issue which is almost absent in the public debates, and almost no local government raises it as an important burden to their budgets.

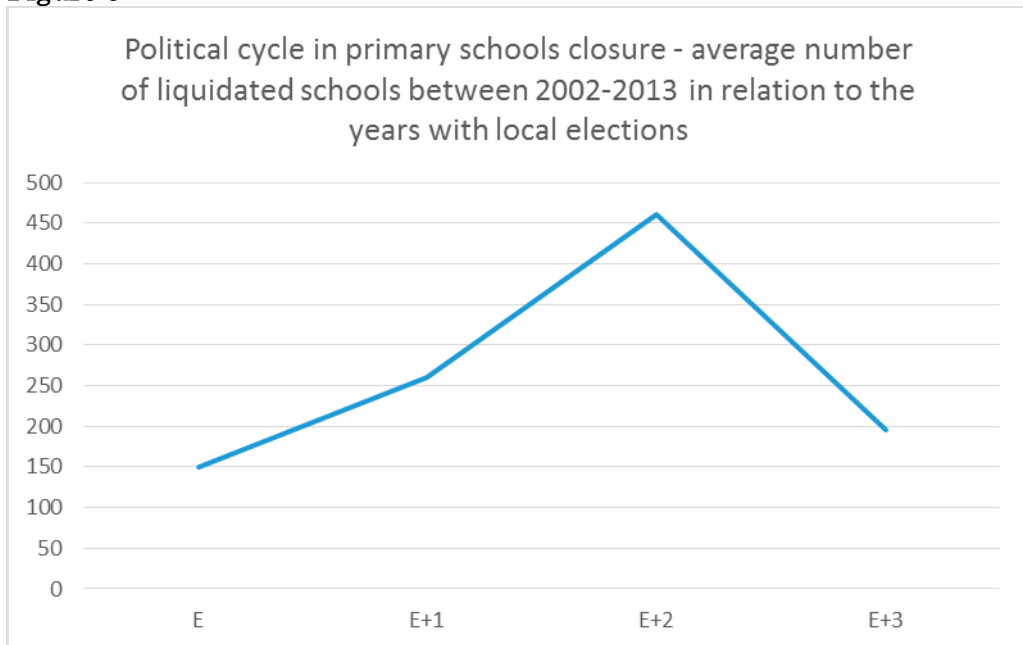
Table 3. Pupils in secondary schools in selected counties (2013)

County	Pupils in secondary school as % of residents 15-18 years old
Zamość city	241%
Zamojski (rural country around Zamość city)	6%
Siedlce city	184%
Siedlecki (rural country around Siedlce city)	0%
Konin city	202%
Koniński (rural country around Konin city)	11%

Source: Swianiewicz et. al. 2016.

The third important issue is related to decisions regarding school network. Especially rural local governments in depopulating areas often face the decision whether they want to keep very small (and expensive – in per pupil terms) schools in small villages, or if they want to organise one or two big schools and arrange school buses. The decision has an economic but even more so a political dimension. Liquidation of schools often raises protests from parents, even if it may be argued that the larger schools may provide better quality education and that transport of children is arranged efficiently. Until 2009, local governments were not fully independent in making those decisions – local school closure decisions required an approval of state education authorities. But starting from 2010, there is no such requirement, and the only limitation is of a political nature. The process of changes of school network has been comprehensively analysed by Herczyński and Sobotka (2014). They found that, just between 2007 and 2012, the number of primary schools dropped by 5.8% (although the number of pupils dropped – for demographic reasons – by 9.1% during the same period). They found evidence of the political cycle – the number of school closures is significantly lower in years of local elections (see fig. 5).

Figure 5



Note: E – year of local elections (2002, 2006, 2010)

Source: own calculations based on Herczyński & Sobotka 2014.

Even if most local governments treat spending on education as one of their major priorities, several regulations imposed by the central government are treated as unfair and unnecessary. In particular, it relates to regulations on working hours and binding rules of salaries written down in the Teacher’s Charter (discussed in section 3.1). Most central governments after 1990 have admitted that the Charter required some modifications, but they usually felt too weak against the teachers’ trade unions to implement any significant changes in the legislation. This issue also provides an interesting example of some local governments’ creativity in getting around inconvenient regulations. There are cases of municipalities which have encouraged the establishment of local NGOs taking over responsibility for schools from local governments. In such a case, local government still pays for the school, but Charters’ regulations on working hours are binding only for schools run by public authorities. Therefore, schools run by local NGOs “on behalf of local government” allow for more flexibility in the employment policy and allocation of spending. There has been one case of local government passing

all local schools to NGOs, therefore not running any own public schools any more. That case has been questioned in the case court against local government, but it seems that the current law does not exclude such innovative (and at the same time controversial) solutions.

9.4. Pre-school education - towards more regulation of local government policies

Hill et al. (2010: 75) suggest that child care policy for pre-school children may have four possible aims:

1. Care that will supplement (or even exceptionally replace) the care provided by parents
2. Care for children who are exceptionally vulnerable because of their health problems or disabilities
3. Educational activities for children that will prepare them for the compulsory education service
4. Care to facilitate labour market participation on the part of the parents.

In Poland, while local governments have been responsible for the pre-school care and education throughout the entire period since 1990 till nowadays, the perception of the main goals of that activity has been changing dramatically. During the 1990th the focus was entirely on the last of the above-mentioned issues – kindergartens were seen as necessary because parents had to do something with their children in order to go to their offices or factories. But later on, the focus has gradually become to change. Nowadays kindergartens are very much seen as part of the education system. And even the language of official documents has changed. We used to talk about “pre-school care”, the term which has been now banned from official documents and replaced by “pre-school education”. We used to talk about a separate category of “kindergarten care-taker positions”, but nowadays the only term allowed is “pre-school teacher”. The change has not been limited to the language involved. Pre-school institutions are increasingly involved in the education system, which includes formal curricula and pedagogic aims.

Going along with that change in the perception of what kindergartens are about, the organisation of service delivery has changed as well. It has included a change of place in the hierarchy of policy priorities, change in the attendance rate and change in the way of financing the

service. Although, as some recent research suggests (Swianiewicz et al. 2012), the change in the minds of numerous local politicians has been quite superficial. Asked about why kindergartens are important, their answer follows the official dominant discourse: they talk about the role in education and socialisation of children (helping them to learn how to interact with other people etc.). But when enquired about supposed shortage of places in facilities provided by their town (number of available places being considerably lower than number of children), they answer that they see no problem since those children who cannot be admitted to local kindergartens have someone at home (one of the parents or a grandmother) who can take care of them. The latter answer clearly does not match with the semi-official change in the perception of pre-school education.

During the decade of 1990s, when the function was perceived as relatively less important (among many other priorities), the number of central regulations binding organisation of the service by local governments was very limited. Municipal authorities could choose from among various organisational forms and they were to a large extent free in deciding upon fees paid by the parents. At the same time, pre-school education was not taken into account in the calculation of the education grant. Local governments were left alone with financing kindergartens, which was supposed to rely entirely on parents' contributions and own resources of local governments. Not surprisingly, the attendance rate was relatively low, especially in traditional, rural areas. And it has been even dropping throughout most of the last decade of the 20th century – many rural local governments were closing kindergartens either to cut their costs or due to the very limited interest of parents. So the limited willingness to spend resources on kindergartens coincided with the low bottom-up demand for the service, especially in more traditional rural regions.

As is shown in figure 6, in 1999 less than one third of 3-5 year¹⁶⁵ old children attended kindergartens, but the figure started to rise very quickly in following years.

¹⁶⁵ Until 2014, pre-school education was devoted to 3-6 year olds, and the attendance rate was usually considerably higher among 6 year olds. But precise numbers are more difficult to obtain since growing number of classes for 6 year olds were organised in primary schools. The figures concerning 3-5 year old children are easier to compare and they provide a good illustration of trends in pre-school education in Poland.

Figure 6 provides the mean value for the whole country, but actual attendance has differed significantly among regions and between major cities and remote rural areas. The development of pre-school care has been especially lagging in rural areas of Eastern and Northern Poland. Still in 2009, there was no single pre-school education institution in more than half the rural municipalities in three of the Polish regions.

Figure 6

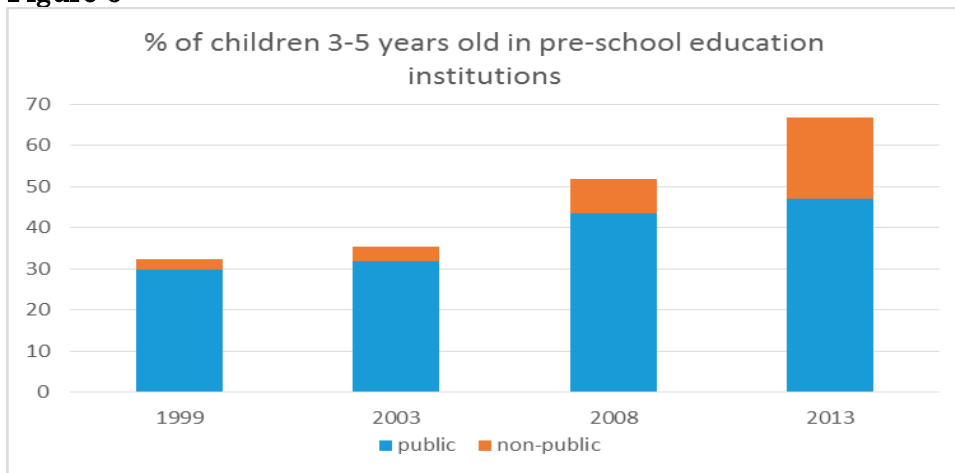
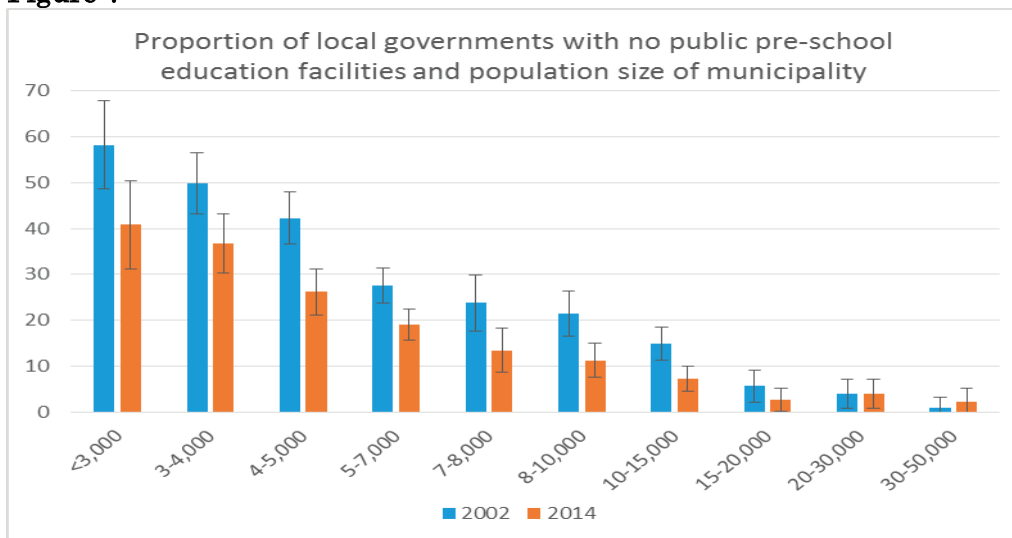


Figure 7



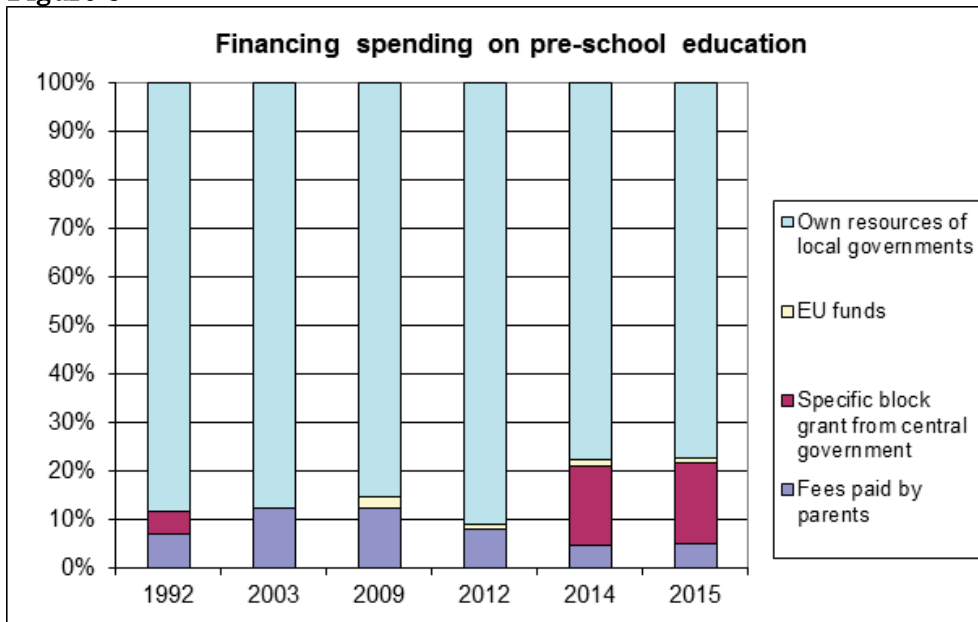
Poor development of the service mostly concerns the smallest local governments – in 2012, still more than one third of municipalities with a population of less than 3,000 and more than one fifth with a population of 3-5,000 did not have a single pre-school education facility within their territory. Such a situation has almost never happened in local governments with a population of over 15,000 (see fig. 7).

The change in the perceived role of pre-school care has been interlinked with a couple of factors:

- development of central policy and following regulations and standards (such as the obligation imposed on local governments to provide a place in the kindergarten for each willing 6-year-old, later extended to 5-year-old).
- access to EU funds available for development of pre-school services especially in rural areas.
- fast development of non-public pre-school education institutions (seen also in figure 6), not only private, for-profit kindergartens but also facilities organised by local and national non-governmental organisations, especially in rural areas. This factor has been to some extent connected with the previous one, since many NGOs proved to be efficient in applying for relevant EU funds.
- series of changes in the rules concerning financing pre-school education.

Let's focus on changes related to financing. Throughout most of 1990s and the first decade of the 21st century, the two main sources of finance for kindergartens were municipal budgets and fees paid by parents. Until 2011, rules on fees were leaving a lot of discretion for local policies. Each local government was establishing a flat monthly rate to be paid by parents. In addition to that, parents were paying small amounts, which should cover the costs of the meals received by their children. Both monthly payments and cost of meals differed significantly among local governments. In 2011, the typical monthly rate was about 30 euro per child, but in 5% of local governments no fee was charged, and in another 3% it was over 50 euro (Swianiewicz et al. 2012). As can be seen in figure 8, the role of parents in financing total costs of pre-school education was slowly but constantly growing, reaching 12% at the end of the previous decade (but in big and mid-size cities it was close to 20%).

Figure 8



But since September 2011, totally new rules have been introduced and they changed the picture dramatically. It has been decided that local government is obliged to provide free care and education for children for 5 hours every day, while the fee may be charged only for additional hours spent by children in the kindergarten. Local governments were still free to decide their own fee system, and in practice the adopted solutions were very much diversified. It is very difficult to compare them, since they differed not only in price per hour, but the whole system of payments was diversified – some local governments introduced flat rate per hour and others introduced progressive or regressive systems in which the cost of every hour was different. In spite of frequent claims in local media that several local governments have used that occasion to increase fees, hard data show the opposite – the share of parents’ fees in total operating costs has decreased significantly. Part of the explanation is in the fact that there was a flat rate in the previous system, and the new situation became more complicated. After the change of the payment system, several parents have reduced their children’s length of stay in the pre-school facilities to reduce their costs. Moreover, the new fee has not been charged on a basis of a pre-declared number of hours, but on the basis of actual time spent in the kindergarten, so e.g. absence

due to illness (or any other reason) needs to be deducted from the amount due. Local governments have complained that the new system introduced serious organisational complications (such as the necessity of a precise registration of the time spent in the kindergarten by each of the child on each day), but also reduced predictability of income. The change made even mid-term planning of functioning of pre-school facilities very difficult. For example, each city is obliged to arrange the number of available kindergarten facilities during the summer holiday season. Normally, attendance during the July and August period is very low, and it is enough to indicate that just a few facilities are available during that period, even in a big city. But after the change of the fee system, parents have started to declare their massive demand for summer services. They had not intended to really use kindergartens, but since payment was not dependent on declarations, but was based on actual time spent by children in kindergarten, they could safely declare their demand “just in case”. It has enormously complicated the planning of the summer services.

The next change of rules came in 2014 when the government imposed the ceiling of 1 PLN (ca. 0.25 euro) of the cost per hour in the kindergarten. At the same time the government introduced the specific block grant offered to local governments as compensation for the local budgets. It resulted in a further drop of the role of parents' contributions in financing the service. On a national scale, the block grant was more than sufficient to compensate the loss of revenues. But in case of some individual local governments (especially in big cities and suburb municipalities in which fees were higher) the loss of parents fees was not compensated by the new grant. Anyway, after all of those changes, municipal own resources remain the main pillar, contributing close to 80% of the total costs of kindergartens.

The impact of new regulations on the equal access to pre-school education is not entirely clear. The critics indicate that less affluent families reduced significantly the time their children spend in kindergartens. It might paradoxically increase not decrease the cleavage between children from better-off and worse-off families.

Changes related to fees paid by parents are only one example of the growing number of strict regulations and standards imposed on local

governments, when pre-school education moved up the hierarchy of national policy priorities.

Similarly, as in the case of schools, local governments are obliged to finance not only their facilities but also to subsidise kindergartens run by other owners – either private or NGOs. The rule is that non-public kindergartens are entitled to receive a per child grant from the local government, which is no lower than 75% of the amount spent by local government per child in their pre-school education facilities. The precise rules concerning the calculation of that amount has changed several times and included several controversial items. One of them was whether spending on current repairs in local government facilities or fees paid by parents should be part of the base for calculating the subsidy for private kindergartens (in the latter case, the consequence was that the more parents were paying for their children in local government kindergartens, the higher the subsidy received by private owners of the pre-school education institution).

Since for a long time there has been no central government money involved in financing local pre-school care institutions, the issue of free-riding has been even more salient than in the case of the school education. Until very recently, regulations on that issue concerned non-public kindergartens only. If child from one municipality was attending a private (or any other non-public) kindergarten in another local government, then the owner of the kindergarten could claim a relevant subsidy from the local government where the facility was located. In such a case, the local government paying the subsidy could request reimbursement from the home municipality of the child. But until 2014, there was no equivalent regulation for kindergartens run by local governments. Consequently, some local governments tried to develop their own policies to reduce the free-riding phenomenon, either limiting access of children from other municipalities to their kindergartens or re-directing them to non-public facilities where reimbursement was possible. But this regulation has changed recently, and now local governments may re-claim reimbursement of costs related to children in both public and non-public kindergartens.

The system of inter-municipal transfers is of course of a bureaucratic burden on the top of the system. Funds involved in those transfers are limited (in 2015 less than 1.5% of total spending on pre-education) and

one may ask whether there are more efficient (and simpler) options of dealing with the issue. Classic fiscal federalism recipe (see e.g. King 1984) would suggest incorporating relevant factors in the grant formula, so as to support those local governments who might suffer of the free-ride problem in kindergartens the most. Until recently, it was not possible since financing pre-school education relied entirely on own municipal resources (although the relevant coefficient might still be incorporated in the general purpose grant system). But recent introduction of the special block grant to support provision of kindergartens provides new opportunities in this respect. The issue, however, has not yet appeared on the agenda of the central-local debates.

The process of recruitment to kindergartens provides an example of a clear overregulation of the local service by central government. In spite of the sharp increase in the number of places in kindergartens, it still happens that the number of applications is larger than the number of places available. In such a case, local government produces sets of criteria which determines the acceptance priority of the applications. But local authorities are not free in that respect, they are bound by the strict rules stipulated by the resolution of the Ministry of Education. The anecdotal example of such strict rules concerns preference for “single mothers with a child” (why only mother? Why not a single father?). The regulation may sound logical for most of the country, but conducting research on local policies on pre-school education, I met representatives of a couple of suburban municipalities who complained that the regulation is meaningless in their case and its strict application leads to absurd outcomes. A huge proportion of families in the municipality are informal couples, so almost all mothers should be treated as “single mothers” according to the formal criteria of the resolution. It provides a good example of over-regulation leading to the waste of local knowledge, an issue which has been discussed in the introductory section of the paper.

9.5. Conclusions

Polish local governments have relatively broad responsibilities for the delivery of social services. It is not as comprehensive as in the Nordic model, but it is the broadest among all countries of Central and Eastern Europe (it is also reflected in the highest local spending compared to national GDP). It is mainly the result of considerable decentralisation of education and to a lesser extent of social care, while the current financ-

ing of the health care remains to a large extent out of the scope of the responsibility of sub-national governments.

However, if we look at the importance of various topics in local political agendas, delivery of social services is still less salient a political issue than investments in physical infrastructure. But this is gradually changing and the level of current social services gains its importance in local political debates. Perhaps the model very slowly evolving towards the local welfare state?

At the same time, we see a very clear (and perhaps even increasing) tension between decentralisation and central regulation of services. In some areas (pre-school education is a very good example) going along with the growing political importance of the policies, there is a parallel trend of decreasing local discretion through various national norms and standards as well as through increasing financial inter-dependencies with other actors (central government budget, but also EU funds and activity of non-governmental actors). It would still be a too far going simplification to see local governments as just agents implementing central government (and EU) policies. There is still considerable discretion in choosing the ways in which goals are to be reached. Moreover, some empirical observations confirm the issue of asymmetry of access to information, known from principal-agent theory. The local government has more precise and accurate information on the local environment, and central government is unable to predict and control every local decision; in some cases, that enables the local government to creatively omit inconvenient central policies. It seems that in several areas deregulation, i.e. relying more on the local capability to adjust decisions to specific local conditions, might help to gain from the potential positive aspects of decentralisation.

At the same time, empirical studies suggest that discomfort related to overregulation coming from the central level, which is felt by many local politicians and bureaucrats, is not an important issue for the majority of local governments. In numerous municipalities, education or social care are seen as tasks which should be properly managed, but not a task which requires local policy making. Securing financial resources (perhaps in the form of sufficient grants from the central budget) is seen as much more important than the discretion in policy formulation and im-

plementation. I discussed that issue more systematically in my paper for the Copenhagen seminar four years ago (Swianiewicz 2013).

This observation should not be very unexpected. When Nordic governments had decided to implement *free commune experiments* in the 1980s, concrete proposals to release troublesome national regulations were submitted by only about 10% of local governments. In the interpretation of researchers describing the experiment, the vision of local governments, which are frustrated by national bonds and are waiting for a liberation, is an over-simplification (Baldersheim, Ståhlberg 1994). The group of local government innovators is relatively narrow, although most visible in public debates. The larger, although silent group, is focused on securing financial resources and implementing policy directives. It should not be surprising that the Polish contemporary situation is not so different in that respect from the reality of the Scandinavian countries described 20 years ago.

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Chapter 10

Checking alternative European strategies reforming education in Italy

Giorgio Brosio¹⁶⁶

Abstract

The paper examines the reform of the educational sector in Italy in an intergovernmental framework by assessing its attractiveness for it and the feasibility of three alternative models. These models are the Spanish, the Nordic and the British ones. Education in Italy is characterised by relatively low students' scores and high level of staffing matched by relatively low wages. Opposition to reform is also high, as well mistrust of elected and appointed officials. In this context, increasing the weight of school-based management seems as a sensible strategy, although its exact content needs accurate definition.

10.1. Introduction

Providing good education is an extremely complex and difficult task. Effective schooling requires strategic decisions about investment in levels of schools, definition of curricula, selection of inputs and evaluation of students' scores and of the activity of teachers and principals. Day-to-day implementation of decisions is as crucial as is their taking.

Different levels of government and many groups in society are involved in the production/provision process, with a level of integration that is rarely, if ever, present in the provision of other public services. Only very traditional, very centralised systems do not fit with this represen-

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tation, but even these systems are engaged in a more articulated system of assignment. This is the case in Asia with Laos, Cambodia and Vietnam.

While traditionally governments were focused on expanding the coverage of education by extending access to everybody in the population, other imperatives have emerged in the last decades, mainly because of the increased competition on global markets. Not only do governments have to provide education for everyone, but this also has to be high quality education. Good education, leading to the formation of human capital well expendable in the labour market, is a growing concern of families, whose role in the education process has greatly expanded.

It is hard to find models and identify the direction of change and even harder to make assessment of policies. Rather than reviewing them, the paper uses a different comparative approach. It starts from the consideration of a specific case, Italy, where education is still totally centralised, but where the constitution stipulates decentralisation, or more exactly the regionalisation of educational policies. The paper illustrates the present Italian system and singles out the main shortcomings that could be corrected with decentralisation. Then it proceeds to the analysis of the alternatives, singling out three alternative stylised models of intergovernmental arrangements, somewhat singled out for this purpose.

The paper is organised into two large sections. The first one presents the Italian system, starting with an illustration of basic features and issues and continuing with a presentation of the existing constitutional arrangements and of the most recent policy changes. The second section starts with a short review of the School-based management (SBN) approach to the organisation of the public sector and then proceeds to present three main stylised models of intergovernmental arrangements in the sector of education that are relevant for Italy, in the sense that they are to a large extent compatible with the present constitutional/institutional arrangements and their possible evolution. They are labelled the Spanish, the Nordic and the English models, respectively. They refer to the actual arrangements, as interpreted by the author of this paper. The advantages and the problems of introducing their main traits into the Italian system are considered. This allows a brief comparison between their pros and their cons. All the three models already

have some elements of school-based management, or intend to introduce or to strengthen them. This offers an opportunity for a brief consideration of this system.

A *caveat* is in order before starting. To illustrate the Italian system and the three models, this paper makes spare use of indicators of outcomes and of resources spent. The author is very conscious of the complexity of the education sector, of the numbers of factors impacting the achievement of students and the like. Inserting and working with some figures helps, however, to put the discussion on a firmer and most interesting ground than a purely literary discussion.

10.2. Education system and policies in Italy

10.2.1. Basic facts and issues

The provision of education in Italy follows the traditional continental European model based on strong centralisation. This happens despite the recently introduced constitutional provisions, as we will see in a while. Most, almost 90 percent, of the expenditure is centralised, with limited contribution of regional, provincial and municipal governments. All the features of education policies are centralised. The central government is responsible – also thorough its regional deconcentrated units – for all relevant decisions starting from the structure of educational systems, students' qualifications and curricula and going to management and payment of salaries of teachers (see column 2 of Table 3 for more detail). As a matter of fact, the frequently quoted Eurydice Report of 2007 on School Autonomy in Europe has for Italy mostly red diamonds – meaning the absence of autonomy - with reference to the various questions about the autonomy of schools.¹⁶⁷

With due, although rare, exceptions the education sector in Italy does not show exciting performances. The level of public expenditure is relatively low and below the OECD average (see Table 1). Also the contribution of the other sectors (families and charitable organisations) is low and below the average of the OCDE (10.8 percent of the total against 16.1 percent)¹⁶⁸.

¹⁶⁷ European Commission (Eurydice European Unit), 2007.

¹⁶⁸ The source is OCDE, Education at a Glance 2014. Table B3.1.

Outcomes of education, as shown by Pisa scores, are deceiving. Italy is slightly below the OECD average in all disciplines. For example, in mathematics, the Italian score is 485.3 compared to the average of 494.03.

Table 1. Public expenditure on education as a percentage of GDP. Italy and the OECD

	Pre-primary education	Primary, secondary and post-secondary non-tertiary education	Tertiary education	All levels of education combined
Italy	0.4	3.0	0.8	4.3
OECD average	0.6	3.6	1.4	5.6
EU21 average	0.6	3.6	1.4	5.6

Source: OECD, *Education at a Glance, 2014*, Table B4.1.

Public expenditure presented in this table includes public subsidies for households for living costs (scholarships and grants to students/households and students loans), which are not spent on educational institutions. Therefore, the figures presented here exceed those on public spending on institutions found in Table B2.3.

However, the cost per student is also below the OECD average and, especially, the EU 21 average, showing *prima facie* that the level of overall efficiency – ratio of spending to outcomes – is not too distant from that of the countries with the best scores.

A closer look at cost and at typical indicators of the education sector shows some characteristics than can impact on any reform. The cost of teachers is relatively low, but so is their workload, as shown by the ratio of teachers to students and the average size of classes. The ratio of teachers to students is higher than average, while classes are smaller. Teachers' salaries are low with reference to comparable jobs in the tertiary sector in Italy (OECD, *Education at a Glance, 2014*, Table D3.2). The high ratio of feminisation of teachers - Italy has, with a percentage of 77%, the second highest ratio of female teachers to all teachers after Estonia – may explain (and is traditionally taken to explain) the combination of low pay and relatively low workload. There seems to be a sort of long-term equilibrium with few demands for pay rise coupled with constant opposition to any reform that could imply a higher workload.

Table 2. Annual public expenditure on educational institutions per student, by type of institution. Italy and OECD and EU 21 average (2011)

	Pre-primary education	Primary, secondary and post-secondary non-tertiary education	Tertiary education	Total all levels of education
Italy	5,216	7,682	6,795	7,158
OECD average	6,043	7,996	9,221	7,876
EU21 average	6,748	8,525	10,326	8,128

In equivalent USD converted using PPPs for GDP, by level of education and type of institution

Source: OECD, *Education at a Glance 2014*. Table B3.3

Compensation of teachers (and staff) absorbs a high share of current spending, while current spending absorbs a high (and higher than average) proportion of total spending. (OECD, *Education at a Glance*. 2014, Table B6.1).

Table 3. Italy. Indicators of cost and of output in the education sector

	2000	2005	2008	2012	Variation 2008-2012 (%)
<i>Teachers' salary (annual, in USD. 2012 constant prices)</i>					
Italy	33,216	35,157	34,252	33,570	-2.0
OECD average	34,176	38,056	38,865	39,642	0.9
<i>Instruction time (for students, hours per year)</i>					
Italy	1,020	1,023	990	891	-10.0
OECD average	852	846	787	805	3.6
<i>Ratio of students to teaching staff (number of students per teacher)</i>					
Italy	10.7	10.6	10.6	12.1	14.7
OECD average	17.6	16.1	15.8	15.2	-3.1
<i>Estimated class size (number of students per classroom)</i>					
Italy	14.7	14.7	14.2	14.4	0.9
OECD average	19.1	17.6	16.2	15.7	-0.6

Source: OECD, *Education at a Glance 2014*. Table B7.2a.

The most evident feature of education in Italy is territorial disparities. Outcomes, measured by scores, differ by Region and expenditure per capita differs as well. However, contrary to what could be expected, the relation between scores and expenditure is inverse: the Regions with

higher scores tend to spend less (with the exception of special statute Regions). As a matter of fact, as shown in Table 4, the expenditure per point of PISA score is higher in the Regions of the South and in the islands, where scores are lower. This is a manifestation of the traditional gap between Italian regions. It also means that in the Northern part of the country educational scores are more acceptable and that the sector has a reasonable level of efficiency, while the South is lagging behind.

A last characteristic of the Italian public sector and also of education that is worth mentioning in this context is the prevalence among public servants of persons born in the Southern regions. This feature is a widely recognised manifestation of the economic gap between the Northern and the Southern part of the country, but is not easy to demonstrate with direct evidence, since detailed statistical information on the origin of public servants is very scarce.¹⁶⁹ While in the North the private sector is the preferred employment option, in the South the public sector is the first, although constrained, option. People born there seek employment in the public sector and migrate to other regions, waiting for positions to be available at home.

It may be useful to summarise the main implications for reform deriving from this review of basic facts and figures. While all of them suggest the need of reform, many of them are at the same time an obstacle of reform, especially if the reform will move, according to the constitutional stipulations, in the direction of a more decentralised system. They are the following:

- The relatively low wages impact on the quality of teachers, but increasing them is facing rigid budget constraints. To contain the cost of overall wage increases, elements of merit should be introduced, allowing a higher remuneration to those who perform better. In turn, this requires the introduction of a system of valuation of teachers and also of principals.
- Gaps between geographic areas in outcomes and in efficiency create opposition to decentralisation in the South, as the central

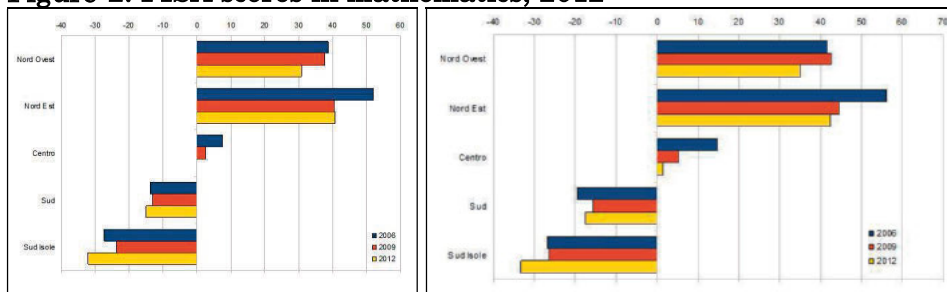
¹⁶⁹ Alesina, Danninger, Rostagno (2001).

government is viewed here as the least bad option for the assignment of responsibilities, compared with either the Regions or the Municipalities. Migration of teachers from the South to the North is a further source of opposition to the regionalisation of education since employment opportunities could be lowered by discriminating regional policies. These fears are exploited by the central bureaucracy to ensure, for its benefit, the maintenance of the *status quo*. Hence the devolution of powers to schools could ease opposition, since it would empower families, principals and teachers at the expense of widely discredited elected and non-elected officials.

It has also be added that the system has eschewed reform in the last decades, although many governments have tried with varying effort to change it. As it frequently happens in economic sectors, where big and sudden technological changes are unlikely to take place, a low level but stable equilibrium has been established.

Figure 1. PISA scores in literacy by Italian subdivisions 2012

Figure 2. PISA scores in mathematics, 2012



Source: OCSE PISA, 2012 *Rapporto Nazionale a cura di Invalsi. Pisa 2013*

10.2.2. Intergovernmental arrangements

The Italian constitutional defines a model of education where all levels of government plus schools are involved in the provision of general education.¹⁷⁰ The central government is responsible for framework legislation defining the main characteristics of the education system; for ensuring “essential levels of service provision” all over the country; and

¹⁷⁰ Vocational education is not considered in this paper.

for monitoring the whole system.¹⁷¹ Regions are assigned with concurrent legislation (art.117), and with area-wide responsibilities in the administration of schools such as, presumably, network planning and personnel (art.118). Local governments, Municipalities and Provinces (these latter are, however, in the process of being eliminated) are responsible for building and maintenance of school premises and for the management of pre-primary schools. However, according to the constitution Regions should devolve to local governments all those administration activities that can be adequately performed at that level.

Schools enjoy an explicit constitutional guarantee concerning their autonomy and an implicit one via the constitutional recognition of the subsidiarity principle. As a matter of fact, schools are by definition the educational bodies that are closer to citizens, hence according to the subsidiarity principle, they should be assigned with the tasks that they can carry out at their best. This implies that schools can compete with local governments and even with Regions in the assignment of administration functions, although the constitutional provisions have not yet been implemented.

¹⁷¹ Article 117 of the constitution assigns to the exclusive responsibility of the central government the definition of “essential levels of service provision” for a set of basic services that are considered “necessary to guarantee equality of basic individual and social entitlements across the whole nation”.¹⁷¹ These services include education, health and social protection, plus a still undefined set of services provided by local governments (municipalities and provinces).

Table 4: Public sector expenditure by point of PISA student score and by Region 2007. (Euros)

	Reading	Mathematics	Science	Average
Piedmont	122	126	122	123
Lombardy	123	124	121	123
Liguria	126	129	125	126
North-West Italy	124	125	122	124
Trentino AA	177	175	170	174
Veneto	116	116	113	115
Friuli VG	127	128	123	126
Emilia R	124	124	120	123
North-East	127	127	123	126
Central Italy	124	128	123	125
Campania	127	127	125	126
Puglia	119	121	117	119
Basilicata	145	146	143	144
Southern Italy	128	129	126	127
Sicily	131	131	128	130
Sardinia	148	151	144	148
Islands	135	138	133	135
National total	127	129	125	127

Source: Bordignon and Fontana (2010).

The main traits of this system are not necessarily wrong, but need complete definition. Alternative education provision models are still compatible with the constitutional discipline depending on the extent of legislative autonomy given to the Regions and to the sharing of administrative tasks between Regions and local governments. In turn, the way these issues will be solved will determine the degree of school autonomy.

10.2.3. Recent policy-decisions

State/Regions agreement

To implement the constitutional mandate, the blueprint of an agreement between the central government and the Regions has been agreed upon in 2008. It provides a more detailed assignment of the competences, whereby and as in almost any other country, the central government is responsible for the definition of the overall structure of the education-

al system, such as the number of years of schooling at each level, the qualifications that can be obtained, the definition of the basic structure of curricula, the devising and monitoring of systems for the evaluation of teachers and other staff and of the educational outcomes. Also the central government will be responsible for the determination of the minimum standards concerning not only curricula, but also the qualification of teachers, the methods for evaluation of students and the quality of school buildings and the organisation of services.¹⁷²

Regions are responsible for secondary legislation, such as the adaptation of curricula to local conditions, the definition of qualifications of teachers. They are also responsible for planning and management of schools. Teachers would also be hired and managed by the Regions, but their legal status would still be defined at the centre in order to ensure, among other things, their mobility across the Regions. Salaries would be settled through a national contract, but with the possibility of regional adjustments.

An important feature of the agreement worth mentioning is that it introduces an asymmetric system, whereby each Region can individually choose whether to sign the contract with the central government and receive the competences or to stick with the present system. Financing will be assured, as for other basic functions for which minimum standard (essential levels) of service provision is centrally guaranteed, by a mix of own revenues and central transfers based on standard costs. The agreement presupposes for its implementation the passing of framework national legislation defining the new, circumscribed role, of the central government. This legislation has not been passed by the national Parliament, however. Critics¹⁷³ advance that resistance of central bureaucracy and lack of enthusiasm on behalf of the Regions have a lot to do.

¹⁷² For education, health and other non-well defined social services the constitution mandates, that the national government determines standards of service provision, named literally essential level of services, aimed at ensuring uniformity across the whole country.

¹⁷³ See for example Poggi (2008) and (2010).

Start of school-based management

Pending progress in the implementation of the agreement, a significant overhaul of Italy's education system has been approved on July 2015. It introduces some elements of school management into the system.

The main reform is the introduction of a system of evaluation of teachers that is aimed also to link teachers' wages to merit rather than seniority, representing an important shift in a sector that suffers from a lack of meritocracy. The reform expands the role of school principals that are called to become the strategic player in the new school system.

The new rules also seek to give schools more independence in setting curricula and managing operations.

Putting the school principal in centre stage, the reform introduces some elements of deconcentration as the principal is a central government civil servant who will be assigned with more responsibilities and powers. The reform has been, as always, strongly opposed by the teachers' unions that maintain that the evaluation system and the changes in the allocation of funds that will derive from it will favour private schools and those situated in high-income areas at the expense of the poorer ones. Most teachers oppose the evaluation system to which they will be subject under the new system. The reform, known as *Good Schools*, also includes the granting of a permanent position to more than 100,000 temporary teachers and new investments in the sector worth €3bn.

Constitutional reform

A constitutional review including the reform of the Senate and a curtailment of assignments of responsibilities to the Regions has been very recently approved by both houses and will be submitted to referendum. The reform will reduce the concurrent power of the Regions in legislation eliminating it in a number of areas. Concerning specifically education, the reform seems to bring in a reduction of their powers. While the present constitutional text make a general reference to the Regions' power of concurrent legislation in the "educational sector", the new text refers specifically to their legislative power concerning the "organisation of school services, education and the promotion of the right to education". These more detailed but not clearly defined assignments could mean smaller competences and open the way to diverging interpreta-

tions, leading to more conflict and increased litigation brought to the constitutional court.

10.3. Looking for inspiration at European models

The State/Regions agreement and the start of school-based management do not pre-empt the political and policy space for reform. Regions can decide whether to take over all the powers devolved to them, or that they are not interested in assuming competences in education (which can look a little bit odd, but not too much) and accept either the devolution of some functions to local governments or the maintenance of the status quo. At the same time, the relatively ambitious elements of school-based management introduced very recently need to be implemented and also could be clearly expanded. Implementing and/or furthering school-based management is compatible with any decentralisation and recentralisation option.

10.3.1. Characteristics of school-based management

Given the potential relevance for Italy of this institutional approach to education reform, it may be of interest to make a short assessment of it. As a matter of fact, one is witnessing an increasing recourse to school-based management worldwide. This instrument is widely supported by international organisations, such as the OECD and the World Bank.

SBM is introduced in both developed and developing countries, in centralised and decentralised systems of education provision.

Insofar as SBM is devolution of decision-making powers and of finance from a given level of government to the producing units of the service, *i.e.* the schools, it is clearly a decentralisation device. However, when considered in the broader framework of intergovernmental relations, SBM becomes a tool for alternatively centralisation or decentralisation of policies. The United Kingdom, and to some extent Sweden, provide a very good example. In all cases, the SBM has a big potential of mobilising effort at the most decentralised level possible.

Table 5. Main features of distinct models of institutional arrangements

Function and area of responsibility	Present arrangements in Italy	Alternatives models		
		English model	Spanish model	Nordic model
<p>Allocative efficiency: determining how much to invest in education by level of schools and related decision. Definition of structure of education. Duration of cycles. Educational qualifications delivered. Certification of teachers' qualification. Private/public schools. Vouchers.</p>	<p>Full centralisation of both budgetary decisions and regulation. Small participation in financing of infrastructure and other by local governments</p>	<p>Increasingly dominant role played by Central government for main tasks and financing. Full supervisory role.</p>	<p>Central government determines general orientations and national/minimum standards. Supervises evaluation systems. Responsible for qualification certification of teachers.</p>	<p>Strong and increased role played by central government. Growing emphasis in Sweden on competition between schools through support to independent schools</p>
<p>Input efficiency. Choosing the appropriate number of teachers, books and materials. The involvement of families for each level of school. Planning the network of schools. Building and maintenance of premises.</p>	<p>School principals (and parents via the local school councils) very recently enabled in the selection and evaluation of teachers.</p>	<p>Involvement of local governments in finance (with central government supervision), planning and building premises and in setting pupils' evaluation. Basic reliance on local schools councils (half of those members are parents) for the choice and management of inputs and involvement of families.</p>	<p>Regional laws implement national standards. Regions run schools and hire and manage personnel. Pilot projects ad experimentation. Local governments are involved in building and running of premises.</p>	<p>Mainly at the municipal level, through municipal school boards, composed of politically appointed members hose but not entirely within the municipal council. Teachers are hired and managed locally. School premises built and run locally.</p>
<p>t composition efficiency. Definition of curricula, hours of schooling, complementary activities.</p>	<p>Marginal involvement of local school councils</p>	<p>Local school councils have some marginal discretion power. Local governments involved in complementary activities.</p>	<p>Central government defines minimum content of curricula as to ensure use of qualifications across the whole country. Minimum includes mastering of Spanish language. Regions can add and modify according to local characteristics. Minimum involvement of local school councils constituted by teachers parents and members of local elective council in the definition of curricula.</p>	<p>Increasing role played by local school boards, with participation of parents and leadership role assigned to the principal.</p>

Sources of the Table: compilation by the author based on Moos and Paulsen Eds. (2014); Kim, Lotz and Mau, (2013); Moeller (2008); Perez Esparrels, and Morales Sequeira, (2012); Bonal, Rambla, Eduardo Calderón i Núria Pros (2005); Bordignon and Fontana, (2010). EU (Eurydice) (200&).

SBM is a set of extremely different models. One could even label it as a trend rather than as a model instrument. SBM projects generally involve a transfer of responsibility and decision-making power to a combination of principals, teachers, parents and other school community members.

Following Barrera Osorio *et al.* (2009), one can distinguish four models on the basis of assignment of responsibilities:

1. The decision-making authority is devolved to the school principal. This option can be labelled administrative-control SBM, implying *per se* a deconcentration move.
2. The main decision-making authority is assigned to teachers. It can be labelled professional-control SBM (it is also called the functional autonomy model).
3. The major decision-making authority is devolved to parents. We have in this case community-control SBM.
4. Parents, principals and teachers share decision-making authority. It has been labelled as balanced-control SBM. In the current practice, most SBM projects work through some sort of school committee (or school council, or local school management committee).

In general, SBM programmes devolve authority over one or more activities and areas. These can be any of the following and various combinations of them: (1) budget allocations; (2) hiring and management of teachers and other school staff; (3) curriculum development; (4) procurement of textbooks and other educational materials; (5) infrastructure improvement; and (6) monitoring and evaluation of teacher performance and student learning outcomes.

The combination of the locus of decision-making with the assignment of competences produces a large number of possible combinations of SBM models. Each programme may be shaped by the objectives of the reformers and by the broader national policy and social context in which it is created. For example, in the United Kingdom the increased devolution of powers to school boards was also targeted to reduce the powers of local governments.

The literature even distinguishes between “weak” SBM reforms, where schools have limited autonomy, consisting mostly in an advisory role, and “strong” forms of SBM, where principals and school councils receive a budget and are assigned with the responsibility of hiring and firing

teachers and for setting a large part of curricula. For a long time, the Netherlands have exemplified the working of a strong form of SBM. In particular, since 1985 the government has given school principals authority over a large number of functions with the goal of increasing efficiency, and it has allowed parents to create new schools that meet their own specific cultural and religious preferences.

The literature, particularly that emanating from the international organisations, has tried to check the effectiveness of the instrument. This is a task that, given this variety of models and also of contexts where they are applied, is an almost impossible. This does not imply, however, that the instrument cannot be effective. It also takes time to produce the effects. A branch of this literature, reported in Osorio *et al.* (2009), considers that a minimum time span of 8 years is needed to show results.

10.3.2. Models to which the Italian reform could refer to

After consideration of the institutional constraint, three main reform options are considered here. They are labelled the Spanish, the Nordic or Scandinavian and the English model, applied in the UK excluding Scotland. They refer to actual models as interpreted by the author of this paper, with no clear personal limits. They are also partially reconstructed models in the sense that arrangements are evolving all the time within countries and that a presentation of them, however accurate, will inevitably miss some points.

If Italian Regions were eager to be assigned with more responsibilities which is doubtful, the Spanish model seems to be the most obvious benchmark for Italy, considering the regionalisation of government in both countries, their broadly similar administration/constitutional structure, their economic size and also the urbanisation characteristics. The Spanish model is based on a large devolution of powers from the central government to the Regions, which would become the main players in education, more or less along the lines envisaged in the central/regional agreement in Italy. Then the Regions would have the power to devolve some of their responsibilities either to the local governments, or to the schools (this has, however, not yet taken place in Spain), but will still keep ownership of responsibilities.

The literature suggests a number of general advantages deriving from decentralisation (including regionalisation), such as increased effectiveness of expenditure (less central bureaucracy), reduction of the role played by teachers' unions, fostering experimentation and quality, and better adaptation of education to local preferences (also with inclusion of local languages in curricula).

It is, however, more interesting to single out which would be the specific advantages of devolution for the Regions in the present Italian context. With reference to them, one should take into account the following.

- Ownership of responsibilities means alignment of incentives. This would be one of the main advantages of devolution to the Regions (see Bordignon and Fontana, 2010). The core functions in the management of the whole educational sector would be concentrated in the Regions eliminating conflict of competences and incongruities, for example with the municipalities about the location of schools. As a matter of fact, one of the reasons advanced for the high ratio of teachers to students in Italy is the pressure by municipalities to keep the school network rather dense, forcing the Ministry to staff very small schools and classes. Alignment of incentive also includes some discretion in the definition of curricula, with a view to the main economic specialisation of the Regions.
- A second advantage would be the possibility to adjust teachers' wage levels to the regional cost of living and to the local labour market conditions. In both cases regional differences are presently huge. Assigning teachers' management to the Regions would also constrain the impact of "return to home mobility" that is considered to be an important factor behind inflated staffing levels. Return to home mobility refers to the phenomenon by which teachers move from South to North to find a position, but then try hard (with the help of unions) to return home and frequently succeed. In this framework, one has also to consider a main risk that is associated with devolution not only to Regions, but with devolution *tout court*. The risk is that Regions could inflate the number of teachers and staff and then try to shift the burden on the central government exploiting the long tradition of soft budget constraint.

- A third advantage has to do with school-management reform. There is no obvious or prevalent model of SBM, as shown above. Devolving the choice of the model to the Regions would allow adaptation to local circumstances. Just to offer an example, Regions could choose among enabling parents, teachers, or principals. The first option would fit better the Northern and Central regions, while the second option looks as the preferred one in the South, considering the higher reliance in these Regions on central government bureaucracy.

Clearly, devolution could strengthen the gap between North and South by giving more discretionary power and resources to the relatively better equipped Regions. Richer and better performing Regions could make efficiency savings and invest them in teachers' salaries to attract more talented people. As a matter of fact, this seems to be what appeals most to those Regions, such as Lombardy, Tuscany and Emilia Romagna, that are showing more interest in the reform. The richest Regions could also finance additional spending with their own resources.

Asymmetrical devolution can be a way to insert more competition within the reform process and at the same time provide a guarantee to the Regions that will not request devolution of new functions. The central government, *i.e.* the Education Ministry, could concentrate its efforts on lagging Regions, instead of continuing to steer the whole system. This seems to be something that its actual performance shows it is not really able to do. Moreover, the constitutional provision on "essential levels of service provision" should act as a guarantee against widening of regional disparities.

Also, and this could assuage the fears of the Regions, there is no indication that regionalisation and decentralisation in other sectors in Italy has led to more regional divergence, although also no significant convergence is shown. A short comparison between Italy and Spain reported in Table 6 shows that inequality is higher in Italy than in Spain, although the first country is much more centralised than the second. Of course, one should weigh these scores with regional inequality that is somewhat higher in Italy than in Spain, but centralisation is expected to overcome the impact on economic inequality in the provision of basic services. Also, recent analyses of the Spanish model (Esparrels y Se-

queira 2012, among others) show that, at least from the point of view of the expenditure per student, which is a partial factor, divergence has not taken place in the last decade, but rather some convergence.

The second model is the Author's reconstruction of the Nordic one. Although the model is quite composite, it presents a few peculiar characteristics, such as the prevalence of politically staffed School Boards at the municipal level and the increased competition among schools, which could make it attractive to Italy if the regional option is not exploited. In principle, the main difference between the Spanish model and the Nordic one is the size and level of government involved. Even after the recent restructuring, the size of municipalities in the Nordic countries is still much smaller than the average size of Italian or Spanish regions and their number is higher.

Table 6. Regional inequality of educational scores Italy and Spain, 2012

	Italy		Spain	
Highest	Trento	524	Navarra	517
Second highest	Veneto	517	Basque Country	505
National average		485		484
Second lowest	Sicily	447	Murcia	462
Lowest	Calabria	430	Extremadura	461

Sources: for Spain Ministerio educación cultura y deportes Pisa 2012, *Programa para la Evaluación Internacional de los Alumnos*. Informe español. Madrid 2013. For Italy OCSE PISA 2012 *Rapporto Nazionale a cura di Invalsi*. Pisa 2013.

This means that closeness to users of services is higher, but on the other hand the range of functions that can be efficiently devolved to municipalities is smaller than those devolved to regions, implying possibly lesser alignment of incentives. On the other hand, consolidation of municipalities seems to have been achieved, at least in Denmark, where municipal consolidation has reduced the number to 98 (in 2007), implying an average size of municipalities – 56,000 inhabitants – that is large enough to avoid diseconomies of scale in the school network. More specifically, schools are big enough, also after a few merger processes allowed by municipal consolidation, to avoid the small classes and the high teacher-to-student ratios that affect the Italian educational sector. However, municipal small size – there are more than 8,000 municipalities in Italy – is presently an almost insurmountable obstacle to the

adoption of the Nordic model in case the other constitutional obstacles were overcome.

The third model, the English one, has the smallest chance of being implemented in Italy. It would practically require the dismantling of the Regions and an almost complete restructuring of the Italian intergovernmental system. The English model, however, would be compatible with the present centralisation in the education sector. The central government would still remain competent for all regulatory and organisation matters, municipalities would retain their present limited competences, and more powers would be devolved to the school level. This solution would make large use of subsidiarity and would be appreciated by large sectors of the Italian public opinion and would also put in action the largely unexploited potential of school-based management. Finally, it must also be noted that the English/British system is characterised by a relatively high involvement of the private sector in the funding of education institutions, much higher than in Italy. In other words, one should expect that, in the absence of an increased private involvement in education, one should expect lesser advantages coming from the adoption of the English model.

Table 7. Some comparative indicators of the characteristics and performances of the educational sector in the countries referred to in this paper

	Public expenditure ¹ on education as a percentage of GDP				Private expenditure on education institutions as a percentage of GDP	Performance in mathematics	Proficiency in mathematics below level 2
	Pre-primary education	Primary, secondary and post-secondary non-tertiary education	Tertiary education	All levels of education combined			
Denmark	1.4	4.7	2.4	8.7	0.12	500.03	16.8
Finland	0.4	4.2	2.2	6.8	n.a.	518.75	12.3
Italy	0.4	3.0	0.8	4.3	0.12	485.32	24.7
Japan	0.1	2.7	0.8	3.8	0.21	536.41	11.1
Korea	0.2	3.4	0.8	5.0	0.77	553.77	9.1
Norway	0.5	5.3	2.6	8.7	n.a.	489.37	22.3
Spain	0.7	3.0	1.1	4.8	0.29	489.37	23.6
Sweden	0.7	4.1	2.0	6.8	n.a.	484.32	27.1
United Kingdom	0.3	4.4	1.3	6.0	0.37	478.26	21.8
OECD average	0.6	3.6	1.4	5.6		494.04	23.0
EU21 average	0.6	3.6	1.4	5.6			

10.4. Conclusions

The paper has dealt with possible decentralised strategies in the education sector making specific reference to the case of Italy, where decentralisation of this sector is on the political agenda, although with some diminishing attention. In any case, given the unsatisfactory perfor-

mance of the sector, reform is needed in terms of school outcomes, large spatial disparities and also other factors. There are also political and social obstacles to the reform, such as the large acceptance of the present system by teachers and the bureaucracy.

The paper has explored avenues for reform by looking at the three distinct models of institutional arrangements in the public sector. They are the Spanish model, the Nordic and the English one. Although Spain is not performing exceedingly well in education, the Spanish model remains the most obvious choice for Italy, considering the similarity of their present (and future) institutional arrangements. One of its main attractions would be the alignment of incentives, deriving from the concentration of a bulk of competences at a single level of government.

The adoption of the Nordic model based on the assignment of a central role to municipalities is constrained by the present fragmentation of municipalities in Italy. The English model is more compatible with the present (and possibly future) maintenance of centralisation of education in Italy, but would require much more involvement of the private sector in education.

Adoption of all models should be accompanied by the strengthening of school-based management. As briefly reviewed in the paper, SBM is far from being a unique approach. The variety of projects one can observe across the world precludes reaching conclusions about its performances. Its main asset, which is of value for Italy, is to stimulate the involvement of those operating at the final stage of the provision of educational services and those, primarily families, interested in the outcomes of the sector.

In a stagnating context, such as the Italian one, where multiple veto-players oppose reform, SBM could help to reduce opposition to reform and assuage the fears of widening spatial gaps in the provision of education.

The author is, at the same time, quite conscious that a substantial improvement in education requires a comprehensive national strategy, making education an absolute priority for society and involving all the sectors of society, not only the educational sector. Korea and Japan are

among the most valuable examples and would need to be considered up front and not only in the conclusions.

Education in Korea is completely centralised, while in Japan subnational governments are responsible for managing and paying teachers and also for implementing standards and guidelines mandated by the central government.

In both Asian countries, standards of educational achievement are at the top of the world. Also variation of scores is relatively small, meaning uniformity of achievement. Both countries, but more intensely Korea, ask families to contribute heavily to the education of their children, both financially and with personal support. Families in Korea contribute to almost 20 percent of the total expenditure of primary and secondary institutions, while in Japan the corresponding share is about 6 percent. In both countries, family contributions to tertiary education come on the top of the world list, only slightly surpassed by Chile. Japan and Korea have also a very substantial amount of family non-monetary contributions, such as assistance to pupils, which exert heavy continuous pressure on families.

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