

3.2 Local government in Norway

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3.2.1 Introduction

The organization 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.³ Since equalization of services 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.

This chapter describes the Norwegian local public sector from an economic perspective. It starts out in section 3.2.2 by giving a historical overview of the development from extreme decentralization in the 19th century to extreme centralization in the 20th century. Section 3.2.3 discusses the present organization of the local public sector, emphasizing division of tasks, financing, and regulatory framework. Section 3.2.4 is devoted to trends and reform discussion, while section 3.2.5 concludes by discussing reforms that could improve the working of the Norwegian model.

3.2.2 The historical development: From decentralization to centralization

The Norwegian local public sector has developed from extreme decentralization in the nineteenth century to extreme centralization during the twentieth century. From the establishment of local democracy and local self rule in 1837 and throughout the 1800s, local governments developed a high degree of autonomy, and Kjellberg (1981) has characterized this early period as *laissez-faire* national policy. Activity and service production increased as the local governments took on new responsibilities. They engaged in building of infrastructure related to water supply, sewage, garbage collection, gas and electricity supply, roads, and tramways, as well as welfare services within education and health care. Local

³ I use the concept local government to describe both levels of the local public sector, municipalities and counties.

governments were also engaged in housing policy and poverty relief. The activities were primarily financed by local taxation, and initially the property tax was the dominating local tax. Soon the income tax became more important due to industrialization and transition from barter economy to money economy. The Tax Act of 1882 introduced a compulsory income tax. The design and coverage of the income tax was determined by national law, but each local government could determine its own tax rate. By 1900, the income tax had become the most important local tax (about 60% of tax revenues) and the tax rate varied substantially across local governments. Central government grants represented only about 10% of local government revenue. Although activity and revenues had increased sharply, the local public sector was still small compared to present standards. Total revenues amounted to less than 4% of GDP.

The local autonomy regime broke down primarily because economic differences developed. Income tax rate variation increased, and many local governments entered a debt crisis during the overall economic contraction in the 1920s. Redistributive concerns motivated a national response to evolving economic differences, and a maximum local income tax rate was introduced by the 1911 Tax Act. Since the regulation of the income tax rate did not address the underlying inequalities in tax bases, more national intervention was necessary. At first, ad hoc economic support to specific local governments was motivated by their unemployment problems. The role of equalization grants was formalized by the introduction of the “tax equalization fund” in 1936, marking the beginning of a new grant policy. A block grant based on objective and measurable criteria (per capita income, unemployment, and so on) was financed by a national tax on bank deposit interest. This redistribution scheme, introduced to help poor local governments, became the vehicle of increased national control of local revenues and spending.

After World War II, the regulation of the local income tax continued and the local public sector became an integrated part of the welfare state. While most public assistance were taken over by central government and included in a national social security system, the local public sector maintained responsibility for provision of the main welfare services. The welfare services expanded and new services were introduced (expansion of primary schools and compulsory lower secondary schools, later expansion of the health care system, then care for the elderly, and most recently daycare). The expansion of the welfare services was to a large extent financed by matching grants, and by 1980 central government grants amounted to nearly 40% of local government revenue. Equalization was achieved by differentiating the matching rates. However, the matching rates did not only take into account spending needs and tax base, they were also used to “punish” local governments with below maximum tax rate.

Finally, all low-tax governments gave in, and since 1980 all local governments have used the maximum tax rates in income and wealth taxation.

The rising level of national control was also of concern, and a commission was established in the early 1970s to propose reforms in the local public sector. The commission proposed changes in the system of financing that were implemented during the first half of the 1980s. The process culminated with a large grant reform in 1986, where most of the selective grants were consolidated into a single block grant to promote local democracy, local accountability, and efficiency. The reform gave the local governments large discretion in the allocation of resources between service sectors, but did not address the limited discretion to influence own revenues. Since 1986 there has been a fairly balanced growth of central government grants and local taxes. The division of tasks between the different tiers of governments has also been fairly stable. The main exception is that the responsibility for hospitals was shifted from the counties to the central government in 2002.

3.2.3 The present organization of the local public sector

Overview of organization, tasks, and revenues

Norway is quite large in terms of area, but small in terms of population. By January 2010 the population size was nearly 4.9 million. The public sector is divided in three tiers; the central government, the county governments, and the municipal governments. The 19 counties and the 430 municipalities constitute the local public sector. 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 17 percent of (mainland) GDP. Nearly 20 percent of the workforce is employed in the local public sector.

There is considerable variation in population size across the municipalities, from a few hundred in the smallest rural communities to nearly 600,000 in the capital Oslo. More than 50% of the municipalities have less than 5,000 inhabitants. Despite the huge variation in population size, all municipalities have the same responsibilities (except that Oslo also is a county government). The counties are more homogeneous in terms of population size, with variation from just above 70,000 to nearly 600,000.

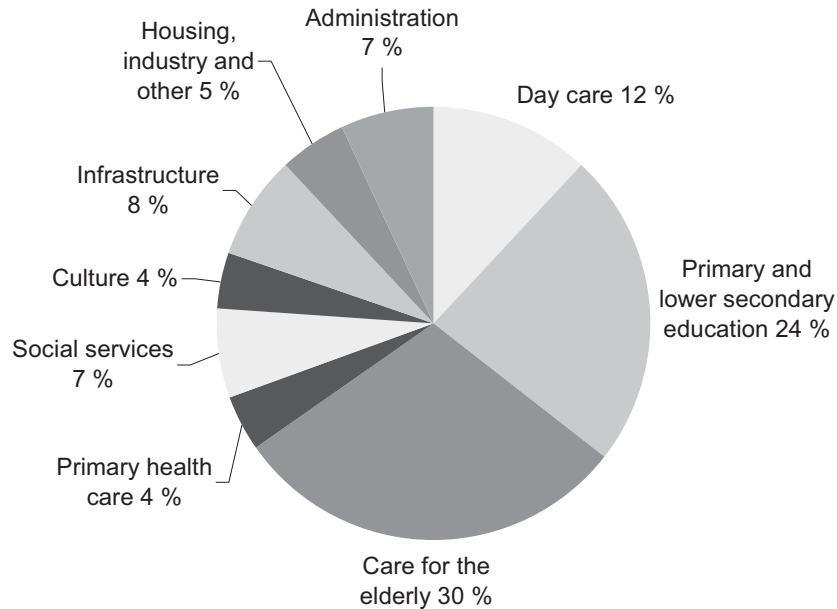
The political system at the local level is a representative democracy where the members of the municipal and county councils are elected every fourth year. The national parties are important actors, but at the municipal level also local lists are frequently represented in the councils. The traditional, and most common model,

is not a parliamentary system. Rather, an executive board with proportional representation from all major parties is established. The executive board is led by the mayor, and all members of the executive board are elected among the council members. Some counties and larger municipalities have chosen to have a parliamentary system, and some municipalities (mainly smaller ones) have experimented with direct election of mayor.

In terms of revenues and expenditures the competence of the municipalities is much larger than the competence of the counties. This was also the case before the responsibility for hospitals was moved from the counties to the national government in 2002. In terms of revenues the municipal level is now more than 5 times as large as the county level.

Figure 3.10 provides an overview of the municipal responsibilities. It is evident that welfare services within the educational, health, and social sectors account for the bulk of expenditures. The welfare services under municipal responsibility are day care, primary and lower secondary education (1st to 10th grade), care for the elderly (nursing homes and home based care), primary health care (general practitioners, health centers and emergency ward), and social services (mainly social assistance and child custody, social assistance). These services amount to 77 percent of the total budget. The more local services include a large number of activities, but make up less than 20 percent of the budget. They can broadly be categorized as culture (libraries, cinemas, sports facilities, etc), infrastructure (roads, water, sewage and garbage collection), and planning (including land use planning), industry, and housing.

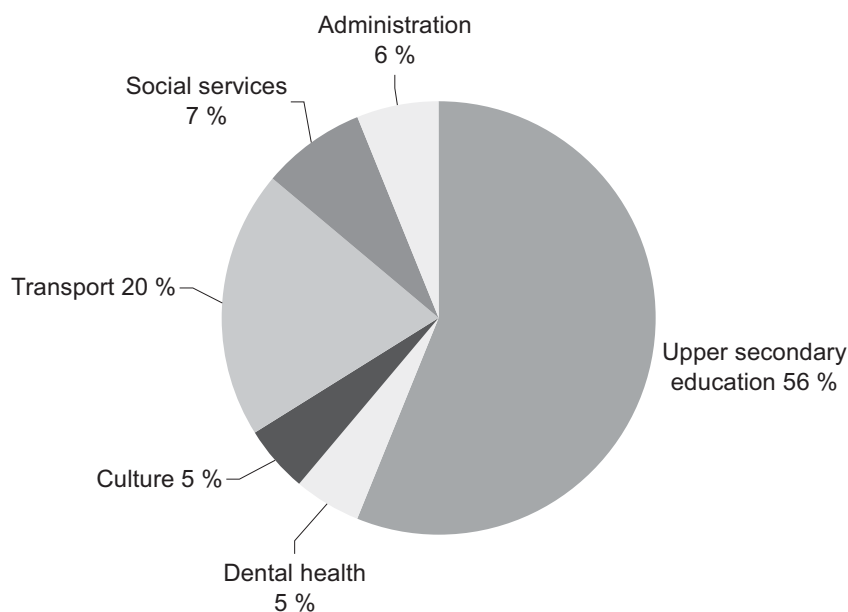
Figure 3.10. *Municipal service sectors, percent of current expenditures in 2008*



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

The main responsibilities of the counties are shown in figure 3.11. After the national government took over the responsibility for the hospitals, upper secondary education (general and vocational) is the largest task for the counties. It amounts to more than half of the total budget. The second largest service sector is transport (roads and public transport), which accounts for 20% of the budget. The remaining services are dental health (mainly for the young and residents in nursing homes), culture (libraries, museums, sports facilities, etc), and regional development (planning and business development). Together, the welfare services upper secondary education and dental services make up a bit more than 60 percent of county expenditures. However, if we consider county transport as part of a national infrastructure, this share increases to 80 percent.

Figure 3.11. County service sectors, per cent of current expenditure in 2008



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

Total local government revenue amounts to around 17 percent of GDP, and table 3.4 gives an overview of the major revenue sources. Local revenues (taxes and user charges) amount to 55 percent of total revenues in the local public sector. Block grants and earmarked grants are of roughly the same magnitude, and account for nearly 20 percent each. Interest and dividend) amount to nearly 5 percent of total revenues. The significant role of financial revenues reflects the local governments' historical role as owners of power companies. After the deregulation of the electricity market in the early 1990s many local governments reduced their ownership in power companies and increased their holdings of financial assets.

Table 3.4. *The financing of the local public sector (%) in 2008*

Revenue source	Total	Municipalities	Counties
User charges	12.9	14.3	4.4
Taxes	41.5	41.8	39.3
Block grants	19.9	17.2	36.0
Earmarked grants	19.0	20.0	13.1
Interest and dividend	4.8	4.7	5.1
Other	1.9	2.0	2.1
Total	100.0	100.0	100.0

Note: Oslo, which is both a municipality and a county, is included in the figures for the municipalities. In these figures VAT-compensation is defined as an earmarked grant.

The main differences between the two local government tiers are that the counties are more dependent on central government grants, while user charges are more important for the municipalities. The municipalities apply user charges for a wide range of services, but technical services (water, sewage, and garbage collection), day care, and care for the elderly account for most of the revenue. User charges cannot be applied in primary and secondary education.

Table 3.5. *Revenues, activity, and net operating surplus, 2002–2008*

	2002	2003	2004	2005	2006	2007	2008	2009
Revenue, share of GDP	16.3	16.7	16.4	16.4	16.4	16.0	16.3	17.6
Real revenue growth	0.3	0.6	3.8	3.4	5.6	1.4	1.0	3.9
Activity growth	1.6	0.9	1.6	-1.1	2.9	5.3	3.2	3.4
Net operating surplus	0.6	0.6	2.2	3.6	5.5	2.5	0.4	3.0

Note: Activity growth is an index of growth in employment and purchase of goods and services (including investments). Net operating surplus is current revenues minus current expenditures, net interest, and net installment on debt. It is measured in percent of current revenues.

Table 3.5 shows that local government revenues as share of GDP has been fairly stable around 16–17 percent since the national government took over the responsibilities for the hospitals from 2002. The real revenue growth however,

shows substantial variation from year to year. Revenue growth was quit low in 2002–2003, high in 2004–2006, modest in 2007–2008, and high in 2009. Activity, as reported in table 3.5, is an index of the growth in employment and purchase of goods and services (including investments). During the period 2002–2009 activity growth has on average been 2.2 percent, which is the same as the average revenue growth. The activity growth tend to be lower (higher) than the revenue growth in years with high (low) revenue growth, implying that there is a positive relationship between revenue growth and the main indicator of fiscal balance (the net operating surplus).

Local governments all over the world were negatively affected by the global financial crisis in 2008 and 2009. As can be seen from table 3.5, this was not the case for Norwegian local governments who experienced a high revenue growth and improved fiscal balance. This partly reflects that Norway was not severely hit by the financial crisis as the oil price quickly came to back to a relatively high level. The unemployment rate increased only modest and the local governments did not experience a sharp decline in tax revenues. In addition, the large oil-fund gave the central government financial resources to run a very expansionary fiscal policy. And an important element in the expansionary fiscal policy was to increase the grants to the local governments.

On the other hand, many Norwegian local governments have substantial financial wealth⁴ that is invested in national and global financial markets. They experienced severe financial losses in 2008 when the financial markets dropped and large gains in 2009 when the financial markets picked up again. The development in the financial markets contributed to the low net operating surplus in 2008 and the sharp recovery in 2009.

Tax financing and tax discretion

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

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

⁴ Historically local governments have been major owners of power companies. After the deregulation of the electricity market many local governments chose to sell these companies. The revenues were used to build up funds that are invested in financial markets.

The base for the local income tax is so called general income (*alminnelig inntekt*), which is labor income, pensions and capital income less allowances. Since 1992 tax reform general income is taxed at flat rate of 28 percent and the revenue is shared between the municipalities, the counties and the central government.⁵ The tax rate for each government tier is decided annually by the Parliament. The 2010 tax rates are respectively 12.8 percent (municipalities), 2.65 percent (counties) and 12.55 percent (the central government).⁶

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

Property tax is levied at the municipal level only and comprises both residential and business property. Before 2007 the property tax was restricted to urban areas and certain facilities (notably hydroelectric power plants)⁷, and was in practice not available for all municipalities. The law did not provide any precise definition of urban areas, and several municipalities were taken to court by property owners arguing that their property was not located in an urban area. In 2006 the Property Tax Law was changed to avoid confusion and to increase fairness among tax payers, and since 2007 property tax can also be levied in rural (non-urban) areas. The change has lead to increased use of the property tax in rural municipalities. In particular, it became more attractive for municipalities with a lot of cottages (typically located in non-urban areas) to introduce residential property tax or to extend it to also include non-urban areas.⁸ Property taxation of cottages is a prime example of tax exporting, and cottage owners have heavily opposed the introduction of a “cottage tax”. In 2008 a total of 293 municipalities used the property tax. Among these, 145 taxed certain facilities only. Residential property tax is levied in 148 municipalities, and in a majority of these (83) it applies to both urban and rural areas.

⁵ In the tax system there is a second income tax base, personal income, which is a gross income tax base comprising labor income, income from self employment and fringe benefits. The tax on personal income is highly progressive and is received by the central government.

⁶ In the most northern part of Norway the central government tax rate is 9.55 percent and the total tax on general income is 25 percent.

⁷ The law did not provide a definition of these certain facilities, but in practice they are defined as larger works used for production of goods or maintenance. Property tax can be levied on certain facilities without taxing all property in urban areas.

⁸ The residential property tax applies to all residential property, and the municipalities cannot tax cottages without taxing other residential property. However, they can still choose to have the property tax in urban areas only.

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

Table 3.6. The composition of the local tax base, billion NOK and percentage of total tax revenue in 2008

	Municipal governments		Country governments	
	Billion NOK	Percentage	Billion NOK	Percentage
Income tax ^a	95.8	85.8	17.3	98.9
Wealth tax ^a	8.4	7.5		
Property tax	6.2	5.5		
Natural resource tax	1.3	1.2	0.2	1.1
Total	111.7	100.0	17.5	100.0

^a The separation between income and wealth tax for the municipalities is based own calculations.
Source: Tax accounts, Statistics Norway

Table 3.6 reports the revenues from the different tax bases in 2008. As in the other Nordic countries, income tax from individuals is the most important local tax. It amounts to 86 percent of municipal taxes and 99 percent of county taxes. Other taxes constitute a small share of aggregate local tax revenue, but property tax and the natural resource tax are important revenue sources for individual municipalities. The most prosperous municipalities are small rural communities with waterfalls, where property tax and natural resource tax from power companies make up substantial amounts per capita.

The grant system

It is common to separate between earmarked grants and grants within the block grant system. All grants not included in the block grant system are labeled earmarked grants. They are conditional in the sense that they must be spent on a specific program or a specific purpose. The largest earmarked grants are for day care, care for elderly and disabled, and for refugees and immigrants.

The degree of earmarking has steadily increased during the last two decades (Borge 2010), but the actual level of earmarking is to some extent a matter of definition. If we include all earmarked grants (as in table 3.4), earmarked grants and block grants are of roughly equal size. However, then the general VAT-

compensation scheme is classified as an earmarked grant. The VAT-compensation was not intended to (and does not) affect local government priorities across services. If it rather is classified as a block grant, the degree of earmarking drops to 39 percent. Moreover, the ministries use a revenue concept that excludes earmarked grants related to labor market policy and refugees and immigrants. With this revenue concept the degree of earmarking drops further to 33 percent.

Despite the steady growth of earmarking, it is the block grant system that is most important for the distribution of revenues. The block grant system has two main purposes; to equalize the economic opportunities across local governments, to promote regional policy goals, and to transfer resources to the local public sector.

Equalization is achieved through tax equalization and spending needs equalization. The role of the tax equalization scheme is to reduce the differences in per capita revenue due to differences in tax bases. The present tax equalization scheme for the municipalities consists of a symmetric part with a compensation rate of 60 percent.⁹ This means that municipalities with tax revenues (per capita) below average are compensated for 60 percent of the differences and that 60 percent of tax revenues above the average is withdrawn to the state. In addition there is an extra 35 percent compensation for municipalities with tax revenues below 90 percent of the average. As an example, a municipality with a tax base of 80 percent of the average first receives 60 percent of the difference between 80 and 100 percent from the symmetric part. In addition, this municipality receives 35 percent of the difference between 80 and 90 percent. It is also important to notice that tax equalization only applies to the income tax, the wealth tax, and the natural resource tax.¹⁰ Property tax revenues are not taken into account. This peculiarity is of great advantage to the small municipalities that have substantial property tax revenues per capita from hydroelectric power plants.¹¹ The tax equalization scheme for the counties implies that counties with tax revenues below 120 percent of the average are compensated for 90 percent of the difference.

⁹ The tax equalization was made more ambitious from 2009. The compensation rate will gradually increase from 55 to 60 percent. The description refers to the situation in 2011 when the new system is fully implemented.

¹⁰ For these taxes all municipalities use the same rate so there is no need to distinguish between tax revenues and tax base.

¹¹ The statement refers to the municipalities where the hydroelectric power plant is located. Other local governments, typically counties and larger municipalities, are owners of some of the power plant and receive the profit. Since these local governments have a large population size, the profit does not amount to large amounts per capita.

Spending needs equalization is in place because equalization of per capita revenues is insufficient to equalize the economic opportunities for service provision. Local governments have different costs conditions due to differences in population size and settlement pattern. The age composition of the population affects the demand for important services education and care for the elderly. And social criteria like unemployment rate and divorce rate influence expenditures on social services like welfare payments and child custody. The spending needs equalization scheme compensates local governments with unfavorable cost conditions (small population size and sparse settlement pattern), expensive age structure, and social problems. Spending needs equalization cover so-called national welfare services. The spending needs equalization for the municipalities include primary and lower secondary education, primary health care, care for the elderly, child welfare, social assistance, and administration. For the counties upper secondary education, dental health, and transport are included in the spending needs equalization. Spending needs equalization is arranged as a pure redistribution between municipalities and between counties. This means that transfers to local governments with needs (per capita) above average are financed by contributions from local governments with spending needs below average.

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

While tax and spending needs equalization promotes equality of service provision, the elements motivated by regional policy create new differences. Through the regional policy elements rural municipalities in the southern part of the country and municipalities and counties in the northern part of the country receive extra grants. The design of the regional policy elements have changed over time, but during the 1990s they were separated out as specific grants and their regional policy purpose was clarified. The justification of the grants is that rural and northern local governments should be able to provide better services than the rest in order to promote employment and population growth. The grants are now named Grant for Small Municipalities (for municipalities with less than 3,200 inhabitants), Regional Grant Southern Norway (for rural municipalities in Southern Norway with population above 3,200), and the Northern Norway Grant (for municipal and county governments in the three most Northern counties Nordland, Troms, and Finnmark, as well as some municipalities in Nord-

Trøndelag). A requirement for receiving the Grant for Small Municipalities and the Regional Grant Southern Norway is that per capita tax revenue has been below 120 percent of the average the last 3 years. The Northern Norway Grant is paid out as a flat amount per capita (mainly differentiated by county), the Grant for Small Municipalities as a fixed amount per municipality (differentiated by regional policy zone), and the Regional Grant Southern Norway as a mix of a flat amount per capita and a fixed amount per municipality (both differentiated by regional policy zone).¹²

Both the spending needs equalization and the regional policy grants imply that municipal mergers will lead to a reduction in block grants. The reduced spending needs equalization reflects (long term) cost savings due to a larger population, while the reduction in regional policy grants represent lower “real” revenue. These features of the system are obviously hindering municipal mergers, and a merger grant is established to avoid a block grant reduction the first 10 years after a merger.¹³

In addition to the grants described above, the block grant system consists of a specific grant for fast growing municipalities, a grant to limit reduction in total block grant, and a judgment grant. The judgment grant takes account of specific local conditions not captured by the objective criteria in the system.

The capital city Oslo is both a municipality and county,¹⁴ and it is included in the block grant system for the municipalities and the block grant system for the counties. Technically this is done by splitting the Oslo’s tax revenues in a municipal part and a county part. Since Oslo has high tax revenues per capita, it is a large contributor to the municipal tax equalization (where 60 percent of tax revenues above the average are withdrawn to the state). In the spending needs equalization there is large city criterion for Oslo and a few other cities. The underlying argument is that they face social problems that are not sufficiently captured by the other criteria.

The distribution of taxes and block grants

Figure 3.12 illustrates the revenue distribution among the municipalities after the block grant system has done its job. The starting point for the revenue measure

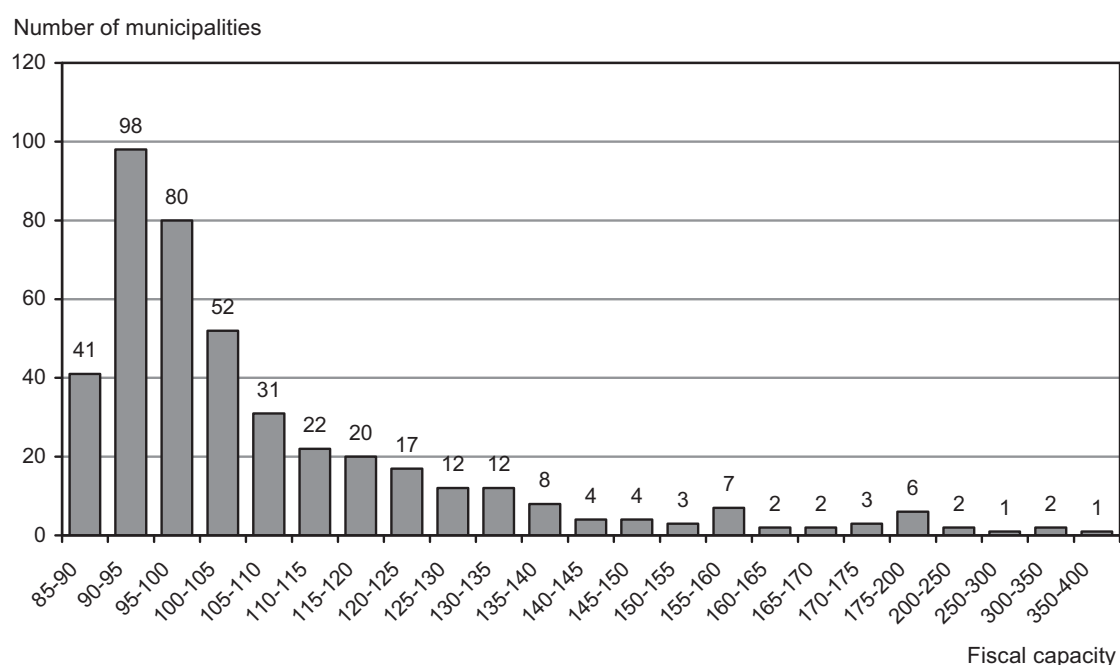
¹² In 2005 a government commission (headed by the author of this chapter) proposed a major simplification of the regional policy grants. The political outcome (as described in the main text) was to make the system even more complicated.

¹³ The merger grant makes sure that the merged municipalities get the same block grant as if they still were separate municipalities. After 10 years the merger grant is gradually reduced.

¹⁴ Strictly speaking it is a municipality that also has county responsibilities.

applied is the sum of block grants and local tax revenues. Since high per capita revenue to some extent is compensation for unfavorable cost conditions, the revenues must be “deflated” in order to capture the real differences across local governments. The cost index from the spending needs equalization system is used as deflator. It captures unfavorable cost conditions related to population size, settlement pattern, the age composition of the population, and social factors. The importance of deflating can be illustrated through an example. Consider a small and sparsely populated local government that is unable to exploit economies of scale. It will have high per capita revenues because the unfavorable cost conditions are compensated through the grant system, but the fiscal capacity will not be in tandem with the per capita revenues.

Figure 3.12. The distribution of fiscal capacity, 2008



Note: Fiscal capacity is measured as an index where the national average is set equal to 100.

Figure 3.12 reveals that few municipalities have very low fiscal capacity. Only 41 municipalities (less than 10 percent) have fiscal capacity below 90 percent of the national average. Around 60 percent of the municipalities are within 10 percent of the national average. The main peculiarity by the distribution of fiscal capacity and the system of financing is that some municipalities are allowed to be very rich. There are basically three types of municipalities that end up with high levels of fiscal capacity; small rural municipalities with substantial tax revenue from hydroelectric power plants, small rural municipalities that receive regional policy grants, and urban municipalities with high levels of income and wealth

taxes.¹⁵ However, in the upper 10 percent of the distribution we only find local governments of the first two types. The substantial variation in fiscal capacity reflects the working of the present centralized system of financing, and in particular centrally determined tax and grant design.

Budgeting and regulatory framework

At the local level, the decision-making is organised around the annual budget and a long-term economic plan. The long-term economic plan covers at least the next four years and provides a forecast of revenues, expenditures, and priorities in this period. The plan also includes a survey of debt, interest payments, and installments. The executive board and the chief administrative officer (*rådmannen*) play a prominent role in the early stages of the budgetary process, and the executive board puts forward a budget proposal for the local council. The local council is free to make amendments and to work out alternative budget proposals.

The main requirement for the annual budget is operational budget balance. In the budget, current revenue must cover current expenditures, interest payments and regular installment of debt. Loan financing of current spending is not allowed, but the budget may be balanced by use of ‘rainy-day’ funds.

A balanced budget ex ante does not rule out an actual deficit when the account is settled. In particular local taxes and expenditures linked to rules (like social support) may deviate from the budget. Actual deficits are allowed to be carried over, but as a main rule they must be ‘repaid’ within 2 years.¹⁶ In understanding with the central government, the local council can extend the period to 4 years if faster repayment has severe consequences for local service provision.

Until 2001, budgets and borrowing for each and every local government were controlled and approved by the central government. For the municipalities the control was carried out by the county governor (*fylkesmannen*), who is the central government’s representative in the county. The annual budget would not be approved if it implied an operational deficit, and the budget would be sent back to the local government for revision. Moreover, borrowing would not be approved if planned loan financing were inconsistent with the economic balance projected in the long-term economic plan. The regulatory framework that has prevailed since 2001 is more selective. Budgetary control and approval of borrowing only applies to local governments that violates the rules described

¹⁵ Income and wealth tax are subject to tax equalization, but the equalization is only partial.

¹⁶ The surpluses in the following two years must be large enough to cover the deficit.

above regarding the annual budgets, the long-term economic plan, or the period for ‘repayments’ of deficits.

Local governments subject to budgetary control and approval of borrowing are registered in ROBEK (the register for local governments with economic problems). The register receives a lot of media attention, and it is politically costly for the ruling parties if the local government is on the list. The number of local governments in the register varies with the general fiscal position of the local public sector. In December 2004 as much as 118 municipalities (more than 25 percent) were in the register. Currently around 50 municipalities are on the list.

3.2.4 Trends and reform discussion

Abolition, reintroduction, and abolition of a local corporate income tax

In 1995 a government expert commission was set up to evaluate the financing of the local public sector and to propose reforms in grant and tax financing. The evaluation of the tax financing was based on four criteria derived from the economics literature on tax assignment:

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

The commission’s most controversial tax proposal was to abolish the corporate income tax as a local tax based on the argument that it did not meet the criteria for good local taxes. First, the corporate income tax was very unevenly distributed between local governments. The max-min ratio was 20:1 across the municipalities and 8:1 across the counties. Second, the corporate was strongly procyclical. It was referred to the booming year 1995 where the aggregate corporate income tax base grew by 21 percent, more than three times the growth of the personal income tax base. At the local level the corporate income tax was even more volatile, mainly because industry is less diversified at the local level. Another source of unpredictability and instability at the local level was the coordination of tax assessment of companies with activity in several municipalities. A local firm that ran a surplus did not generate much tax revenue if it was included in a company or concern that ran deficits in other municipalities. Third, the mobile corporate income tax base encouraged tax

competition. The municipalities and counties did not compete by lowering tax rates, but rather by offering subsidized sites and buildings, and advice and services from the local development agency. The opponents of the proposal argued that the corporate income tax was important in order to give municipalities and counties proper incentives to promote economic development, an argument that also was acknowledged by the commission.

Although the proposal was controversial politically, the parliament, with a majority comprising the center parties and the socialist parties, decided to abolish the corporate income tax as a local tax from 1999. The conservative party was against the proposal, and when a center-right government was formed after the 2001 election it took initiative to reintroduce a municipal corporate income tax.¹⁷ A new municipal corporate income tax was introduced from 2005, and implied that a fraction (that may vary from year to year) of the corporate income tax is reserved for the municipalities. For companies with activity in several municipalities the tax is distributed according to the municipalities' share of the company's employment. In the old tax the distribution was based on a detailed calculation of economic profit in each municipality. The new tax was considered to give a more just distribution of the corporate income tax across municipalities. It also required less tax administrative resources, but did otherwise have the same weaknesses. A more ambitious tax equalization program was proposed to counterbalance the adverse distributional implications (see section "Tax discretion" for further discussion).

After the 2005 election the center-right government was replaced by a red-green government. The new government proposed several changes in the financing of the municipalities from 2009, and one of the proposals was to abolish the recently introduced municipal corporate income tax. The government emphasized that abolition of the municipal corporate income tax would give a more stable and more evenly distributed tax base.

Tax discretion

If we only look at the tax rules described in Section 3.2.3, Norwegian local governments have substantial tax autonomy. The municipalities can choose tax rate within an interval for the income tax, the wealth tax and the property tax, and the counties can choose tax rates within an interval for the income tax. The real picture is quite different since all local governments have used the maximum tax rates in income and wealth taxation during the last 30 years. In practice tax discretion is restricted to the municipal property tax. The municipalities can also

¹⁷ It was never considered to reintroduce a corporate income tax for the counties.

influence their revenues through user charges. The county governments have less tax discretion than the municipalities since they do not have property tax and because user charges to a less extent can be levied on their services. It is widely accepted that local tax autonomy is more restricted in Norway than in the neighboring countries Denmark and Sweden where the local governments have discretion to set the income tax rates (e.g. Blom-Hansen, 1998).

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

From time to time the issue of local tax discretion is raised in the political debate, most recently by the Local Democracy Commission (NOU 2005: 06). An important background for the appointment of the commission was a drop in voter participation to 55 percent in the 2003 local elections. The commission considered more tax discretion as an important mean to increase democratic participation and local accountability. Other commissions like the Property Tax Commission (NOU 1996: 20), the Local Public Finance Commission (NOU 1997: 8), and the Tax Commission (NOU 2003: 9) have more explicitly suggested an extended property tax with local tax discretion. Proposals to increase local tax discretion are typically met with two types of concern from national politicians. Conservatives are concerned that local tax discretion will increase public spending and the overall level of taxation, while socialdemocrats are concerned that tax discretion will cause larger differences in service provision. Although they use different arguments, the socialdemocrats and the conservatives constitute a grand coalition against more local tax discretion.

The main economic argument in favor of local tax discretion is related to the decentralization theorem of Oates (1972): When the local tax rate can adjust to varying spending preferences and cost conditions, a decentralization gain can be achieved compared to a situation with a uniform tax rate decided at the national level. Borge (2003) provides some tentative calculations of which effects more local tax discretion may have for efficiency (decentralization gains) and service provision in the Norwegian setting. The analysis is based on a median voter

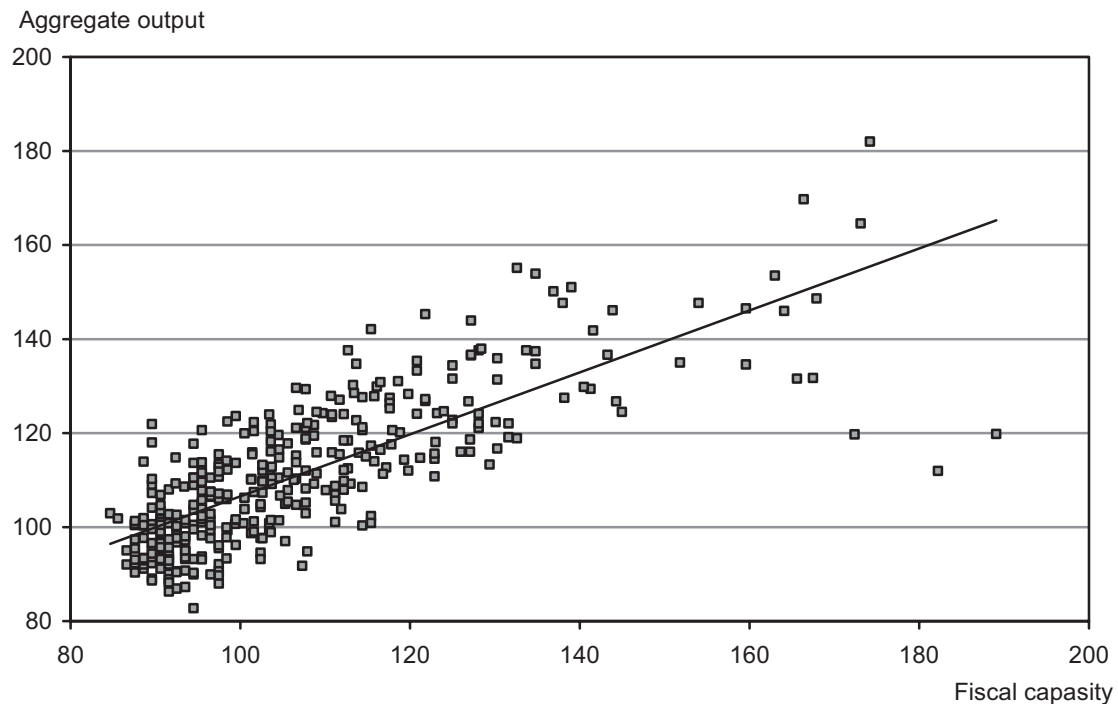
model that is calibrated on Norwegian data for 1996. The decentralization gain is calculated to nearly 1000 NOK per taxpayer or 3 billion NOK in aggregate. In addition increased local tax autonomy may give a much more equal provision of local public services. The main driving force is that small, rural communities (with high levels of service provision and low private disposable income within the present system) are predicted to reduce their tax rates, whereas larger, urban communities (with relatively low levels of service provision) are expected to increase their tax rates.

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

Large variations in fiscal capacity: A challenge to the block grant system

Despite substantial tax and spending needs equalization, the remaining differences in fiscal capacity are quite large (see figure 3.12). The remaining differences reflect that tax equalization is partial and that regional policy grants create new differences. Differences in fiscal capacity will tend to be reproduced into similar differences in service provision. The relationship between service provision and fiscal capacity is illustrated in figure 3.13 where we take advantage of a global output measure developed by the Advisory Commission on Local Government Finances (*Det tekniske beregningsutvalg for kommunal og fylkeskommunal økonomi – TBU*) which has been published annually since 2001. The commission's idea was to establish a measure of aggregate output based on indicators of production for several service sectors. Six service sectors are included: care for the elderly, primary and lower secondary education, day care, welfare benefits, child custody, and primary health care. Borge et al. (2008) provides a more detailed description of the aggregate output measure.

Figure 3.13. Aggregate output and fiscal capacity, 2005



Note: Output and revenue are normalized such that the weighted averages (for the 374 municipalities in the sample) equal 100. In order to ease visual interpretation of the plot, two municipalities with revenue above 200 are excluded from figure. The straight line is the regression line.

As shown in figure 3.13, there is a positive relationship between fiscal capacity and service provision. That is, municipalities with high fiscal capacity are able to provide more services to their citizens than municipalities with low fiscal capacity. The global output measure varies from 80 to around 180, implying that service provision is more than twice as high in the municipality with highest service provision compared to the municipality with the lowest.

The large differences in service provision represent a challenge for the system of financing. When the differences are identified and illustrated in the media, national politicians tend to address the consequences rather than the underlying causes. The solution to the problem is typically earmarked grants and/or minimum standards to improve the situation in local governments with low service provision, and not to rethink the central tax and grant designed that have produced the differences in fiscal capacity and thereby service standards. During the last 15 years there has been a series of centrally initiated action plans for several service sectors, starting with the action plan for elderly care in the mid 1990s, followed up by plans for school buildings and psychiatry, and most recently daycare. A main problem with such action plans is that they tend to reward local governments that have not given the actual service sector sufficient priority, and

to punish those who have. In the longer run one may fear that local governments shift their focus from local problem solving to guessing where the next action will come, and also that local governments will be less innovative in terms of developing the welfare services.

The regional policy grants are important sources of the differences in fiscal capacity, and thereby also for the pressure on the block grant system. It is not obvious that providing grants to municipalities and counties is the most efficient way of stimulating economic development in rural areas. Other means like direct support or tax reductions for businesses or individuals could be more efficient.¹⁸ And if so, one could achieve a better regional policy and less variation in fiscal capacity across by reducing the role of grants to local governments in the regional policy.

Unfortunately, we have limited knowledge about the effectiveness of regional policy grants compared to other regional policy means. Berg and Rattsø (2009) analyze the general effects of municipal revenues by utilizing the abolition of the local corporate income tax in 1999. They are only able to document modest effect on population size, basically reflecting the direct effect of increased revenues on municipal employment. The study does not compare local government to other regional policy means, but at least it indicates that the regional policy grants to local governments have little impact on economic development in rural areas.

Efficiency in service provision

Norwegian local governments are the main providers of welfare services, and one of the justifications for giving them this role is that they are supposed to provide these services efficiently. A necessary condition for proper evaluation of efficiency is reliable and comparable information on service provision. The national indicator system KOSTRA has been in place since 2001 and integrates information from local government accounts, service statistics, and population statistics. It includes indicators of production, service coverage, need, quality, and efficiency. The information is easily accessible via internet and facilitates detailed comparison of the performance of local governments. The information is frequently used by the local government themselves, and by media and researchers. Although individual local governments still could use KOSTRA more efficiently (e.g. by systematic benchmarking), the system has contributed to

¹⁸ Notice that the regional policy grants are general purpose grants that are not earmarked for economic development. The grants are supposed to promote economic development by improving local public services generally.

increased attention and a more informed discussion of local government service provision.

Borge et al. (2008) have utilized the information in the KOSTRA data base to analyze municipal efficiency. The analysis is based on the global efficiency measure discussed before and shown in figure 3.13, and departs from the observation that there is substantial variation in aggregate output between municipalities with similar levels of fiscal capacity. Some municipalities seem to be more efficient than others in the sense that they get more services out of their revenues. The authors consider the ratio between service provision and fiscal capacity (the two series in Figure 3.11) as an indicator of efficiency. That is, efficient municipalities have a high level of service provision relative to their fiscal capacity, while inefficient municipalities have low service provision relative to fiscal capacity. With this definition of efficiency, there is substantial variation in efficiency across municipalities. The most efficient municipality is nearly three times as efficient as the least efficient, and the aggregate efficiency potential is slightly above 30%. The authors investigate whether the degree of efficiency is related to political and budgetary institutions, fiscal capacity, and democratic participation. They find strong evidence that high fiscal capacity and a high degree of party fragmentation contribute to low efficiency. In addition there is some evidence that democratic participation increases efficiency, while a centralized top-down budgetary process is associated with low efficiency. Political ideology, measured by the share of socialists in the local council, does not have a systematic impact on efficiency.

A few studies have investigated the relationship between efficiency and methods of financing. In an analysis of cost efficiency in the municipal sewage industry, Borge and Rattsø (2005a) find that municipalities with residential property tax have lower costs than others. The interpretation is that having a visible and controversial local tax related to property stimulates voter interest in local government activities and thereby may help cost control. In a companion paper (Borge and Rattsø 2005b) find that a high degree of user charge financing contributes to lower costs. Here the underlying argument is that the combination of user charge financing of net budgeting provides incentives for high production (rather than budgetary slack) and thereby low costs. Borge and Haraldsvik (2009) document a similar effect of user charge financing in a study of efficiency in the care for the elderly sector.

During the last decade the performance of the educational sector has received large attention. The main reason is that international knowledge tests have provided new and easily accessible information that facilitates comparison of educational performance across countries. These tests have revealed a mismatch between performance and resource use in the Norwegian educational system. Norway stands out as one of the countries with highest resource use per student,

but student performance is generally below average. This mismatch has triggered a political debate regarding resource use, curriculum, and the organization of the educational sector. Borge and Naper (2006) perform an efficiency analysis of the lower secondary schools in Norway. Using DEA analysis with grades in core subjects (adjusted for student characteristics and family background) as outputs, they calculate an efficiency potential of 14 percent. This means that resource use can be reduced by 14 percent without affecting student performance.

The middle tier

The county level is the oldest of the three government tiers in Norway, and dates back to the 17th century. However, in its present form it is the youngest and was “born” in 1976. Then the county level was established as separate political level with direct elections to the county councils. Prior to 1976 each municipality appointed members to the county council among the members of the municipal council. The aim of the reform was to strengthen local democracy by establishing the county level as a strong political unit. The counties were never able to live up to these high expectations and have not gained legitimacy on par with the municipalities and the central government. When the central government took over the hospitals in 2002, the county level became even weaker.

The hospital reform initiated a debate on what to do with the county level. Two alternatives to the present organization are discussed:

- Larger regions with larger responsibilities
- A two tier system

The first alternative (larger regions with larger responsibilities) assumes mergers of counties, more precisely that the 19 counties are transformed into 5–10 regions. The new and larger regions can then be given larger responsibilities. They can get back the hospitals, take on responsibilities within higher education (regional colleges), and increase their responsibilities within transport, culture, and economic development. This alternative was considered by the present red-green government in 2007, but it did not propose it. A main argument was that it was too early to reverse the hospital reform that had been implemented a few years before. The outcome was to give the counties slightly more responsibilities within transport, culture, and economic development, but to keep the 19 counties. It is not an unfair interpretation that the outcome was close to status quo.

The second alternative is to abolish the middle tier as a separate political system, and to divide the tasks between the municipalities and the central government. The proponents of a two tier system argue that there is mismatch between the current county responsibilities and a political and administrative system designed

for much larger responsibilities. A two tier system would facilitate a reallocation of resources from administration and political institutions towards service provision for the citizens. The main problem with this alternative is that most municipalities are too small to take on larger responsibilities, for example within upper secondary education. And since the central level is still struggling with the organization of the hospitals, it is reluctant to take over more county responsibilities.

Municipal mergers

The last wave of municipal mergers took place in the 1960s when the number of municipalities was reduced from 744 (in 1957) to 454 (in 1967). The reform discussion started in the late 1940s with the building of the welfare state after WWII and the increased municipal responsibility for welfare services. Larger municipalities were seen as a necessary condition for increased responsibilities.

The number of municipalities has been pretty stable since the 1960s, but during the last two decades there has been a heated debate on the need for municipal mergers. The starting point was a government expert commission that in 1992 proposed a major reduction in the number of municipalities. As a main rule the commission proposed that no municipality should have less than 5,000 inhabitants. Keeping in mind that more than half of the municipalities are below that size, the proposal implied a large number of municipal mergers (mainly affecting rural municipalities). The main arguments for this reform proposal was (i) that the municipal responsibilities had further increased since the 1960s and larger municipalities were needed to exploit economies of scale, and (ii) better communications had led to substantial reduction in travelling time. The commission also proposed mergers in city areas comprising several municipalities.

The politicians did not follow the expert advice. Although many agreed with the need for larger municipalities, the outcome was a compromise stating that all municipal mergers should be voluntary. The Parliament will not vote for a merger if one of the municipalities involved are opposing the merger. The problem with this decision is that the combination of this voluntariness principle and the generous treatment of the small municipalities in the block grant system (described section 3.2.3) is not likely to result in many mergers. Why merge if the outcome is reduced fiscal capacity and lower service provision?

Several actions were taken to stimulate municipal mergers. First a merger grant was introduced in the block grant system to avoid grant reductions the first 10 years after the merger. Later the central government initiated a process where all municipalities were obliged to consider mergers with neighboring municipalities. Project money was supplied for analyses of concrete merger plans and state

financing of infrastructure projects was used as carrot for realization of the plans. However, the policy has not resulted in many mergers. There have been a total of 5 mergers (all involving 2 municipalities) and a reduction in the number of municipalities from 435 (in 1994) to 430 in 2009. In the aftermath it is clear that the voluntariness principle has been in favor of those who oppose municipal mergers.

The lack of mergers, either as a national reform or voluntarily, is a challenge for efficiency and quality in service provision. It is difficult for the smaller municipalities to recruit competent personnel to satisfy national regulations and meet the demand from citizen. In the longer term the large number of small municipalities may have the effect that the central government takes on more responsibilities for provision of welfare services, as it recently has done with the hospitals and to some extent also in child welfare.

Cooperation among municipalities is a possible solution to this challenge. In Norway there is no register of all cooperation agreements, only some survey evidence. ECON (2006) conducted a survey of 158 municipalities, and reports that the number of cooperative agreements per municipality is 14.¹⁹ Cooperation is most widespread within administration (e.g. information technology) and primary health care (e.g. emergency ward). First and foremost municipal cooperation applies to specialized functions and not to whole service sectors. Obviously there are different opinions on the potential of municipal cooperation. Proponents of maintaining the present municipal structure argue that cooperation is the answer to the challenges of efficiency and quality in service provision. On the other hand, the proponents of mergers argue that cooperation is unlikely to fully solve the efficiency and quality problems, and also that it weakens the political control with service provision. However, it is my view that in the perspective of division of tasks between different tiers of government it is hard to see that cooperation is a serious alternative to mergers. In the choice between central and municipal responsibility the municipal option will have a weaker position when it is based on an (ex ante) unspecified cooperative agreement.

3.2.5 Concluding remarks

In Norway, as in the other Nordic countries, the local public sector has an agency role in the welfare state with important responsibilities for education, health and social services. The financing of the local public sector seeks to balance the goals of equal provision of welfare services and local self-rule. This chapter has provided an overview of the historical development, grant and tax design,

¹⁹ A broad definition of cooperative agreements is applied, including oral agreements.

national control of budgets and borrowing, and trends and reform discussion. I close the chapter by summarizing some reforms that, in my view, could improve the Norwegian model.

Municipal structure and responsibility for welfare services

As the welfare services are getting more complicated and require more skills, it will be increasingly difficult for the smaller municipalities to obtain efficiency and quality in service provision. The combination of the present municipal structure and large responsibilities for welfare services will be difficult to maintain. The future will either bring municipal mergers, more municipal cooperation, or increased state responsibility for welfare services. In my view the preferred outcome is a national reform of the municipal structure to establish robust municipalities that can provide welfare services efficiently and also take on new tasks. I find the alternatives less attractive. Municipal cooperation is more complicated and less robust, and state responsibility for welfare services means too much centralization.

The middle tier

The counties have a very small portfolio after the central government took over the responsibility for the hospitals, and the present organization of the counties is far from ideal. It is hard to defend a political system with direct election to county councils with such limited responsibilities. On the other hand, it is more difficult to have strong opinions on where to go. Larger regions with increased responsibilities is one alternative, but is unlikely in the near future because it means reversal of the hospital reform. Based on the experience from the counties, I also have doubts on whether regions could gain sufficient political legitimacy. The other end of the spectrum is a two-tier system, but that is not realistic until a reform of the municipal structure is accomplished. In the short term we therefore need a middle tier, but with a downscaled administration and political system (possibly with council members appointed by the municipalities).

Grant design

The main argument for the centralization of the system of financing after WWII was to promote equalization of welfare services. It is therefore a paradox that the present grant system contributes to substantial variation in fiscal capacity and welfare service provision through the regional policy grants. The large variation in service provision is a challenge for the system of financing, and the working of the system could be improved by a redesign of the regional policy with less emphasis on grants to local governments.

Tax design

Compared to the other Nordic countries, Norwegian local governments have less tax financing and less tax discretion. The relatively low level of tax financing can partly be understood by the municipal structure. The large number of small municipalities leads to large variation in tax bases, and a high share of taxes would lead to large variation in tax revenues. However, in my view the share of taxes could be somewhat increased given the present municipal structure. And after a merger reform it should be substantially increased. More tax discretion may be necessary to increase local accountability and local responsibility for welfare services, preferably through an extended property tax. Given the current system of financing, more tax discretion will not necessarily lead to more variation in service provision.